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Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the

quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency and fairness.

Statement of Principles of Internal Revenue Tax Administration

The function of the Internal Revenue Service is to administer the Internal Revenue Code. Tax policy for raising revenue is determined by Congress.

With this in mind, it is the duty of the Service to carry out that policy by correctly applying the laws enacted by Congress; to determine the reasonable meaning of various Code provisions in light of the Congressional purpose in enacting them; and to perform this work in a fair and impartial manner, with neither a government nor a taxpayer point of view.

At the heart of administration is interpretation of the Code. It is the responsibility of each person in the Service, charged with the duty of interpreting the law, to try to find the true meaning of the statutory provision and not to adopt a strained construction in the belief that he or she is "protecting the revenue." The revenue is properly protected only when we ascertain and apply the true meaning of the statute.

The Service also has the responsibility of applying and administering the law in a reasonable, practical manner. Issues should only be raised by examining officers when they have merit, never arbitrarily or for trading purposes. At the same time, the examining officer should never hesitate to raise a meritorious issue. It is also important that care be exercised not to raise an issue or to ask a court to adopt a position inconsistent with an established Service position.

Administration should be both reasonable and vigorous. It should be conducted with as little delay as possible and with great courtesy and considerateness. It should never try to overreach, and should be reasonable within the bounds of law and sound administration. It should, however, be vigorous in requiring compliance with law and it should be relentless in its attack on unreal tax devices and fraud.

These principles of tax administration were previously published in the Internal Revenue Bulletin as Revenue Procedure 64-22, 1964-1 (Part 1) C.B. 689. They are restated here to emphasize their importance to all employees of the Internal Revenue Service.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents of a permanent nature are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of

other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

Cumulative Bulletin 1995-2 is a consolidation of all items of permanent nature published in the weekly Bulletins 1995-26 through 1995-52 for the period of July 1 through December 31, 1995.

The Internal Revenue Cumulative Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Notice of Proposed Rulemaking.

The preambles and text of proposed regulations that were published in the **Federal Register** during this six month period are printed in this section. Included in this section is a list of person disbarred or suspended from practice before the Internal Revenue Service.

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior

ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If

the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.

PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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Cumulative List of Actions Relating to Court Decisions Published in the Internal Revenue Bulletin from January 1, 1995 through December 31, 1995

It is the policy of the Internal Revenue Service to announce at an early date whether it will follow the holdings in certain cases. An Action on Decision is the document making such an announcement. An Action on Decision will be issued at the discretion of the Service only on unappealed issues decided adverse to the government. Generally, an Action on Decision is issued where its guidance would be helpful to Service personnel working with the same or similar issues. Unlike a Treasury Regulation or a Revenue Ruling, an Action on Decision is not an affirmative statement of Service position. It is not intended to serve as public guidance and may not be cited as precedent.

Actions on Decisions shall be relied upon within the Service only as conclusions applying the law to the facts in the particular case at the time the Action on Decision was issued. Caution should be exercised in extending the recommendation of the Action on Decision to similar cases where the facts are different. Moreover, the recommendation in the Action on Decision may be superseded by new legislation, regulations, rulings, cases, or Actions on Decisions.

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now

may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will be published in the Internal Revenue Bulletin.

The recommendation in every Action on Decision will be summarized as acquiescence, acquiescence in result only, or nonacquiescence. Both "acquiescence" and "acquiescence in result only" mean that the Service accepts the holding of the court in a case and that the Service will follow it in disposing of cases with the same controlling facts. However, "acquiescence" indicates neither approval nor disapproval of the reasons assigned by the court for its conclusions; whereas, "acquiescence in result only" indicates disagreement or concern with some or all of those reasons. Nonacquiescence signifies that, although no further review was sought, the Service does not agree with the holding of the court and, generally, will not follow the decision in disposing of cases involving other taxpayers. In reference to an opinion of a circuit court of appeals, a nonacquiescence indicates that the Service will not follow the holding on a nationwide basis. However, the Service will recognize the precedential impact of the opinion on cases arising within the venue of the deciding circuit.

The announcements published in

the weekly Internal Revenue Bulletins are consolidated semiannually and annually. The semiannual consolidation appears in the first Bulletin for July and in the Cumulative Bulletin for the first half of the year, and the annual consolidation appears in the first Bulletin for the following January and in the Cumulative Bulletin for the last half of the year.

The Commissioner ACQUIESCE in the following decisions:

Baker, Willard K. & Irene L.,¹ 748 F.2d 1465 (11th Cir. 1984)

Kisling, Est. of,² 32 F.3d 1222 (8th Cir. 1994)

Louisiana Land & Exploration Co.,³ 102 T.C. 21 (1994)

National Semiconductor Corp. & Consolidated Subs. v. Commissioner,⁴ T.C. Memo 1994-195

Seagate Technology, Inc. & Consolidated Subs.,⁵ 102 T.C. 149 (1994)

Taisei Fire & Marine Inc. Co., Ltd., et al. v. Commissioner,⁶ 104 T.C. 535 (1995)

Trump Village v. Commissioner,⁷ T.C. Memo 1995-281

The Commissioner does NOT ACQUIESCE in the following decisions:

Louisiana Land & Exploration Co.,⁸ 90 T.C. 630 (1988)

Louisiana Land & Exploration Co.,⁹ 102 T.C. 21 (1994)

Milligan, Robert E., v. Commissioner,¹⁰ 38 F.3d 1094 (9th Cir. 1994)

¹Acquiescence relating to whether Rev. Rul. 80-173, 1980-2 C.B. 60, should be applied retroactively to disallow a section 162(a) deduction for flight training course expenses.

²Acquiescence relating to whether transfers of irrevocable fractional shares in a revocable trust to donees designated by decedent within the three-year period preceding the death of decedent are includible in decedent's gross estate pursuant to sections 2035(d)(2) and 2038(a)(1) of the Code.

³Acquiescence in the issue relating to whether costs related to acquiring, transporting and installing gas processing equipment and the offshore modules that house such equipment are deductible as intangible drilling and development costs. Acquiescence in result in the issue relating to whether the Claus method used by plaintiff to recover elemental sulphur from hydrogen sulfide produced from an oil or gas well qualified as a mining process for percentage depletion purposes. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

⁴Acquiescence in result relating to whether (i) prices paid by petitioner's offshore Asian subsidiaries for silicon wafers manufactured by petitioner in the U.S., and incorporated by the former into electronic products, and (ii) the prices that petitioner paid the subsidiaries for the completed products were arm's length. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

⁵Acquiescence in result relating to whether certain royalties attributable to intangibles that petitioner transferred to its wholly-owned subsidiary, and the prices that petitioner paid the subsidiary for products manufactured by the latter, were arm's length. Acquiescence "in result" means acceptance of the Court but disagreement with some or all the reasons assigned for the decision.

Cumulative List of Actions Relating to Court Decisions Published in the Internal Revenue Bulletin from January 1, 1995 through December 31, 1995—Continued

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Placid Oil Co. v. IRS, ¹² 988 F.2d 554 (5th Cir. 1993)	Sealy Power Ltd., ¹⁴ 46 F.3d 382 (5th Cir. 1995)	Vulcan Materials Co. & Subsidiaries v. Commissioner, ¹⁶ 959 F.2d 973 (11th Cir. 1992)
St. Jude Medical, Inc. v. Commis-	Security Bank Minnesota v. Commis-	

⁶Acquiescence relating to whether four Japanese reinsurance companies have agency permanent establishments in the U.S. because their U.S. agent was not “an agent of independent status” under Article 9(5) of the U.S.-Japan Tax Treaty.

⁷Acquiescence relating to whether the limitations of section 277 apply to a cooperative housing corporation described in section 216, which is also subject to the provisions of subchapter T of the Code.

⁸Nonacquiescence relating to whether section 613A(e)(2) of the Code eliminates percentage depletion under section 613 for nonhydrocarbon minerals produced from an oil or gas well.

⁹Nonacquiescence relating to whether all income from the sales of oil, gas and sulphur are to be combined when calculating the taxable income from the property under section 613(a) of the Code, even though the oil and gas income is subject to a separate depletion regimen.

¹⁰Nonacquiescence relating to whether payments to a former insurance agent, which are based on the amount of compensation during the last twelve months as an agent, derive from a trade or business carried on by the individual, so as to be subject to tax under the Self-Employment Contributions Act (SECA).

¹¹Nonacquiescence relating to whether the Second Circuit Court of Appeals, in affirming the U.S. District Court for Connecticut, erred as a matter of law in determining that a multiemployer pension trust was a labor organization exempt under section 501(c)(5) of the Code.

¹²Nonacquiescence relating to whether the U.S. or the taxpayer bears the ultimate burden of proof in bankruptcy proceedings in which the taxpayer challenges a federal income tax claim arising from the disallowance of deductions.

¹³Nonacquiescence relating to whether section 1.861-8(e)(3) of the regulations is invalid as applied to DISC combined taxable income calculations.

¹⁴Nonacquiescence relating to whether an electrical generating facility that produced only *de minimis* amounts of electricity on a sporadic basis in 1984 due to functional deficiencies in its equipment “placed in service” was within the meaning of sections 46 and 167 of the Code.

¹⁵Nonacquiescence relating to whether a cash method bank that makes short-term loans with a stated interest rate to customers in the ordinary course of its business is subject to accrual of the interest on those loans under section 1281(a)(2) of the Code.

¹⁶Nonacquiescence relating to whether the term “accumulated profits” as used in the denominator of the section 902 deemed paid credit fraction before the Tax Reform Act of 1986 means all of the foreign corporation’s accumulated profits for the taxable year.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Subtitle A.—Income Taxes

Chapter 1.—Normal Taxes and Surtaxes

Subchapter A.—Determination of Tax Liability

Part I.—Tax on Individuals

Section 1.—Tax Imposed

26 CFR 1.1-1: Income tax on individuals.

The Service is providing adjusted tax tables for individuals and trusts and estates for taxable years beginning in 1996 to reflect changes in the cost of living. Also provided are certain reductions allowed against the unearned income of minor children in computing the "kiddie tax." See Rev. Proc. 95-53, page 445.

Part IV.—Credits Against Tax

Subpart A.—Nonrefundable Personal Credits

Section 25.—Interest on Certain Home Mortgages

26 CFR 1.25-3T: Qualified mortgage credit certificate (temporary).

The qualified census tracts for Puerto Rico and the Virgin Islands are set forth for use in determining the portion of loans required to be placed in targeted areas under section 143(h) of the Code. See Rev. Proc. 95-31, page 378.

26 CFR 1.25-4T: Qualified mortgage credit certificate program (temporary).

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 95-32, page 379.

Subpart B.—Foreign Tax Credit, etc.

Section 30.—Credit for Qualified Electric Vehicles

26 CFR 1.30-1: Definition of qualified electric vehicle and recapture of credit for qualified electric vehicle. (Also Section 179A; 1.179A-1.)

T.D. 8606

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Definition of Qualified Electric Vehicle, and Recapture Rules for Qualified Electric Vehicles, Qualified Clean-fuel Vehicle Property, and Qualified Clean-fuel Vehicle Refueling Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations on the definition of a qualified electric vehicle, the recapture of any credit allowable for a qualified electric vehicle, and the recapture of any deduction allowable for qualified clean-fuel vehicle property or qualified clean-fuel vehicle refueling property. These regulations reflect changes to the law made by the Energy Policy Act of 1992 and affect taxpayers who are owners of qualified electric vehicles, clean-fuel vehicles, and clean-fuel vehicle refueling property.

DATES: These regulations are effective August 3, 1995.

For dates of applicability of these regulations, see §1.30-1(c) and §1.179A-1(h).

SUPPLEMENTARY INFORMATION:

Background

On October 14, 1994, the IRS published in the Federal Register a notice of proposed rulemaking providing the definition of a qualified electric vehicle under section 30(c) and the rules for the recapture of the section 30 credit and section 179A deduction under sections 30(d)(2) and 179A(e)(4), respectively (59 FR 52105 [PS-72-92, 1994-2 C.B. 894]).

Written comments responding to the notice were received. No public hearing was requested or held. After consideration of all the comments, this Treasury decision adopts the regulations as proposed.

Explanation of Provisions

In General

The final regulations define a qualified electric vehicle for purposes

of section 30 of the Internal Revenue Code (Code). Several commentators recommended expanding the definition to include a vehicle converted from a used non-electric vehicle. The final regulations do not adopt this recommendation because section 30(c)(1)(B) provides that the original use of the vehicle must commence with the taxpayer. Moreover, conversion costs are deductible under section 179A.

Some commentators suggested including a hybrid-electric vehicle in the definition of a qualified electric vehicle. This issue will be addressed along with other substantive rules in additional proposed regulations under sections 30 and 179A of the Code.

Effective Date

The final regulations are effective on October 14, 1994. If the recapture date is before the effective date of these regulations, a taxpayer may use any reasonable method to recapture the benefit of any section 30 credit allowable or section 179A deduction allowable consistent with sections 30 and 179A and their legislative history.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.30-1 also issued under 26 U.S.C. 30(d)(2) * * *

Section 1.179A-1 also issued under 26 U.S.C. 179A(e)(4) * * *

Par. 2. Section 1.30-1 is added immediately following the undesignated center heading "Credits Allowable" to read as follows:

§1.30-1 Definition of qualified electric vehicle and recapture of credit for qualified electric vehicle.

(a) *Definition of qualified electric vehicle.* A qualified electric vehicle is a motor vehicle that meets the requirements of section 30(c). Accordingly, a qualified electric vehicle does not include any motor vehicle that has ever been used (for either personal or business use) as a non-electric vehicle.

(b) *Recapture of credit for qualified electric vehicle—(1) In general—(i) Addition to tax.* If a recapture event occurs with respect to a taxpayer's qualified electric vehicle, the taxpayer must add the recapture amount to the amount of tax due in the taxable year in which the recapture event occurs. The recapture amount is not treated as income tax imposed on the taxpayer by chapter 1 of the Internal Revenue Code for purposes of computing the alternative minimum tax or determining the amount of any other allowable credits for the taxable year in which the recapture event occurs.

(ii) *Reduction of carryover.* If a recapture event occurs with respect to a taxpayer's qualified electric vehicle, and if a portion of the section 30 credit for the cost of that vehicle was disallowed under section 30(b)(3)(B) and consequently added to the taxpayer's minimum tax credit pursuant to section 53(d)(1)(B)(iii), the taxpayer must reduce its minimum tax credit carryover by an amount equal to the portion of any minimum tax credit carryover attributable to the disallowed section 30 credit, multiplied by the recapture percentage for the taxable year of recapture. Similarly, the taxpayer must reduce any other credit carryover amounts (such as under section 469) by the portion of the carryover attributable to section 30, multiplied by the recapture percentage.

(2) *Recapture event—(i) In general.* A recapture event occurs if, within 3 full years from the date a qualified electric vehicle is placed in service, the vehicle ceases to be a qualified electric vehicle. A vehicle ceases to be a qualified electric vehicle if—

(A) The vehicle is modified so that it is no longer primarily powered by electricity;

(B) The vehicle is used in a manner described in section 50(b); or

(C) The taxpayer receiving the credit under section 30 sells or disposes of the vehicle and knows or has reason to know that the vehicle will be used in a manner described in paragraph (b)(2)-(i)(A) or (B) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(2)(i)(C) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of a qualified electric vehicle is not a recapture event.

(3) *Recapture amount.* The recapture amount is equal to the recapture percentage times the decrease in the credits allowed under section 30 for all prior taxable years that would have resulted solely from reducing to zero the cost taken into account under section 30 with respect to such vehicle, including any credits allowed attributable to section 30 (such as under sections 53 and 469).

(4) *Recapture date.* The recapture date is the actual date of the recapture event unless a recapture event described in paragraph (b)(2)(i)(B) of this section occurs, in which case the recapture date is the first day of the recapture year.

(5) *Recapture percentage.* For purposes of this section, the recapture percentage is—

(i) 100, if the recapture date is within the first full year after the date the vehicle is placed in service;

(ii) 66⅔, if the recapture date is within the second full year after the date the vehicle is placed in service; or

(iii) 33⅓, if the recapture date is within the third full year after the date the vehicle is placed in service.

(6) *Basis adjustment.* As of the first day of the taxable year in which the recapture event occurs, the basis of the qualified electric vehicle is increased by the recapture amount and the carryover reductions taken into account under paragraphs (b)(1)(i) and (ii) of

this section, respectively. For a vehicle that is of a character that is subject to an allowance for depreciation, this increase in basis is recoverable over the remaining recovery period for the vehicle beginning as of the first day of the taxable year of recapture.

(7) *Application of section 1245 for sales and other dispositions.* For purposes of section 1245, the amount of the credit allowable under section 30(a) with respect to any qualified electric vehicle that is (or has been) of a character subject to an allowance for depreciation is treated as a deduction allowed for depreciation under section 167. Therefore, upon a sale or other disposition of a depreciable qualified electric vehicle, section 1245 will apply to any gain recognized to the extent the basis of the depreciable vehicle was reduced under section 30(d)(1) net of any basis increase described in paragraph (b)(6) of this section.

(8) *Examples.* The following examples illustrate the provisions of this section:

Example 1. A, a calendar-year taxpayer, purchases and places in service for personal use on January 1, 1995, a qualified electric vehicle costing \$25,000. On A's 1995 federal income tax return, A claims a credit of \$2,500. On January 2, 1996, A sells the vehicle to an unrelated third party who subsequently converts the vehicle into a non-electric vehicle on October 15, 1996. There is no recapture upon the sale of the vehicle by A provided A did not know or have reason to know that the purchaser intended to convert the vehicle to non-electric use.

Example 2. B, a calendar-year taxpayer, purchases and places in service for personal use on October 11, 1994, a qualified electric vehicle costing \$20,000. On B's 1994 federal income tax return, B claims a credit of \$2,000, which reduces B's tax by \$2,000. The basis of the vehicle is reduced to \$18,000 (\$20,000 - \$2,000). On March 8, 1996, B sells the vehicle to a tax-exempt entity. Because B knowingly sold the vehicle to a tax-exempt entity described in section 50(b) in the second full year from the date the vehicle was placed in service, B must recapture \$1,333 ($\$2,000 \times 66\frac{2}{3}$ percent). This recapture amount increases B's tax by \$1,333 on B's 1996 federal income tax return and is added to the basis of the vehicle as of January 1, 1996, the beginning of the taxable year in which the recapture event occurred.

Example 3. X, a calendar-year taxpayer, purchases and places in service for business use on January 1, 1994, a qualified electric vehicle costing \$30,000. On X's 1994 federal income tax return, X claims a credit of \$3,000, which reduces X's tax by \$3,000. The basis of the vehicle is reduced to \$27,000 ($\$30,000 - \$3,000$) prior to any adjustments for depreciation. On March 8, 1995, X converts the qualified electric vehicle into a gasoline-propelled vehicle. Because X modified the vehicle so that it is no longer primarily powered by electricity in the second full year from the date the vehicle was

placed in service, X must recapture \$2,000 ($\$3,000 \times 66 \frac{2}{3}$ percent). This recapture amount increases X's tax by \$2,000 on X's 1995 federal income tax return. The recapture amount of \$2,000 is added to the basis of the vehicle as of January 1, 1995, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 4. The facts are the same as in *Example 3*. In 1996, X sells the vehicle for \$31,000, recognizing a gain from this sale. Under paragraph (b)(7) of this section, section 1245 will apply to any gain recognized on the sale of a depreciable vehicle to the extent the basis of the vehicle was reduced by the section 30 credit net of any basis increase from recapture of the section 30 credit. Accordingly, the gain from the sale of the vehicle is subject to section 1245 to the extent of the depreciation allowance for the vehicle plus the credit allowed under section 30 (\$3,000), less the previous recapture amount (\$2,000). Any remaining amount of gain may be subject to other applicable provisions of the Internal Revenue Code.

(c) *Effective date.* This section is effective on October 14, 1994. If the recapture date is before the effective date of this section, a taxpayer may use any reasonable method to recapture the benefit of any credit allowable under section 30(a) consistent with section 30 and its legislative history. For this purpose, the recapture date is defined in paragraph (b)(4) of this section.

Par. 3. Section 1.179A-1 is added to read as follows:

§1.179A-1 Recapture of deduction for qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property.

(a) *In general.* If a recapture event occurs with respect to a taxpayer's qualified clean-fuel vehicle property or qualified clean-fuel vehicle refueling property, the taxpayer must include the recapture amount in taxable income for the taxable year in which the recapture event occurs.

(b) *Recapture event*—(1) *Qualified clean-fuel vehicle property*—(i) *In general.* A recapture event occurs if, within 3 full years from the date a vehicle of which qualified clean-fuel vehicle property is a part is placed in service, the property ceases to be qualified clean-fuel vehicle property. Property ceases to be qualified clean-fuel vehicle property if—

(A) The vehicle is modified by the taxpayer so that it may no longer be propelled by a clean-burning fuel;

(B) The vehicle is used by the taxpayer in a manner described in section 50(b);

(C) The vehicle otherwise ceases to qualify as property defined in section 179A(c); or

(D) The taxpayer receiving the deduction under section 179A sells or disposes of the vehicle and knows or has reason to know that the vehicle will be used in a manner described in paragraph (b)(1)(i)(A), (B), or (C) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(1)(i)(D) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of qualified clean-fuel vehicle property is not a recapture event.

(2) *Qualified clean-fuel vehicle refueling property*—(i) *In general.* A recapture event occurs if, at any time before the end of its recovery period, the property ceases to be qualified clean-fuel vehicle refueling property. Property ceases to be qualified clean-fuel vehicle refueling property if—

(A) The property no longer qualifies as property described in section 179A(d);

(B) The property is no longer used predominantly in a trade or business (property will be treated as no longer used predominantly in a trade or business if 50 percent or more of the use of the property in a taxable year is for use other than in a trade or business);

(C) The property is used by the taxpayer in a manner described in section 50(b); or

(D) The taxpayer receiving the deduction under section 179A sells or disposes of the property and knows or has reason to know that the property will be used in a manner described in paragraph (b)(2)(i)(A), (B), or (C) of this section.

(ii) *Exception for disposition.* Except as provided in paragraph (b)(2)(i)(D) of this section, a sale or other disposition (including a disposition by reason of an accident or other casualty) of qualified clean-fuel vehicle refueling property is not a recapture event.

(c) *Recapture date*—(1) *Qualified clean-fuel vehicle property.* The recapture date is the actual date of the recapture event unless an event described in paragraph (b)(1)(i)(B) of this section occurs, in which case the recapture date is the first day of the recapture year.

(2) *Qualified clean-fuel vehicle refueling property.* The recapture date is

the actual date of the recapture event unless the recapture occurs as a result of an event described in paragraph (b)(2)(i)(B) or (C) of this section, in which case the recapture date is the first day of the recapture year.

(d) *Recapture amount*—(1) *Qualified clean-fuel vehicle property.* The recapture amount is equal to the benefit of the section 179A deduction allowable multiplied by the recapture percentage. The recapture percentage is—

(i) 100, if the recapture date is within the first full year after the date the vehicle is placed in service;

(ii) $66\frac{2}{3}$, if the recapture date is within the second full year after the date the vehicle is placed in service; or

(iii) $33\frac{1}{3}$, if the recapture date is within the third full year after the date the vehicle is placed in service.

(2) *Qualified clean-fuel vehicle refueling property.* The recapture amount is equal to the benefit of the section 179A deduction allowable multiplied by the following fraction. The numerator of the fraction equals the total recovery period for the property minus the number of recovery years prior to, but not including, the recapture year. The denominator of the fraction equals the total recovery period.

(e) *Basis adjustment.* As of the first day of the taxable year in which the recapture event occurs, the basis of the vehicle of which qualified clean-fuel vehicle property is a part or the basis of qualified clean-fuel vehicle refueling property is increased by the recapture amount. For a vehicle or refueling property that is of a character that is subject to an allowance for depreciation, this increase in basis is recoverable over its remaining recovery period beginning as of the first day of the taxable year in which the recapture event occurs.

(f) *Application of section 1245 for sales and other dispositions.* For purposes of section 1245, the amount of the deduction allowable under section 179A(a) with respect to any property that is (or has been) of a character subject to an allowance for depreciation is treated as a deduction allowed for depreciation under section 167. Therefore, upon a sale or other disposition of depreciable qualified clean-fuel vehicle refueling property or a depreciable vehicle of which qualified clean-fuel vehicle property is a part, section 1245 will apply to any gain recognized to the extent the basis of the depreciable

property or vehicle was reduced under section 179A(e)(6) net of any basis increase described in paragraph (e) of this section.

(g) *Examples.* The following examples illustrate the provisions of this section:

Example 1. A, a calendar-year taxpayer, purchases and places in service for personal use on January 1, 1995, a clean-fuel vehicle, a portion of which is qualified clean-fuel vehicle property, costing \$25,000. The qualified clean-fuel vehicle property costs \$11,000. On A's 1995 federal income tax return, A claims a section 179A deduction of \$2,000. On January 2, 1996, A sells the vehicle to an unrelated third party who subsequently converts the vehicle into a gasoline-propelled vehicle on October 15, 1996. There is no recapture upon the sale of the vehicle by A provided A did not know or have reason to know that the purchaser intended to convert the vehicle to a gasoline-propelled vehicle.

Example 2. B, a calendar-year taxpayer, purchases and places in service for personal use on October 11, 1994, a clean-fuel vehicle costing \$20,000, a portion of which is qualified clean-fuel vehicle property. The qualified clean-fuel vehicle property costs \$10,000. On B's 1994 federal income tax return, B claims a deduction of \$2,000, which reduces B's gross income by \$2,000. The basis of the vehicle is reduced to \$18,000 (\$20,000 - \$2,000). On January 31, 1996, B sells the vehicle to a tax-exempt entity. Because B knowingly sold the vehicle to a tax-exempt entity described in section 50(b) in the second full year from the date the vehicle was placed in service, B must recapture \$1,333 ($\$2,000 \times 66\frac{2}{3}$ percent). This recapture amount increases B's gross income by \$1,333 on B's 1996 federal income tax return and is added to the basis of the motor vehicle as of January 1, 1996, the beginning of the taxable year of recapture.

Example 3. X, a calendar-year taxpayer, purchases and places in service for its business use on January 1, 1994, qualified clean-fuel vehicle refueling property costing \$400,000. Assume this property has a 5-year recovery period. On X's 1994 federal income tax return, X claims a deduction of \$100,000, which reduces X's gross income by \$100,000. The basis of the property is reduced to \$300,000 (\$400,000 - \$100,000) prior to any adjustments for depreciation. In 1996, more than 50 percent of the use of the property is other than in X's trade or business. Because the property is no longer used predominantly in X's business, X must recapture three-fifths of the section 179A deduction or \$60,000 ($\$100,000 \times (5-2)/5 = \$60,000$) and include that amount in gross income on its 1996 federal income tax return. The recapture amount of \$60,000 is added to the basis of the property as of January 1, 1996, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 4. X, a calendar-year taxpayer, purchases and places in service for business use on January 1, 1994, qualified clean-fuel vehicle refueling property costing \$350,000. Assume this property has a 5-year recovery period. On X's 1994 federal income tax return, X claims a deduction of \$100,000, which reduces X's gross

income by \$100,000. The basis of the property is reduced to \$250,000 ($\$350,000 - \$100,000$) prior to any adjustments for depreciation. In 1995, X converts the property to store and dispense gasoline. Because the property is no longer used as qualified clean-fuel vehicle refueling property in 1995, X must recapture four-fifths of the section 179A deduction or \$80,000 ($\$100,000 \times (5-1)/5 = \$80,000$) and include that amount in gross income on its 1995 federal income tax return. The recapture amount of \$80,000 is added to the basis of the property as of January 1, 1995, the beginning of the taxable year of recapture, and to the extent the property remains depreciable, the adjusted basis is recoverable over the remaining recovery period.

Example 5. The facts are the same as in *Example 4.* In 1996, X sells the refueling property for \$351,000, recognizing a gain from this sale. Under paragraph (f) of this section, section 1245 will apply to any gain recognized on the sale of depreciable property to the extent the basis of the property was reduced by the section 179A deduction net of any basis increase from recapture of the section 179A deduction. Accordingly, the gain from the sale of the property is subject to section 1245 to the extent of the depreciation allowance for the property plus the deduction allowed under section 179A (\$100,000), less the previous recapture amount (\$80,000). Any remaining amount of gain may be subject to other applicable provisions of the Internal Revenue Code.

(h) *Effective date.* This section is effective on October 14, 1994. If the recapture date is before the effective date of this section, a taxpayer may use any reasonable method to recapture the benefit of any deduction allowable under section 179A(a) consistent with section 179A and its legislative history. For this purpose, the recapture date is defined in paragraph (c) of this section.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved June 21, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 2, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 3, 1995, 60 F.R. 39649)

Subpart C.—Refundable Credits

Section 32.—Earned Income

26 CFR 1.32-2: *Earned income credit for taxable years beginning after December 31, 1978.*

The Service is providing inflation adjustments to the limitations on the earned income tax credit

for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Subpart D.—Business Related Credits

Section 40.—Alcohol Used as Fuel

Application of section 40. Guidance is provided under section 40 of the Code regarding the application of the alcohol mixture credit with respect to eligible alcohol that has been commingled with ineligible alcohol.

Rev. Rul. 95-54

ISSUE

If a taxpayer commingles alcohol eligible for the alcohol mixture credit under § 40(b)(1)(A) of the Internal Revenue Code with other alcohol and then uses some of the resulting commingled alcohol in a manner that qualifies for the credit, how does the taxpayer determine the amount of the credit?

FACTS

X buys 300 gallons of methanol that is derived from biomass. This methanol (the *eligible alcohol*) meets the definition of *alcohol* in § 40(d)(1). X also buys 700 gallons of methanol that is derived from natural gas. This methanol (the *ineligible alcohol*) does not meet the definition of *alcohol* in § 40(d)(1).

X commingles the eligible and ineligible alcohol in a storage tank. X withdraws 100 gallons of the commingled alcohol from the storage tank and mixes it with gasoline for sale for use as a fuel. X sells the remaining 900 gallons of the commingled alcohol for use in the production of paints and plastics.

LAW AND ANALYSIS

Section 40(b)(1)(A) allows an alcohol mixture credit for alcohol used by the taxpayer in the production of a qualified mixture.

Section 40(b)(1)(B) provides that *qualified mixture* means a mixture of alcohol and gasoline or of alcohol and a special fuel that is sold by the taxpayer producing that mixture to any person for use as a fuel, or is used as a fuel by the taxpayer producing that mixture.

Section 40(d)(1) provides that *alcohol* includes methanol and ethanol but does not include (i) any alcohol produced from petroleum, natural gas, or coal (including peat), or (ii) alcohol with a proof of less than 150.

Because the eligible and ineligible alcohol are commingled in X's storage tank, a portion of the alcohol removed from the tank contains both eligible and ineligible alcohol. Therefore, a portion of the commingled alcohol may not be designated as composed *only* of either eligible or ineligible alcohol. Because X cannot determine the actual amounts of eligible and ineligible alcohol contained in the portion removed, these amounts should be determined based on the proportionate volume of each that was placed into the storage tank. Thus, because the eligible and ineligible alcohol were placed into the storage tank at a thirty-seventy ratio, of the 100 gallons of alcohol that X mixes with gasoline for sale for use as a fuel, 30 gallons are eligible for the alcohol mixture credit allowed by § 40(b)(1)(A).

HOLDING

If a taxpayer commingles eligible alcohol with ineligible alcohol and then uses some of the resulting commingled alcohol in a manner that qualifies for the alcohol mixture credit under § 40(b)(1)(A), the amount of alcohol eligible for the credit is determined based on the proportionate amount of eligible alcohol that is contained in the commingled alcohol.

Section 42.—Low-Income Housing Credit

Low-income housing tax credit. An extended low-income commitment satisfies section 42(h)(6) of the Code even though its provisions may be suspended or terminated after the compliance period when a tenant exercises a right of first refusal to purchase a low-income building.

Rev. Rul. 95-49

ISSUE

Does an extended low-income housing commitment satisfy § 42(h)(6) if its provisions may be suspended or terminated after the compliance period when a tenant exercises a right of first refusal to purchase a low-income building?

FACTS

The owner (Owner) of a qualified low-income building (as defined in § 42(c)(2) of the Internal Revenue Code) rents the building to a single low-income family (Tenant). In an agreement between the Owner and the Tenant, the Owner grants the Tenant a right of first refusal to purchase the building after the close of the 15-year compliance period (as defined in § 42(i)(1)) at a minimum purchase price as specified in § 42(i)(7)(B). The provisions of the extended low-income housing commitment (Commitment) executed by the Owner with the applicable state housing agency (Agency) are terminated after the compliance period if the right is exercised by the Tenant. The Commitment otherwise meets the requirements of § 42(h)(6).

LAW AND ANALYSIS

Section 42 provides a tax credit for investment in qualified low-income buildings placed in service after December 31, 1986.

Section 42(h)(6) provides that no tax credit is allowed for a building unless an extended low-income housing commitment between the low-income building owner and the appropriate housing credit agency is in effect at the end of the taxable year. The commitment is binding on all successors to the owner and includes certain provisions that continue after the close of the building's 15-year compliance period. One of the commitment's provisions ensures that a certain percentage of a low-income building's units will continue to be available for rental by low-income tenants after the close of the compliance period.

Section 42(i)(7) provides that no federal income tax benefit fails to be allowable to the owner of a qualified low-income building merely by reason of a right of first refusal held by the building's tenants to purchase the building after the close of the 15-year compliance period. Section 42(i)(7) also continues the availability of low-income housing beyond the compliance period by permitting low-income tenants to be homeowners instead of renters.

The objectives of § 42(h)(6) and (i)(7) are similar in that both sections attempt to promote housing for low-income individuals beyond the compliance period, by rental in the case of § 42(h)(6) or by outright ownership in the case of § 42(i)(7).

Accordingly, under § 42(h)(6) it is appropriate for an owner and a state housing agency to reference a right of first refusal to be granted by the owner to tenants (either initially or by later amendment) in a commitment between the owner and the agency. In this case, the Owner and the Agency have agreed that the provisions of the Commitment will be terminated after the compliance period on the exercise by the Tenant of a right of first refusal. The Commitment nevertheless satisfies § 42(h)(6). The Commitment would likewise have satisfied § 42(h)(6) if it had provided that application of its provisions would be suspended, subject to conditions imposed by the Agency, on the exercise of the Tenant's right of first refusal.

HOLDING

An extended low-income housing commitment satisfies § 42(h)(6) even though its provisions may be suspended or terminated after the compliance period when a tenant exercises a right of first refusal to purchase a low-income building.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through September 1995. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through September 1995.

Rev. Rul. 95-64

In Rev. Rul. 90-60, 1990-2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period January through September 1995.

Table 1
Rev. Rul. 95-64

Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year								
	1987	1988	1989	1990	1991	1992	1993	1994	1995
Jan '95	85.42%	87.94%	90.66%	93.89%	97.76%	102.37%	107.25%	111.85%	112.52%
Feb '95	85.15	87.66	90.38	93.59	97.44	102.00	106.81	111.28	112.52
Mar '95	84.89	87.39	90.10	93.30	97.13	101.66	106.41	110.79	112.52
Apr '95	91.28	94.91	98.83	103.36	108.66	114.82	121.31	127.40	130.24
May '95	91.00	94.62	98.53	103.04	108.33	114.45	120.88	126.91	130.24
Jun '95	90.73	94.34	98.24	102.74	108.00	114.09	120.48	126.47	130.24
Jul '95	84.10	86.58	89.27	92.44	96.22	100.65	105.26	109.51	112.52
Aug '95	83.86	86.34	89.02	92.19	95.97	100.37	104.97	109.23	112.52
Sep '95	83.62	86.10	88.79	91.95	95.72	100.11	104.69	108.97	112.52

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see the following revenue rulings: Rev. Rul. 90-60, 1990-2 C.B. 3, for dispositions occurring during calendar years 1987, 1988, and 1989; Rev. Rul. 90-88, 1990-2 C.B. 7, for dispositions occurring during calendar year 1990; Rev. Rul. 91-67, 1991-2 C.B. 13, for dispositions occurring during calendar year 1991; Rev. Rul. 92-101, 1992-2 C.B. 9, for dispositions occurring during calendar year 1992; Rev. Rul. 93-83, 1993-2 C.B. 6, for dispositions occurring during calendar year 1993; and Rev. Rul. 94-71, 1994-2 C.B. 4, for dispositions occurring during calendar year 1994.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through December 1995. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 1995.

Rev. Rul. 95-83

In Rev. Rul. 90-60, 1990-2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing

the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period January through December 1995.

Table 1
Rev. Rul. 95-83

Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

Month of Disposition	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year								
	1987	1988	1989	1990	1991	1992	1993	1994	1995
Jan '95	85.42%	87.94%	90.66%	93.89%	97.76%	102.37%	107.25%	111.85%	112.52%
Feb '95	85.15	87.66	90.38	93.59	97.44	102.00	106.81	111.28	112.52
Mar '95	84.89	87.39	90.10	93.30	97.13	101.66	106.41	110.79	112.52
Apr '95	91.28	94.91	98.83	103.36	108.66	114.82	121.31	127.40	130.24
May '95	91.00	94.62	98.53	103.04	108.33	114.45	120.88	126.91	130.24
Jun '95	90.73	94.34	98.24	102.74	108.00	114.09	120.48	126.47	130.24
Jul '95	84.10	86.58	89.27	92.44	96.22	100.65	105.26	109.51	112.52
Aug '95	83.86	86.34	89.02	92.19	95.97	100.37	104.97	109.23	112.52
Sep '95	83.62	86.10	88.79	91.95	95.72	100.11	104.69	108.97	112.52
Oct '95	83.40	85.87	88.55	91.72	95.47	99.86	104.43	108.74	112.52
Nov '95	83.17	85.64	88.32	91.49	95.24	99.62	104.19	108.53	112.52
Dec '95	82.95	85.42	88.10	91.26	95.01	99.39	103.96	108.34	112.52

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see the following revenue rulings: Rev. Rul. 90-60, 1990-2 C.B. 3, for dispositions occurring during calendar years 1987, 1988, and 1989; Rev. Rul. 90-88, 1990-2 C.B. 7, for dispositions occurring during calendar year 1990; Rev. Rul. 91-67, 1991-2 C.B. 13, for dispositions occurring during calendar year 1991; Rev. Rul. 92-101, 1992-2 C.B. 9, for dispositions occurring during calendar year 1992; Rev. Rul. 93-83, 1993-2 C.B. 6, for dispositions occurring during calendar year 1993; and Rev. Rul. 94-71, 1994-2 C.B. 4, for dispositions occurring during calendar year 1994.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for

the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

26 CFR 1.42-14: Allocation rules for post-1989 State housing credit ceiling amounts.

This procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 421(h)(3)(D) of the Code for calendar year 1995. See Rev. Proc. 95-36, page 393.

Subchapter B.—Computation of Taxable Income
Part I.—Definition of Gross Income, Adjusted Gross Income, Taxable Income, etc.

Section 61.—Gross Income Defined

26 CFR 1.61-2: Compensation for services, including fees, commissions, and similar items.

T.D. 8607

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Allowances Received by Members of the Armed Forces in Connection With Moves to New Permanent Duty Stations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the exclusion from gross income under section 61 of the Internal Revenue Code of 1986 (Code) of certain allowances received by members of the uniformed services in connection with a change of permanent duty station. The final regulations are required because of amendments to the law made by section 13213(a)(1) of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993), 107 Stat. 473 (1993), which redefined the term *moving expenses* under section 217(b) of the Code. Persons affected by the final regulations are members of the uniformed services (the Armed Forces, the commissioned corps of the National Oceanic and Atmospheric Administration, and the commissioned corps of the Public Health Service).

DATES: These regulations are effective August 7, 1995.

For dates of applicability, see "Effective date" portion under *Supplementary Information*.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 61 and 217 of the Internal Revenue Code (Code) that are required because of the amendment of section 217(b) by OBRA 1993. In Notice 94-59, 1994-1 C.B. 371, the IRS announced its intention to issue guidance to clarify that certain allowances received by members of the Armed Forces continue to be excludable from gross income notwithstanding the amendment of section 217(b).

On December 21, 1994, temporary regulations (TD 8575 [1995-1 C.B. 5]) relating to military expense allowances under sections 61 and 217 (relating to definitions of gross income and of moving expenses) were published in the Federal Register (55 FR 65711). A notice of proposed rulemaking (IA-50-94 [1995-1 C.B. 945]) relating to the same subjects was published in the Federal Register for the same day (55 FR 65739). No public hearing was requested or held.

Written comments regarding the regulations were received. After consideration of all the comments, the regulations proposed by IA-50-94 are adopted as revised by this Treasury decision, and the corresponding temporary regulations are withdrawn. The comments are discussed below.

Explanation of Provisions

I. General Background

Section 217(g) of the Code provides that a member of the Armed Forces on active duty who moves pursuant to a military order and incident to a permanent change of station does not include in income reimbursements or allowances for moving or storage expenses, or the value of moving and storage services furnished in kind. For purposes of section 217(g), moving expenses are defined in section 217(b). OBRA 1993 amended section 217(b) by narrowing the definition of deductible moving expenses.

As a result of this amendment, questions arose concerning the federal tax treatment of certain allowances provided by the Department of Defense and by the Department of Transportation under title 37 of the United States

Code to members of the Armed Forces in connection with a transfer to a new permanent duty station. Those allowances include: (1) a dislocation allowance, intended to partially reimburse expenses (e.g., lease forfeitures, temporary living charges in hotels, and breakage of household goods in transit) incurred in relocating a household; (2) a temporary lodging expense, intended to partially offset the added living expenses of temporary lodging (up to 10 days) within the United States (other than Hawaii or Alaska); (3) a temporary lodging allowance, intended to help defray higher than normal living costs (for up to 60 days) outside the United States or in Hawaii or Alaska; and (4) a move-in housing allowance, intended to defray costs (e.g., rental agent fees, home-security improvements, and supplemental heating equipment) associated with occupying leased quarters outside the United States.

Section 1.61-2(b) of the Income Tax Regulations provides, in part, that subsistence and uniform allowances granted to members of the Armed Forces, Coast and Geodetic Survey (now known as the National Oceanic and Atmospheric Administration), and Public Health Service, and amounts received by them as commutation of quarters, are to be excluded from gross income. Similarly, the value of quarters or subsistence furnished to such persons is excluded from gross income. These exclusions from gross income of quarters and subsistence allowances paid to members of the uniformed services are ones of long standing, dating back to 1925. See *Jones v. United States*, 60 Ct. Cl. 552 (1925).

The Treasury Department and the IRS have determined that the four above-referenced allowances, to the extent not excluded under other provisions of the Code (such as section 217(g) or section 132(g)), are to be treated as quarters or subsistence allowances. Section 1.61-2(b) is revised to provide that these allowances are excluded from the gross income of members of the uniformed services. Section 1.61-2(b)(2) and section 1.217-2(g)(6) clarify that no deduction is allowed for any expenses incurred in connection with a transfer to a new permanent duty station to the extent the expenses are reimbursed by an excluded allowance. However, any expense that meets the definition of a *moving expense* as defined in section

217(b) and is not reimbursed continues to be deductible under current law.

II. Public Comments

The National Oceanic and Atmospheric Administration (NOAA) requested that the regulations provide active duty officers of the NOAA Corps with an exclusion for the allowances covered by these regulations. The commissioned corps of NOAA, the commissioned corps of the Public Health Service (PHS), and the Armed Forces collectively comprise the uniformed services. 10 U.S.C. 101(a)(5) (Supp. IV 1992). The Armed Forces consist of the Army, Navy, Air Force, Marine Corps, and Coast Guard. 10 U.S.C. 101(a)(4) (1988).

The pay and allowance provisions of title 37 apply to all members of the uniformed services. In particular, the allowances that are the subject of these regulations are the same for the NOAA commissioned corps and the PHS commissioned corps as for the Armed Forces. The Department of Treasury historically has extended the holdings of *Jones v. United States* to all members of the uniformed services. I.T. 2232, IV-2 C.B. 144 (1925); Mim. 3413, V-1 C.B. 29 (1926). Accordingly, the final regulations under section 1.61-2(b) provide that the four earlier-referenced allowances are quarters or subsistence allowances and are excluded from gross income for members of the uniformed services.

III. Effective Date

The final regulations are effective with respect to allowances for expenses incurred after December 31, 1993.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for

Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.61-2 is amended by:

1. Removing the language “Coast and Geodetic Survey” from the second sentence of paragraph (a)(1) and adding in its place the language “National Oceanic and Atmospheric Administration”.

2. Revising paragraph (b) to read as follows:

§1.61-2 Compensation for services, including fees, commissions, and similar items.

* * * * *

(b) *Members of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service.* (1) Subsistence and uniform allowances granted commissioned officers, chief warrant officers, warrant officers, and enlisted personnel of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service of the United States, and amounts received by them as commutation of quarters, are excluded from gross income. Similarly, the value of quarters or subsistence furnished to such persons is excluded from gross income.

(2) For purposes of this section, quarters or subsistence includes the following allowances for expenses incurred after December 31, 1993, by members of the Armed Forces, members of the commissioned corps of the National Oceanic and Atmospheric Administration, and members of the commissioned corps of the Public Health Service, to the extent that the allowances are not otherwise excluded from gross income under another provi-

sion of the Internal Revenue Code: a dislocation allowance, authorized by 37 U.S.C. 407; a temporary lodging allowance, authorized by 37 U.S.C. 405; a temporary lodging expense, authorized by 37 U.S.C. 404a; and a move-in housing allowance, authorized by 37 U.S.C. 405. No deduction is allowed under this chapter for any expenses reimbursed by such excluded allowances. For the exclusion from gross income of—

(i) Disability pensions, see section 104(a)(4) and the regulations thereunder;

(ii) Miscellaneous items, see section 122.

(3) The per diem or actual expense allowance, the monetary allowance in lieu of transportation, and the mileage allowance received by members of the Armed Forces, National Oceanic and Atmospheric Administration, and the Public Health Service, while in a travel status or on temporary duty away from their permanent stations, are included in their gross income except to the extent excluded under the accountable plan provisions of §1.62-2.

* * * * *

§1.61-22T [Removed]

Par. 3. Section 1.61-22T is removed.

Par. 4. Section 1.217-2 is amended by adding paragraph (g)(6) to read as follows:

§1.217-2 Deduction for moving expenses paid or incurred in taxable years beginning after December 31, 1969.

* * * * *

(g) * * *

(6) *Disallowance of deduction.* No deduction is allowed under this section for any moving or storage expense reimbursed by an allowance that is excluded from gross income.

§1.217-2T [Removed]

Par. 5. Section 1.217-2T is removed.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved July 27, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 4, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 7, 1995, 60 F.R. 40075)

26 CFR 1.61-6: *Gains derived from dealings in property.*

Guidance is provided concerning the use of an optional method of accounting that treats certain rent-to-own contracts as leases for federal income tax purposes. See Rev. Proc. 95-38, page 397.

26 CFR 1.61-6: *Gains derived from dealings in property.*

Guidance is provided concerning the use of an optional method of accounting that treats certain rent-to-own contracts as leases for federal income tax purposes. See Rev. Proc. 95-38, page 397.

26 CFR 1.61-21: *Taxation of fringe benefits.*

Fringe benefits aircraft valuation formula. For purpose of section 1.61-21(g) of the regulations, relating to the rule for valuing non-commercial flights on employer-provided aircraft, the Standard Industry Fare Level (SIFL), cents-per-mile rates and terminal charges in effect for 1995 are set forth. Rev. Rul. 95-35 modified.

Rev. Rul. 95-66

For purposes of the taxation of fringe benefits under section 61 of the Internal Revenue Code, section 1.61-21(g) of the Income Tax Regulations provides a rule for valuing noncommercial flights on employer-provided aircraft. Section 1.61-21(g)(5) of the Income Tax Regulations provides an aircraft valuation formula to determine the value of such flights. The value of a flight is determined under the base aircraft valuation formula (also known as the Standard Industry Fare Level formula or SIFL) by multiplying the SIFL cents-per-mile rates applicable for the period during which the flight was taken by the appropriate aircraft multiple provided in section 1.61-21(g)(7) and then adding the applicable terminal charge. The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are revised semi-annually.

The following chart sets forth the terminal charges and SIFL mileage rates:

*Period During Which
the Flight Was Taken*

7/1/95-12/31/95

*Terminal
Charge*

\$30.86

SIFL Mileage Rates

Up to 500 miles = \$.1688 per mile

501-1500 miles = \$.1287

Over 1500 miles = \$.1237

EFFECT ON OTHER REVENUE RULING

Rev. Rul. 95-35, 1995-1 C.B. 4, is modified.

Section 62.—Adjusted Gross Income Defined

*26 CFR 1.62-2: Reimbursements and other
expenses allowance arrangements.*

Rules under which a reimbursement or other expense allowance arrangement for the cost of operating an automobile for business purposes will satisfy the requirements of section 62(c) of the Code as to business connection, substantiation, and returning amounts in excess of expenses. See Rev. Proc. 95-54, page 450.

Section 63.—Taxable Income Defined

*26 CFR 1.63-1: Change of treatment with
respect to the zero bracket amount and
itemized deductions.*

The Service is providing inflation adjustments to the standard deduction amounts (including the \$500 limitation in the case of certain dependents, and \$600 or \$750 additional standard deduction for the aged or blind) for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Section 68.—Overall Limitation on Itemized Deductions

The Service is providing inflation adjustments to the overall limitation on itemized deductions for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Part II.—Items Specifically Included in Gross Income

Section 83.—Property Transferred in Connection With Performance of Services

26 CFR 1.83-6: Deduction by employer.

T.D. 8599

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Deductions for Transfers of Property

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning deductions for transfers of property. The regulations amend the special rule that required an employer to deduct and withhold income tax as a prerequisite for claiming a deduction for property transferred to an employee in connection with the performance of services. Under the former regulation, employers that failed to deduct and withhold income tax were denied a deduction even where the employee reported the income and paid the tax. The new rules permit service recipients to claim a deduction for the amount included in the service provider's gross income. The service provider will be deemed to have included an amount in gross income if the service recipient provides a timely Form W-2 or 1099, as appropriate. These regulations apply to all service recipients who transfer property in connection with the performance of services.

DATES: These regulations are effective July 19, 1995.

For dates of applicability, see §1.83-6(a)(5).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1448. The estimated annual burden of reporting will be reflected in the reporting requirements for Form 1099-MISC.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On December 5, 1994, the IRS published in the Federal Register (59 FR 62370 [EE-81-88, 1994-2 C.B. 850]) proposed amendments to the income tax regulations (26 CFR part 1) under section 83(h) of the Internal Revenue Code (Code), which permits a deduction for property transferred in connection with the performance of services.

Three written comments were received from the public on the proposed regulations. No public hearing was held. After consideration of the written comments received, the proposed regulations are adopted by this Treasury decision with one technical clarification.

Explanation of Provisions

Under section 83(h) of the Code, in the case of a transfer of property to which section 83(a) applies, the person for whom services were provided may deduct an amount equal to the amount included in the service provider's gross income. In light of the difficulty that a service recipient may have in demonstrating that an amount has actually been included in the service provider's gross income, the general rule in former §1.83-6(a)(1) permitted the deduction for the amount "includible" in the service provider's gross income. Thus, the deduction was allowed to the service recipient even if the service provider did not properly report the includible amount. Where the service

provider was an employee of the service recipient, however, the special rule in §1.83-6(a)(2) provided that a deduction could be claimed only if the service recipient (employer) deducted and withheld income tax in accordance with section 3402. The special rule was designed to ensure that the service recipient's deduction was in fact offset by a corresponding inclusion in the service provider's gross income. The special rule was limited to employer-employee situations because in other situations there was no underlying withholding requirement upon which the deduction could be conditioned.

Taxpayers expressed concern that it was often difficult to satisfy the prerequisite that employers must deduct and withhold income tax from payments in kind as a condition for claiming a deduction. These regulations address this concern by eliminating this prerequisite, while still ensuring consistent treatment between service recipients and service providers as required by the statute. In addition, because the deduction no longer is conditioned on withholding, there no longer is a need to have different rules for those who receive services from employees and those who receive services from others.

Under these regulations, the former general rule and special rule are replaced by a revised general rule that more closely follows the statutory language of section 83(h). The service recipient is allowed a deduction for the amount "included" in the service provider's gross income. For this purpose, the amount included means the amount reported on an original or amended return or included in gross income as a result of an IRS audit of the service provider.

Because of the potential difficulty of demonstrating actual inclusion by the service provider, a special rule provides that, if the service recipient timely complies with applicable Form W-2 or 1099 reporting requirements under section 6041 (or 6041A), as appropriate, with respect to the amount includible in income by the service provider, the service provider is deemed to have included the amount in gross income for this purpose. Thus, the regulations allow the deduction without requiring the service recipient to demonstrate actual inclusion by the service provider. If a transfer meets the requirements for exemption from reporting for payments aggregating less than \$600 in any taxable year, or is eligible for any

other reporting exemption, no reporting is required in order for the service recipient to rely on the deemed inclusion rule.

In order to allow service recipients to take advantage of the deemed inclusion rule with respect to property transfers to *all* service providers, these regulations also permit service recipients to use the special rule in the case of transfers to corporate service providers. To that end, service recipients are permitted, solely for purposes of this rule, to treat the Form 1099 reporting requirements as applicable to transfers to corporate service providers in the same manner as those requirements apply to transfers to noncorporate service providers. Thus, if a service recipient who transferred property to a corporate service provider timely reports that income on Form 1099 (to both the service provider and the federal government), the service recipient is entitled to rely on the deemed inclusion rule in claiming a deduction for the amount of that income. If the transfer meets the requirements for exemption from reporting for payments aggregating less than \$600 in any taxable year, or is eligible for any other reporting exemption applicable to a service provider that is not a corporation, no reporting is required in order for the service recipient to rely on the deemed inclusion rule.

The deemed inclusion rule may be used only by a service recipient whose compliance with applicable Form W-2 or 1099 reporting requirements is timely. Thus, for example, under the current reporting requirements, if amounts attributable to one or more section 83 transfers of property are includible in an employee's income in year 1 (and are not eligible for any reporting exemption), the employer generally is required to furnish the employee a Form W-2 reflecting that amount by January 31 of year 2 and generally is required to file a copy of the Form W-2 with the federal government by the last day of February of year 2. If the employer reports to the employee and the government in a timely manner, the employer can rely on the deemed inclusion rule to claim a deduction for the amount in year 1. If the employee's Form W-2 is not furnished until after January 31 of year 2 or the government's copy of Form W-2 is not filed until after the last day of February of year 2, the employer

generally is required to demonstrate that the employee actually included the amount in income in order to support its deduction of the amount.

Under these regulations, a special rule applies with respect to an amount includible in an employee's or former employee's income by reason of a disqualifying disposition of stock that had been acquired pursuant to a statutory stock option. In the case of such a disposition, and solely for the purpose of determining whether an employer may use the deemed inclusion rule under these regulations, a Form W-2 or W-2c (as appropriate) will be considered timely if it is furnished to the employee or former employee, and filed with the federal government, by the date on which the employer files its tax return (including an amended return) claiming a deduction for that amount.

With respect to disqualifying dispositions, these regulations modify the conditions for an employer's deduction under section 83(h) in a manner that is not inconsistent with the guidance provided by Notice 87-49 (Changes to Incentive Stock Option Requirements by Section 321 of the Tax Reform Act of 1986), 1987-2 C.B. 355. These regulations are not intended to have any effect on the application of Notice 87-49 or the analysis contained therein, and therefore should not be viewed as constituting a reconsideration of Revenue Ruling 71-52, 1971-1 C.B. 278, within the meaning of Notice 87-49.

Three written comments were received from the public on the proposed regulations. One dealt specifically with the withholding requirements as they apply to disqualifying dispositions of stock received under an employee stock purchase plan and, therefore, is beyond the scope of this regulation. The remaining two comments generally applauded the proposed amendments, but they both expressed a concern that, even after elimination of the withholding requirement as a prerequisite for claiming a deduction under section 83(h), there remains a statutory requirement, under subtitle C, to withhold income tax from compensatory transfers of property. Both commentators suggested that regulations be published to exclude transfers of property in payment for services from the withholding requirements.

Treasury and the IRS have carefully considered the comments. However, section 3402 of the Code requires

every employer making payment of wages to deduct and withhold income tax from the wages. Section 3401(a) (relating to the definition of wages for income tax withholding purposes), section 3121(a) (relating to the definition of wages for FICA tax purposes), and section 3306(b) (relating to the definition of wages for FUTA tax purposes) of subtitle C all provide that "wages" means all remuneration "including the cash value of all remuneration (including benefits) paid in any medium other than cash," except as specified otherwise in those sections. A transfer of property in connection with the performance of services is not one of the specified exceptions.

Therefore, although the withholding requirement is eliminated as a prerequisite for claiming a deduction, these regulations do not relieve the service recipient from any applicable withholding requirements of subtitle C or from the statutorily prescribed penalties or additions to tax for noncompliance with those requirements. Thus, for example, if an employer transferred to an employee property to which section 83 applies and failed to withhold income tax on the payment, the employer would be liable for the tax under section 3403. However, under section 3402(d), any tax liability assessed against the employer would be offset by any tax paid by the employee. In addition, nothing in these regulations relieves the service recipient from penalties or additions to tax for noncompliance with the requirements of section 6041 or 6041A (relating to information reporting) to the extent they otherwise apply.

These regulations are effective for deductions allowable for taxable years beginning on or after January 1, 1995. However, taxpayers may apply these regulations when claiming a deduction for any year not closed by the statute of limitations. For example, if substantially vested (within the meaning of §1.83-3(b)) stock was transferred to an employee in 1992 upon the exercise of a nonstatutory stock option, and if the calendar year employer furnished a Form W-2 to the employee by January 31, 1993, reflecting the income generated by the transfer and filed the appropriate Form W-2 with the federal government by February 28, 1993, then the employer could apply these regulations to claim a deduction for 1992 for the amount of the income, even if the employer failed to withhold in accord-

ance with section 3402 and could not demonstrate actual inclusion in income by the employee. If that employer did not claim a deduction for the amount of the income on its 1992 tax return, it could file an amended return for 1992 claiming such a deduction pursuant to these regulations, provided that 1992 is still an open year.

The proposed regulation that was published in the Federal Register on November 16, 1983 (48 FR 52079), proposing to amend the special rule in §1.83-6(a)(2), was withdrawn by the Notice of Proposed Rulemaking published on December 5, 1994 (59 FR 62371).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

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

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

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

Par. 2. Section 1.83-6 is amended as follows:

1. Paragraphs (a)(1) and (2) are revised.
2. Paragraph (a)(5) is added.
3. The revisions and addition read as follows:

§1.83-6 Deduction by employer.

(a) *Allowance of deduction*—(1) *General Rule.* In the case of a transfer of property in connection with the performance of services, or a compen-

satory cancellation of a nonlapse restriction described in section 83(d) and §1.83-5, a deduction is allowable under section 162 or 212 to the person for whom the services were performed. The amount of the deduction is equal to the amount included as compensation in the gross income of the service provider under section 83(a), (b), or (d)(2), but only to the extent the amount meets the requirements of section 162 or 212 and the regulations thereunder. The deduction is allowed only for the taxable year of that person in which or with which ends the taxable year of the service provider in which the amount is included as compensation. For purposes of this paragraph, any amount excluded from gross income under section 79 or section 101(b) or subchapter N is considered to have been included in gross income.

(2) *Special Rule.* For purposes of paragraph (a)(1) of this section, the service provider is deemed to have included the amount as compensation in gross income if the person for whom the services were performed satisfies in a timely manner all requirements of section 6041 or section 6041A, and the regulations thereunder, with respect to that amount of compensation. For purposes of the preceding sentence, whether a person for whom services were performed satisfies all requirements of section 6041 or section 6041A, and the regulations thereunder, is determined without regard to §1.6041-3(c) (exception for payments to corporations). In the case of a disqualifying disposition of stock described in section 421(b), an employer that otherwise satisfies all requirements of section 6041 and the regulations thereunder will be considered to have done so timely for purposes of this paragraph (a)(2) if Form W-2 or Form W-2c, as appropriate, is furnished to the employee or former employee, and is filed with the federal government, on or before the date on which the employer files the tax return claiming the deduction relating to the disqualifying disposition.

* * * * *

(5) *Effective date.* Paragraphs (a)(1) and (2) of this section apply to deductions for taxable years beginning on or after January 1, 1995. However, taxpayers may also apply paragraphs (a)(1) and (2) of this section when

claiming deductions for taxable years beginning before that date if the claims are not barred by the statute of limitations. Paragraphs (a)(3) and (4) of this section are effective as set forth in §1.83-8(b).

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§602.101 [Amended]

Par. 4. In §602.101, paragraph (c) is amended by adding the entry “1.83-6... 1545-1448” in numerical order to the table.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved June 19, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 18, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 19, 1995, 60 F.R. 36995)

Part III.—Items Specifically Excluded from Gross Income

Section 103.—Interest on State and Local Bonds

What are the conditions under which an issuer of State or local bonds may make payments to the U.S. to reduce the yield on investments purchased with the proceeds of advance refunding bonds on a date when the issuer is unable to purchase U.S. Treasury securities—State and Local Government Series (“SLGS”) because the Department of the Treasury has suspended sales of SLGS? See Rev. Proc. 95-47, page 417.

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

The qualified census tracts for Puerto Rico and the Virgin Islands are set forth for use in determining the portion of loans required to be placed in targeted areas under section 143(h) of the Code. See Rev. Proc. 95-31, page 378.

26 CFR 1.103-1: Interest upon obligations of a State, Territory, etc.

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 95-32, page 379.

Section 132.—Certain Fringe Benefits

The Service is providing inflation adjustments to the limitation on the exclusion of a qualified transportation fringe for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Section 135.—Income from United States Savings Bonds Used to Pay Higher Education Tuition and Fees

The Service is providing inflation adjustments to the limitation on the exclusion of income from United States savings bonds for taxpayers who pay qualified higher education expenses for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Part IV.—Tax Exemption Requirements for State and Local Bonds

Subpart A.—Private Activity Bonds

Section 143.—Mortgage Revenue Bonds: Qualified Mortgage Bond and Qualified Veterans’ Mortgage Bond

26 CFR 6a.103A-2: Qualified mortgage bond.

The qualified census tracts for Puerto Rico and the Virgin Islands are set forth for use in determining the portion of loans required to be placed in targeted areas under section 143(h) of the Code. See Rev. Proc. 95-31, page 378.

26 CFR 6a.103A-2: Qualified mortgage bond.

Guidance is provided for the use of the national and area median gross income figures by issuers of qualified mortgage bonds and mortgage credit certificates in determining the housing cost/income ratio described in section 143(f)(5) of the Code. See Rev. Proc. 95-32, page 379.

Subpart B.—Requirements Applicable to All State and Local Bonds

Section 148.—Arbitrage

What are the conditions under which an issuer of State or local bonds may make payments to

the U.S. to reduce the yield on investments purchased with the proceeds of advance refunding bonds on a date when the issuer is unable to purchase U.S. Treasury securities—State and Local Government Series (“SLGS”) because the Department of the Treasury has suspended sales of SLGS? See Rev. Proc. 95-47, page 417.

Part V.—Deductions for Personal Exemptions

Section 151.—Allowance of Deductions for Personal Exemptions

26 CFR 1.151.4: Amount of deduction for each exemption under section 151.

The Service is providing inflation adjustments to the personal exemption and to the threshold amounts of adjusted gross income above which the exemption amount phases out for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade or Business Expenses

26 CFR 1.162-17: Reporting and substantiation of certain business expenses of employees.

The rules for substantiating the amount of a deduction or expense for business use of an automobile that most nearly represents current costs are set forth. See Rev. Proc. 95-54, page 450.

26 CFR 1.162-20: Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.

T.D. 8602

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Lobbying Expense Deductions—Dues, Allocation of Costs to Lobbying Activities, and Influencing Legislation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that define influencing legislation for purposes of the deduction disallowance for certain amounts

paid or incurred in connection with influencing legislation. It also contains final regulations concerning allocating costs to influencing legislation or the official actions or positions of certain federal executive branch officials and the deductibility of dues (and other similar amounts) paid to certain tax-exempt organizations. These regulations are necessary because of changes made to the Internal Revenue Code by the Omnibus Budget Reconciliation Act of 1993. These rules will assist businesses and certain tax-exempt organizations in complying with the Internal Revenue Code.

DATES: These regulations are effective July 21, 1995.

For dates of applicability, see §§1.162-20, paragraphs (c)(5) and (d), 1.162-28(h), and 1.162-29(h).

SUPPLEMENTARY INFORMATION:

Background

On December 27, 1993, the IRS published in the Federal Register temporary regulations (58 FR 68294 [TD 8511, 1994-1 C.B. 37]) under section 162 of the Internal Revenue Code (Code) relating to the dues deduction disallowance and a notice of proposed rulemaking (58 FR 68334 [IA-60-93, 1994-1 C.B. 802]) cross-referencing the temporary regulations. On the same day, the IRS published in the Federal Register a notice of proposed rulemaking (58 FR 68330 [IA-57-93, 1994-1 C.B. 797]) under section 162 of the Code relating to the allocation of costs to lobbying activities. On May 13, 1994, the IRS published in the Federal Register a notice of proposed rulemaking (59 FR 24992 [IA-23-94, 1994-1 C.B. 809]) under section 162 concerning the definition of influencing legislation. Written comments responding to the notices were received and public hearings were held on allocating costs to lobbying activities on April 6, 1994, and on influencing legislation on September 12, 1994. After careful consideration of all the comments, the proposed regulations are adopted, as revised and renumbered by this document. The issues described in this preamble are the principal issues considered in adopting the final regulations. However, a number of other technical and clarifying changes were made.

Lobbying Expense Deductions—Dues—§1.162-20.

The proposed regulations are adopted without change.

Allocation of Costs to Lobbying Activities—§1.162-28.

The proposed regulations generally describe the costs that are properly allocable to lobbying activities and permit taxpayers to use any reasonable method to allocate those costs between lobbying activities and other activities. Under the proposed regulations, a method is not reasonable unless it is applied consistently, allocates a proper amount of costs (including labor costs and general and administrative costs) to lobbying activities, and is consistent with certain special rules of the regulations. The proposed regulations provide that a taxpayer may use the following methods of allocating costs to lobbying activities: (1) the ratio method; (2) the gross-up method; and (3) an allocation method that applies the principles of section 263A and the regulations thereunder.

While the proposed regulations are intended to allow any reasonable method, some commentators interpreted the proposed regulations as treating only the three specified methods as reasonable methods of allocating costs. The final regulations clarify that taxpayers may use any reasonable method of allocating costs to lobbying activities, including, but not limited to, the three specified methods.

Some commentators stated that the regulations should provide that a cost allocation method is not unreasonable simply because it allocates a lesser amount of costs to lobbying activities than any one of the three specified methods. Whether any other allocation method is reasonable depends on the facts and circumstances of a particular case. The three specified methods, alone or in combination, do not establish a baseline allocation against which to compare other methods.

The proposed regulations direct taxpayers to see section 6001 and the regulations thereunder for recordkeeping requirements. Numerous commentators requested additional guidance concerning recordkeeping for lobbying activities. Some commentators recommended that the regulations should provide that the IRS will accept good

faith or reasonable estimates of time spent on lobbying activities. Other commentators recommended that the regulations, like the preamble to the proposed regulations, should state explicitly that taxpayers are not required to maintain any particular records of costs of lobbying activities, such as daily time reports, daily logs, or similar documents.

Section 6001 already requires a taxpayer to keep records necessary for the taxpayer to apply its reasonable method of allocating costs to lobbying activities. Thus, each taxpayer must use methods appropriate for its trade or business. The proposed regulations, nevertheless, do not require a taxpayer to maintain its records of costs of lobbying activities in any particular form. The IRS and Treasury believe that the final regulations should not provide guidance concerning recordkeeping in addition to that already provided in section 6001 and, therefore, no changes were made in response to these suggestions.

Under the ratio method of the proposed regulations, a taxpayer multiplies its total costs of operations (excluding third-party costs) by a fraction, the numerator of which is the taxpayer's lobbying labor hours and the denominator of which is the taxpayer's total labor hours. The taxpayer adds the result of this calculation to its third-party costs to allocate its costs to lobbying activities.

The proposed regulations define the term *total costs of operations* as the total costs of the taxpayer's trade or business for a taxable year, excluding third-party costs. Commentators questioned the scope of the definition and suggested that certain costs should be excluded from the definition. For example, several commentators inquired whether total costs of operations means costs reflected on a company's financial statements or its tax returns. In addition, commentators inquired whether the term included depreciation, charitable contributions, or federal tax expenses. With respect to tax-exempt organizations, commentators inquired whether total costs of operations included the costs of educational conferences, conventions, books and other publications, and unrelated business activities. Among the costs that commentators recommended excluding from the definition of total costs of operations are purchases and other costs of goods sold and all third-party costs unrelated to lobbying activities.

As indicated above, the final regulations clarify that taxpayers may use any reasonable method of allocating costs to lobbying activities. The regulations set forth the ratio method as one simplified method that taxpayers have the option of using. If the regulations were modified to provide a specific definition of total costs of operations encompassing a complex set of exclusions designed to suit the circumstances of all businesses, the ratio method would no longer be a simplified method and would require complex analysis by taxpayers and the IRS. Therefore, the definition of total costs of operations is not changed in the final regulations. Taxpayers who do not find the simple ratio method appropriate to their circumstances may use another reasonable method.

The proposed regulations provide that for purposes of the ratio method, a taxpayer may treat as zero the lobbying labor hours of personnel engaged in secretarial, maintenance, and other similar activities. The IRS and Treasury invited comments on whether this rule will distort the costs allocated to lobbying activities. Most commentators responded favorably to this rule. Some indicated that the administrative benefits far outweighed any minimal distortion. Commentators also requested guidance concerning the term "other similar activities."

The final regulations clarify that a taxpayer using the ratio method may treat as zero the hours of personnel engaged in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities). For example, because paraprofessionals and analysts when engaged in a lobbying activity may engage in activities involving significant judgments with respect to the lobbying activity, taxpayers may not treat their time as zero.

Under the gross-up method of the proposed regulations, a taxpayer allocates costs to lobbying activities by multiplying the taxpayer's basic labor costs for lobbying labor hours by 175 percent. For this purpose, the taxpayer's basic labor costs are limited to wages or other similar costs of labor, such as guaranteed payments for services. Thus, for example, pension costs and other employee benefits are not included in basic labor costs. As with the ratio method, third party costs are then added to the result of the calcula-

tion to arrive at the total costs to allocate to lobbying activities.

Although the proposed gross-up method provides a simple way to calculate costs allocated to lobbying activities, some commentators noted that the proposed gross-up method did not simplify recordkeeping because taxpayers had to keep track of the lobbying labor hours of clerical and support staff in order to determine lobbying labor costs.

In response to this concern, the final regulations provide an alternative gross-up method. Under this alternative, taxpayers may treat as zero the lobbying labor hours of personnel who engage in secretarial, clerical, support, and other administrative activities that do not involve significant judgment with respect to the lobbying activity. However, if a taxpayer uses this alternative, it must multiply costs for lobbying labor hours by 225 percent.

Many commentators suggested that the proposed gross-up percentage of 175 percent was too high, based on information from their industry. The gross-up factors (including the 225 percent factor added to the final regulations) are intended to approximate the average gross-up factors for all taxpayers. The IRS and Treasury believe that these factors are the appropriate factors as averages for all taxpayers. If the regulations were further modified to provide a set of gross-up factors to suit the circumstances of various businesses or industries, the gross-up method would no longer be a simplified method. The final regulations clarify that taxpayers may use any reasonable method of allocating costs to lobbying activities. Thus, taxpayers who do not find the gross-up method appropriate to their circumstances may use another reasonable method.

The proposed regulations provide that taxpayers that do not pay or incur reasonable labor costs for persons engaged in lobbying activities may not use the ratio method or the gross-up method. Several commentators requested that the IRS reconsider this restriction. In addition, some commentators expressed concern that this restriction would prevent tax-exempt organizations from using the ratio method or gross-up method if they used volunteers in their lobbying activities. One commentator inquired whether an exempt organization that uses volunteers should account for the time of volunteers in allocating costs to lobbying activities.

The final regulations provide that all taxpayers may use the ratio method, but prohibit use of the gross-up method by a taxpayer (other than one subject to section 6033(e)) that does not pay or incur reasonable labor costs for its personnel engaged in lobbying. Moreover, tax-exempt organizations affected by the lobbying disallowance rules can use the gross-up method or the ratio method even if some of their lobbying activities are conducted by volunteers. Because volunteers are not taxpayers' personnel, time spent by volunteers is excluded from the taxpayer's lobbying labor hours and total labor hours (although the hours may be included in their employer's lobbying labor hours or total labor hours).

Under the proposed regulations, taxpayers who use the ratio method or the gross-up method must account for certain third-party costs. The proposed regulations define these third-party costs as amounts paid or incurred for lobbying activities conducted by third parties (such as amounts paid to lobbyists and dues that are allocable to lobbying expenditures) and amounts paid or incurred for travel and entertainment relating to lobbying activities.

Some commentators asked that the final regulations clarify that the lobbying-related travel and entertainment expenses of an employee of the taxpayer are not treated as third-party costs for either the ratio or gross-up method. The IRS and Treasury intend for taxpayers to account for employee travel and entertainment expenses separately as third-party costs under both methods. Thus, the final regulations do not adopt this recommendation. However, the final regulations clarify that if a cost defined as a third-party cost is allocable only partially to lobbying activities, then only that portion of the cost must be allocated to lobbying activities under the ratio method and gross-up method.

The proposed regulations provide a special *de minimis* rule for labor hours spent by personnel on lobbying activities. Under this *de minimis* rule, a taxpayer may treat time spent by personnel on lobbying activities as zero if less than five percent of the person's time is spent on lobbying activities.

The *de minimis* rule for labor hours does not apply to direct contact lobbying with legislators and covered executive branch officials. Thus, all hours spent by a person on direct contact lobbying as well as the hours that

person spends in connection with direct contact lobbying (such as background meetings) must be allocated to lobbying activities. For this purpose, an activity is direct contact lobbying if it is a meeting, telephone conversation, letter, or other similar means of communication with a legislator (other than a local legislator), or covered executive branch official (as defined in section 162(e)(6)) and otherwise qualifies as a lobbying activity.

Commentators requested that the *de minimis* percentage be increased and that the direct contact exception be eliminated. The final regulations do not adopt these recommendations. The final regulations do, however, clarify that the direct contact exception applies only to the individuals who make the direct contact, not to support personnel who engage in research, preparation, and other background activities but who do not make a direct contact.

Influencing Legislation—§1.162–29.

The proposed regulations provide definitions of *influencing legislation* and other terms necessary to apply the rules. In general, commentators approved of these definitions. The final regulations modify the definitions only to clarify their application. However, no substantive change is intended by these modifications.

Some commentators stated that the final regulations should distinguish between influencing legislation and educating legislators. The final regulations do not adopt this suggestion. The IRS and Treasury believe that the statute does not draw this distinction and neither should the regulations. Activities undertaken to educate a legislator may constitute influencing legislation under definitions in the final regulations. Further, the legislative history confirms that Congress did not intend to provide an exception for providing technical advice or assistance.

The proposed regulations provide that a lobbying communication is any communication that (1) refers to specific legislation and reflects a view on that legislation, or (2) clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication. The proposed regulations provide that the term *specific legislation* includes both legislation that has already been introduced in a

legislative body and a specific legislative proposal that the taxpayer either supports or opposes.

Several commentators stated that the phrase “reflects a view” should be defined to mean an explicit statement of support or opposition to legislative action. Some commentators also suggested that the regulations should make clear that a taxpayer is not reflecting a view on specific legislation if it presents a balanced analysis of the merits and defects of the legislation.

The final regulations do not adopt either of these recommendations. A taxpayer can reflect a view on specific legislation without specifically stating that it supports or opposes that legislation. Thus, as illustrated in §1.162–29(b)(2), *Example 8*, a taxpayer reflects a view on specific legislation even if the taxpayer does not explicitly state its support for, or opposition to, action by a legislative body. Moreover, a taxpayer’s balanced or technical analysis of legislation reflects a view on some aspect of the legislation and, thus, is a lobbying communication.

The proposed regulations do not contain a definition of the term “specific legislative proposal,” but do contain several examples to illustrate the scope of the term. For instance, in *Example 5* of §1.162–29(b)(2) of the proposed regulations, a taxpayer prepares a paper indicating that increased savings and local investment will spur the state economy. The taxpayer forwards a summary of the paper to legislators with a cover letter that states, in part:

You must take action to improve the availability of new capital in the state.

The example concludes that the taxpayer has not made a lobbying communication because neither the summary nor the cover letter refers to a specific legislative proposal.

In *Example 6* of that section, a taxpayer prepares a paper concerning the benefits of lowering the capital gains tax rate. The taxpayer forwards a summary of the paper to its representative in Congress with a cover letter that states, in part:

I urge you to support a reduction in the capital gains tax rate.

The example concludes that the taxpayer has made a lobbying communication because the communication refers

to and reflects a view on a specific legislative proposal.

Numerous commentators stated that they do not perceive a distinction between the two examples. In addition, certain commentators requested that the term “specific legislative proposal” be defined.

Whether a communication refers to a specific legislative proposal may vary with the context. The communication in *Example 5* is not sufficiently specific to be a specific legislative proposal, and no other facts and circumstances indicate the existence of a specific legislative proposal to which the communication refers. In *Example 6*, however, support is limited to a proposal for reduction of a particular tax rate. Although commentators suggested a number of definitions of the term “specific legislative proposal,” none was entirely satisfactory in capturing the full range of communications referred to in section 162(e)(4)(A). Thus, the final regulations do not adopt these suggestions.

The proposed regulations provide that an attempt to influence legislation means a lobbying communication and all activities such as research, preparation, and other background activities engaged in for a purpose of making or supporting a lobbying communication. The purpose or purposes for engaging in an activity are determined based on all the facts and circumstances.

The proposed regulations provide two presumptions concerning the purpose for engaging in an activity that is related to a lobbying communication. The first presumption provides that if an activity relating to a lobbying communication is engaged in for a nonlobbying purpose prior to the first taxable year preceding the taxable year in which the communication is made, the activity is presumed to be engaged in for all periods solely for that nonlobbying purpose (favorable presumption). Conversely, the second presumption provides that if an activity relating to a lobbying communication is engaged in during the taxable year in which the lobbying communication is made or the immediately preceding taxable year, the activity is presumed to be engaged in solely for a lobbying purpose (adverse presumption).

The adverse presumption was intended to prevent taxpayers from abusing an intent- or purpose-based rule by labelling their lobbying activities as

mere monitoring. On the other hand, the favorable presumption provides substantial certainty to taxpayers who engage in an activity for a nonlobbying purpose a sufficient time before a lobbying communication is made.

While commentators approved of the purpose test, many criticized the presumptions. Many commentators argued that the presumptions would create unreasonable recordkeeping burdens requiring detailed records concerning the purpose of a taxpayer's every activity. Several commentators also argued that the presumptions operated over too great a period of time and recommended that, if retained, they should apply to a period of 6 months or, alternatively, a calendar year. A number of commentators expressed a belief that the presumptions created a 2-year lookback recharacterizing activities as lobbying activities. Other commentators further argued that the presumptions used undefined terms and would be difficult to rebut.

Although the presumptions were intended as an aid in identifying activities that were more or less likely to be lobbying activities, the IRS and Treasury believe that the presumptions have been viewed by the commentators as undermining and complicating the purpose-based test. Therefore, the final regulations eliminate the presumptions, replacing them with a list of some of the facts and circumstances to be considered in determining whether an activity is engaged in for a lobbying purpose.

In addition, in response to various comments concerning the treatment of activities engaged in for the purpose of deciding to lobby, the final regulations clarify that the activity of deciding to lobby is to be treated in the same manner as research, preparation, and other background activities. Thus, a taxpayer who engages in the decision-making process may be treated as engaged in that activity for a lobbying purpose. This rule applies to a taxpayer who alone or as part of a group is deciding whether a lobbying communication should be made.

Under the proposed regulations, if a taxpayer engages in an activity for a lobbying purpose and for some nonlobbying purpose, the taxpayer must treat the activity as engaged in partially for a lobbying purpose and partially for a nonlobbying purpose (multiple-purpose rule). While many commentators approved of a facts and circumstances

analysis to determine whether a taxpayer engages in an activity for a lobbying purpose, some of these commentators thought that an activity should be subject to section 162(e)-(1)(A) only if the principal or primary purpose of the activity is to make or support a lobbying communication. According to these commentators, a principal or primary purpose rule would be easier to administer than the proposed multiple purpose rule. Several commentators noted that a principal or primary purpose test would eliminate the burden of dividing the costs of an activity among purposes under the proposed multiple-purpose rule.

The IRS and Treasury continue to believe that a principal or primary purpose test does not avoid the necessity of determining the various purposes for engaging in an activity and the relative importance of those purposes, and it has a substantial "cliff" effect. Therefore, the final regulations do not adopt a principal or primary purpose test.

The proposed regulations do not specify methods for accomplishing a reasonable cost allocation in the case of multiple purpose activities. Rather, the proposed regulations specify two methods that may not be appropriate. A taxpayer's treatment of multiple purpose activities will, in general, not result in a reasonable allocation if it allocates to influencing legislation (1) only the incremental amount of costs that would not have been incurred but for the lobbying purpose; or (2) an amount based on the number of purposes for engaging in that activity without regard to the relative importance of those purposes.

Some commentators requested additional guidance (by way of example) concerning how a taxpayer should determine the "relative importance" of purposes. In response to these comments, the final regulations are clarified to treat allocations based solely upon the number of purposes for engaging in an activity as generally not reasonable. The IRS and Treasury intend this change to indicate that an allocation based on the number of purposes may be reasonable if it reflects the relative importance of various purposes, even if the allocation is not precise. For instance, if a taxpayer engages in an activity for two purposes of substantially similar importance, treating the activity as engaged in 50 percent for each purpose is reasonable.

The final regulations provide special rules for activities engaged in for a lobbying purpose (including deciding to lobby) where the taxpayer later concludes that no lobbying communication will be made regarding that activity. Specifically, the final regulations treat these activities as if they had not been engaged in for a lobbying purpose if, as of the taxpayer's timely filed return, the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity. Thus, the taxpayer need not treat any amount allocated to that activity for that year under §1.162-28 as an amount to which section 162(e)(1)(A) applies. On the other hand, if the taxpayer reaches that conclusion at any time after the filing date, then the amount (not previously satisfying these special rules) allocated to that activity under §1.162-28 is treated as an amount that is paid or incurred only at that time and that is not subject to section 162(e)(1)(A). Thus, in effect, the taxpayer is treated as if it incurred the costs relating to that activity in that later year in connection with a nonlobbying activity. A special rule is provided for exempt organizations to which section 6033(e) applies, which permits those organizations to instead treat these amounts as reducing (but not below zero) their expenditures to which section 162(e)(1) applies beginning with that year and continuing for subsequent years to the extent not treated in prior years as reducing those expenditures.

The proposed regulations provide a special rule for so-called "paid volunteers." If, for the purpose of making or supporting a lobbying communication, one taxpayer uses the services or facilities of a second taxpayer and does not compensate the second taxpayer for the full cost of the services or facilities, the purpose and actions of the first taxpayer are imputed to the second taxpayer. Thus, for example, if a trade association uses the services of a member's employee, at no cost to the association, to conduct research or similar activities to support the trade association's lobbying communication, the trade association's purpose and actions are imputed to the member. As a result, the member is treated as influencing legislation with respect to the employee's work in support of the trade association's lobbying communication.

The IRS and Treasury intended the special imputation rule to deny a deduction for the amounts paid or incurred by a taxpayer participating in a group activity involving a lobbying purpose and a lobbying communication, even if the lobbying communication was made by a person other than the taxpayer. The final regulations clarify the rule. In addition, in response to commentators who requested clarification on when an employer must account for employee volunteer lobbying activities, the final regulations provide, by way of example, that if a taxpayer's employee not acting within the scope of employment volunteers to engage in activities influencing legislation, then the taxpayer is not influencing legislation.

Certain commentators have indicated that participation in the activities of government advisory bodies, such as federal advisory committees, should be exempt from section 162(e). Commentators argued that federal advisory committees provide information and advice to assist the federal government in matters it specifies, not to influence legislation.

The statutory term *influencing legislation* includes lobbying communications with government employees or officials who may participate in the formulation of legislation. Section 162(e) does not except lobbying communications made by participating in federal advisory committees. Further, the legislative history strongly suggests that no exceptions were intended other than for communications pursuant to subpoena or similar compulsion. Thus, participating in a federal advisory committee is influencing legislation if the purpose of the participant's activities is to make or support a lobbying communication, even if the lobbying communication is made by another participant or by the federal advisory committee as a whole.

The proposed regulations defining influencing legislation propose an effective date of May 13, 1994. Several commentators requested that the effective date of the final regulations be the date they are published or later. The final regulations on influencing legislation adopt this suggestion and are effective as of the date of publication, as are the final regulations on allocating costs to lobbying activities. Taxpayers must adopt a reasonable interpretation of section 162(e) for amounts paid or incurred prior to the effective date.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.162-20, paragraphs (c)(5) and (d) are added to read as follows:

§1.162-20 Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.

* * * * *

(c) * * *

(5) *Expenses paid or incurred after December 31, 1993, in connection with influencing legislation other than certain local legislation.* The provisions of paragraphs (c)(1) through (3) of this section are superseded for expenses paid or incurred after December 31, 1993, in connection with influencing legislation (other than certain local legislation) to the extent inconsistent with section 162(e)(1)(A) (as limited by section 162(e)(2)) and §§1.162-20(d) and 1.162-29.

(d) *Dues allocable to expenditures after 1993.* No deduction is allowed under section 162(a) for the portion of dues or other similar amounts paid by the taxpayer to an organization exempt

from tax (other than an organization described in section 501(c)(3)) which the organization notifies the taxpayer under section 6033(e)(1)(A)(ii) is allocable to expenditures to which section 162(e)(1) applies. The first sentence of this paragraph (d) applies to dues or other similar amounts whether or not paid on or before December 31, 1993. Section 1.162-20(c)(3) is superseded to the extent inconsistent with this paragraph (d).

§1.162-20T [Removed]

Par. 3. Section 1.162-20T is removed.

Par. 4. Section 1.162-28 is added to read as follows:

§1.162-28 Allocation of costs to lobbying activities.

(a) *Introduction—(1) In general.* Section 162(e)(1) denies a deduction for certain amounts paid or incurred in connection with activities described in section 162(e)(1)(A) and (D) (*lobbying activities*). To determine the nondeductible amount, a taxpayer must allocate costs to lobbying activities. This section describes costs that must be allocated to lobbying activities and prescribes rules permitting a taxpayer to use a reasonable method to allocate those costs. This section does not apply to taxpayers subject to section 162(e)-(5)(A). In addition, this section does not apply for purposes of sections 4911 and 4945 and the regulations thereunder.

(2) *Recordkeeping.* For recordkeeping requirements, see section 6001 and the regulations thereunder.

(b) *Reasonable method of allocating costs—(1) In general.* A taxpayer must use a reasonable method to allocate the costs described in paragraph (c) of this section to lobbying activities. A method is not reasonable unless it is applied consistently and is consistent with the special rules in paragraph (g) of this section. Except as provided in paragraph (b)(2) of this section, reasonable methods of allocating costs to lobbying activities include (but are not limited to)—

(i) The ratio method described in paragraph (d) of this section;

(ii) The gross-up method described in paragraph (e) of this section; and

(iii) A method that applies the principles of section 263A and the regula-

tions thereunder (see paragraph (f) of this section).

(2) *Taxpayers not permitted to use certain methods.* A taxpayer (other than one subject to section 6033(e)) that does not pay or incur reasonable labor costs for persons engaged in lobbying activities may not use the gross-up method. For example, a partnership or sole proprietorship in which the lobbying activities are performed by the owners who do not receive a salary or guaranteed payment for services does not pay or incur reasonable labor costs for persons engaged in those activities and may not use the gross-up method.

(c) *Costs allocable to lobbying activities—(1) In general.* Costs properly allocable to lobbying activities include labor costs and general and administrative costs.

(2) *Labor costs.* For each taxable year, labor costs include costs attributable to full-time, part-time, and contract employees. Labor costs include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan.

(3) *General and administrative*

costs. For each taxable year, general and administrative costs include depreciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting).

(d) *Ratio method—(1) In general.* Under the ratio method described in this paragraph (d), a taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and the costs determined by using the following formula:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \text{Total costs of operations.}$$

(2) *Lobbying labor hours.* Lobbying labor hours are the hours that a taxpayer's personnel spend on lobbying activities during the taxable year. A taxpayer may use any reasonable method to determine the number of labor hours spent on lobbying activities and may use the de minimis rule of paragraph (g)(1) of this section. A taxpayer may treat as zero the lobbying labor hours of personnel engaged in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities). Thus, for example, the hours spent on lobbying activities by paraprofessionals and analysts may not be treated as zero.

(3) *Total labor hours.* Total labor hours means the total number of hours that a taxpayer's personnel spend on a taxpayer's trade or business during the taxable year. A taxpayer may make reasonable assumptions concerning to-

tal hours spent by personnel on the taxpayer's trade or business. For example, it may be reasonable, based on all the facts and circumstances, to assume that all full-time personnel spend 1,800 hours per year on a taxpayer's trade or business. If, under paragraph (d)(2) of this section, a taxpayer treats as zero the lobbying labor hours of personnel engaged in secretarial, clerical, support, and other administrative activities, the taxpayer must also treat as zero the total labor hours of all personnel engaged in those activities.

(4) *Total costs of operations.* A taxpayer's total costs of operations means the total costs of the taxpayer's trade or business for a taxable year, excluding third-party costs (as defined in paragraph (d)(5) of this section).

(5) *Third-party costs.* Third-party costs are amounts paid or incurred in whole or in part for lobbying activities conducted by third parties (such as

amounts paid to taxpayers subject to section 162(e)(5)(A) or dues or other similar amounts that are not deductible in whole or in part under section 162(e)(3)) and amounts paid or incurred for travel (including meals and lodging while away from home) and entertainment relating in whole or in part to lobbying activities.

(6) *Example.* The provisions of this paragraph (d) are illustrated by the following example.

Example. (i) In 1996, three full-time employees, A, B, and C, of Taxpayer W engage in both lobbying activities and nonlobbying activities. A spends 300 hours, B spends 1,700 hours, and C spends 1,000 hours on lobbying activities, for a total of 3,000 hours spent on lobbying activities for W. W reasonably assumes that each of its three employees spends 2,000 hours a year on W's business.

(ii) W's total costs of operations are \$300,000. W has no third-party costs.

(iii) Under the ratio method, X allocates \$150,000 to its lobbying activities for 1996, as follows:

Lobbying labor hours	×	Total costs	+	Allocable	=	Costs allocable to
Total labor hours		of operations		third-party costs		lobbying activities
[300 + 1,700 + 1,000	×	\$300,000]	+	[0]	=	\$150,000.
6,000						

(e) *Gross-up method*—(1) *In general.* Under the gross-up method described in this paragraph (e)(1), the taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and 175 percent of its basic lobbying labor costs (as defined in paragraph (e)(3) of this section) of all personnel.

(2) *Alternative gross-up method.* Under the alternative gross-up method described in this paragraph (e)(2), the taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and 225 percent of its basic lobbying labor costs (as defined in paragraph (e)(3)), excluding the costs of person-

nel who engage in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities).

(3) *Basic lobbying labor costs.* For purposes of this paragraph (e), basic lobbying labor costs are the basic costs of lobbying labor hours (as defined in paragraph (d)(2) of this section) determined for the appropriate personnel. For purposes of this paragraph (e), basic costs of lobbying labor hours are wages or other similar costs of labor, including, for example, guaranteed payments for services. Basic costs do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs, or other similar costs.

(4) *Example.* The provisions of this paragraph (e) are illustrated by the following example.

Example. (i) In 1996, three employees, A, B, and C, of Taxpayer X engage in both lobbying activities and nonlobbying activities. A spends 300 hours, B spends 1,700 hours, and C spends 1,000 hours on lobbying activities.

(ii) X has no third-party costs.

(iii) For purposes of the gross-up method, X determines that its basic labor costs are \$20 per hour for A, \$30 per hour for B, and \$25 per hour for C. Thus, its basic lobbying labor costs are $(\$20 \times 300) + (\$30 \times 1,700) + (\$25 \times 1,000)$, or $(\$6,000 + \$51,000 + \$25,000)$, for total basic lobbying labor costs for 1996 of \$82,000.

(iv) Under the gross-up method, X allocates \$143,500 to its lobbying activities for 1996, as follows:

175%	×	Basic lobbying labor costs of all personnel	+	Allocable third-party costs	=	Costs allocable to lobbying activities
[175%	×	\$82,000]	+	[0]	=	\$143,500.

(f) *Section 263A cost allocation methods*—(1) *In general.* A taxpayer may allocate its costs to lobbying activities under the principles set forth in section 263A and the regulations thereunder, except to the extent inconsistent with paragraph (g) of this section. For this purpose, lobbying activities are considered a service department or function. Therefore, a taxpayer may allocate costs to lobbying activities by applying the methods provided in §§1.263A-1 through 1.263A-3. See §1.263A-1(e)(4), which describes service costs generally; §1.263A-1(f), which sets forth cost allocation methods available under section 263A; and §1.263A-1(g)(4), which provides methods of allocating service costs.

(2) *Example.* The provisions of this paragraph (f) are illustrated by the following example.

Example. (i) Three full-time employees, A, B, and C, work in the Washington office of Taxpayer Y, a manufacturing concern. They each engage in lobbying activities and nonlobbying activities. In 1996, A spends 75 hours, B spends 1,750 hours, and C spends 2,000 hours on lobbying activities. A's hours are not spent on direct contact lobbying as defined in paragraph (g)(2) of this section. All three work 2,000 hours during 1996. The Washington office also employs one secretary, D, who works exclusively for A, B, and C.

(ii) In addition, three departments in the corporate headquarters in Chicago benefit the Washington office: public affairs, human resources, and insurance.

(iii) Y is subject to section 263A and uses the step-allocation method to allocate its service costs. Prior to the amendments to section 162(e), the Washington office was treated as an overall management function for purposes of section 263A. As such, its costs were fully deductible and no further allocations were made under Y's

step allocation. Following the amendments to section 162(e), Y adopts its 263A step-allocation methodology to allocate costs to lobbying activities. Y adds a lobbying department to its step-allocation program, which results in an allocation of costs to the lobbying department from both the Washington office and the Chicago office.

(iv) Y develops a labor ratio to allocate its Washington office costs between the newly defined lobbying department and the overall management department. To determine the hours allocable to lobbying activities, Y uses the *de minimis* rule of paragraph (g)(1) of this section. Under this rule, A's hours spent on lobbying activities are treated as zero because less than 5 percent of A's time is spent on lobbying $(75/2,000 = 3.75\%)$. In addition, because D works exclusively for personnel engaged in lobbying activities, D's hours are not used to develop the allocation ratio. Y assumes that D's allocation of time follows the average time of all the personnel engaged in lobbying activities. Thus, Y's labor ratio is determined as follows:

<u>Employee</u>	<u>Lobbying Hours</u>	<u>Departments</u> <u>Overall Management Hours</u>	<u>Total Hours</u>
A	0	2,000	2,000
B	1,750	250	2,000
C	2,000	0	2,000
Totals	3,750	2,250	6,000
Lobbying Department Ratio	=	$\frac{3,750}{6,000}$	= 62.5%
Overall Management Department Ratio	=	$\frac{2,250}{6,000}$	= 37.5%

(v) In 1996, the Washington office has the following costs:

<u>Account</u>	<u>Amount</u>
Professional Salaries and Benefits	\$ 660,000
Clerical Salaries and Benefits	50,000
Rent Expense	100,000
Depreciation on Furniture and Equip.	40,000
Utilities	15,000
Outside Payroll Service	5,000
Miscellaneous	10,000
Third-Party Lobbying (Law Firm)	90,000
Total Washington Costs	\$ 970,000

(vi) In addition, \$233,800 of costs from the public affairs department, \$30,000 of costs from the insurance department, and \$5,000 of costs from the human resources department are allocable to the Washington office from departments in Chicago. Therefore, the Washington office costs are allocated to the Lobbying and Overall Management departments as follows:

Total Washington department costs from above	\$ 970,000	
Plus Costs Allocated from Other Departments	268,800	
Less third-party costs directly allocable to lobbying	(90,000)	
Total Washington office costs	\$1,148,800	
	<u>Lobbying Department</u>	<u>Overall Mgmt. Department</u>
Department Allocation Ratios	62.5%	37.5%
× Washington Office Costs	\$1,148,800	\$1,148,800
= Costs Allocated to Departments	\$ 718,000	\$ 430,800

(vii) Y's step-allocation for its Lobbying Department is determined as follows:

<u>Y's Step-Allocation</u>	<u>Lobbying Department</u>
Washington Costs Allocated To Lobbying Department	\$ 718,000
Plus Third-Party Costs	90,000
Total Costs of Lobbying Activities	\$ 808,000

(g) *Special rules.* The following rules apply to any reasonable method of allocating costs to lobbying activities.

(1) *De minimis rule for labor hours.* Subject to the exception provided in paragraph (g)(2) of this section, a taxpayer may treat time spent by an individual on lobbying activities as zero if less than five percent of the person's time is spent on lobbying activities. Reasonable methods must be used to determine if less than five percent of a person's time is spent on lobbying activities.

(2) *Direct contact lobbying labor hours.* Notwithstanding paragraph (g)(1) of this section, a taxpayer must

treat all hours spent by a person on direct contact lobbying (as well as the hours that person spends in connection with direct contact lobbying, including time spent traveling that is allocable to the direct contact lobbying) as labor hours allocable to lobbying activities. An activity is direct contact lobbying if it is a meeting, telephone conversation, letter, or other similar means of communication with a legislator (other than a local legislator) or covered executive branch official (as defined in section 162(e)(6)) and otherwise qualifies as a lobbying activity. A person who engages in research, preparation, and other background activities related to direct contact lobbying but who does

not make direct contact with a legislator or covered executive branch official is not engaged in direct contact lobbying.

(3) *Taxpayer defined.* For purposes of this section, a taxpayer includes a tax-exempt organization subject to section 6033(e).

(h) *Effective date.* This section is effective for amounts paid or incurred on or after July 21, 1995. Taxpayers must adopt a reasonable interpretation of sections 162(e)(1)(A) and (D) for amounts paid or incurred before this date.

Par. 5. Section 1.162-29 is added to read as follows:

§1.162-29 *Influencing legislation.*

(a) *Scope.* This section provides rules for determining whether an activity is influencing legislation for purposes of section 162(e)(1)(A). This section does not apply for purposes of sections 4911 and 4945 and the regulations thereunder.

(b) *Definitions.* For purposes of this section—

(1) *Influencing legislation.* Influencing legislation means—

(i) Any attempt to influence any legislation through a lobbying communication; and

(ii) All activities, such as research, preparation, planning, and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication, even if not yet made. See paragraph (c) of this section for rules for determining the purposes for engaging in an activity.

(2) *Attempt to influence legislation.* An attempt to influence any legislation through a lobbying communication is making the lobbying communication.

(3) *Lobbying communication.* A lobbying communication is any communication (other than any communication compelled by subpoena, or otherwise compelled by Federal or State law) with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that—

(i) Refers to specific legislation and reflects a view on that legislation; or

(ii) Clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.

(4) *Legislation.* Legislation includes any action with respect to Acts, bills, resolutions, or other similar items by a legislative body. Legislation includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

(5) *Specific legislation.* Specific legislation includes a specific legislative proposal that has not been introduced in a legislative body.

(6) *Legislative bodies.* Legislative bodies are Congress, state legislatures, and other similar governing bodies, excluding local councils (and similar

governing bodies), and executive, judicial, or administrative bodies. For this purpose, administrative bodies include school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive.

(7) *Examples.* The provisions of this paragraph (b) are illustrated by the following examples.

Example 1. Taxpayer P's employee, A, is assigned to approach members of Congress to gain their support for a pending bill. A drafts and P prints a position letter on the bill. P distributes the letter to members of Congress. Additionally, A personally contacts several members of Congress or their staffs to seek support for P's position on the bill. The letter and the personal contacts are lobbying communications. Therefore, P is influencing legislation.

Example 2. Taxpayer R is invited to provide testimony at a congressional oversight hearing concerning the implementation of The Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Specifically, the hearing concerns a proposed regulation increasing the threshold value of commercial and residential real estate transactions for which an appraisal by a state licensed or certified appraiser is required. In its testimony, R states that it is in favor of the proposed regulation. Because R does not refer to any specific legislation or reflect a view on any such legislation, R has not made a lobbying communication. Therefore, R is not influencing legislation.

Example 3. State X enacts a statute that requires the licensing of all day-care providers. Agency B in State X is charged with writing rules to implement the statute. After the enactment of the statute, Taxpayer S sends a letter to Agency B providing detailed proposed rules that S recommends Agency B adopt to implement the statute on licensing of day-care providers. Because the letter to Agency B neither refers to nor reflects a view on any specific legislation, it is not a lobbying communication. Therefore, S is not influencing legislation.

Example 4. Taxpayer T proposes to a State Park Authority that it purchase a particular tract of land for a new park. Even if T's proposal would necessarily require the State Park Authority eventually to seek appropriations to acquire the land and develop the new park, T has not made a lobbying communication because there has been no reference to, nor any view reflected on, any specific legislation. Therefore, T's proposal is not influencing legislation.

Example 5. (i) Taxpayer U prepares a paper that asserts that lack of new capital is hurting State X's economy. The paper indicates that State X residents either should invest more in local businesses or increase their savings so that funds will be available to others interested in making investments. U forwards a summary of the unpublished paper to legislators in State X with a cover letter that states in part:

You must take action to improve the availability of new capital in the state.

(ii) Because neither the summary nor the cover letter refers to any specific legislative proposal and no other facts or circumstances indicate that they refer to an existing legislative

proposal, forwarding the summary to legislators in State X is not a lobbying communication. Therefore, U is not influencing legislation.

(iii) Q, a member of the legislature of State X, calls U to request a copy of the unpublished paper from which the summary was prepared. U forwards the paper with a cover letter that simply refers to the enclosed materials. Because U's letter to Q and the unpublished paper do not refer to any specific legislation or reflect a view on any such legislation, the letter is not a lobbying communication. Therefore, U is not influencing legislation.

Example 6. (i) Taxpayer V prepares a paper that asserts that lack of new capital is hurting the national economy. The paper indicates that lowering the capital gains rate would increase the availability of capital and increase tax receipts from the capital gains tax. V forwards the paper to its representatives in Congress with a cover letter that says, in part:

I urge you to support a reduction in the capital gains tax rate.

(ii) V's communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal (*i.e.*, lowering the capital gains rate). Therefore, V is influencing legislation.

Example 7. Taxpayer W, based in State A, notes in a letter to a legislator of State A that State X has passed a bill that accomplishes a stated purpose and then says that State A should pass such a bill. No such bill has been introduced into the State A legislature. The communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal. Therefore, W is influencing legislation.

Example 8. (i) Taxpayer Y represents citrus fruit growers. Y writes a letter to a United States senator discussing how pesticide O has benefited citrus fruit growers and disputing problems linked to its use. The letter discusses a bill pending in Congress and states in part:

This bill would prohibit the use of pesticide O. If citrus growers are unable to use this pesticide, their crop yields will be severely reduced, leading to higher prices for consumers and lower profits, even bankruptcy, for growers.

(ii) Y's views on the bill are reflected in this statement. Thus, the communication is a lobbying communication, and Y is influencing legislation.

Example 9. (i) B, the president of Taxpayer Z, an insurance company, meets with Q, who chairs the X state legislature's committee with jurisdiction over laws regulating insurance companies, to discuss the possibility of legislation to address current problems with surplus-line companies. B recommends that legislation be introduced that would create minimum capital and surplus requirements for surplus-line companies and create clearer guidelines concerning the risks that surplus-line companies can insure. B's discussion with Q is a lobbying communication because B refers to and reflects a view on a specific legislative proposal. Therefore, Z is influencing legislation.

(ii) Q is not convinced that the market for surplus-line companies is substantial enough to warrant such legislation and requests that B provide information on the amount and types of risks covered by surplus-line companies. After the meeting, B has employees of Z prepare

estimates of the percentage of property and casualty insurance risks handled by surplus-line companies. B sends the estimates with a cover letter that simply refers to the enclosed materials. Although B's follow-up letter to Q does not refer to specific legislation or reflect a view on such legislation, B's letter supports the views reflected in the earlier communication. Therefore, the letter is a lobbying communication and Z is influencing legislation.

(c) *Purpose for engaging in an activity*—(1) *In general.* The purposes for engaging in an activity are determined based on all the facts and circumstances. Facts and circumstances include, but are not limited to—

(i) Whether the activity and the lobbying communication are proximate in time;

(ii) Whether the activity and the lobbying communication relate to similar subject matter;

(iii) Whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication;

(iv) Whether the results of the activity are also used for a nonlobbying purpose; and

(v) Whether, at the time the taxpayer engages in the activity, there is specific legislation to which the activity relates.

(2) *Multiple purposes.* If a taxpayer engages in an activity both for the purpose of making or supporting a lobbying communication and for some nonlobbying purpose, the taxpayer must treat the activity as engaged in partially for a lobbying purpose and partially for a nonlobbying purpose. This division of the activity must result in a reasonable allocation of costs to influencing legislation. See §1.162-28 (allocation rules for certain expenditures to which section 162(e)(1) applies). A taxpayer's treatment of these multiple-purpose activities will, in general, not result in a reasonable allocation if it allocates to influencing legislation—

(i) Only the incremental amount of costs that would not have been incurred but for the lobbying purpose; or

(ii) An amount based solely on the number of purposes for engaging in that activity without regard to the relative importance of those purposes.

(3) *Activities treated as having no purpose to influence legislation.* A taxpayer that engages in any of the following activities is treated as having done so without a purpose of making or supporting a lobbying communication—

(i) Before evidencing a purpose to influence any specific legislation referred to in paragraph (c)(3)(i)(A) or (B) of this section (or similar legislation)—

(A) Determining the existence or procedural status of specific legislation, or the time, place, and subject of any hearing to be held by a legislative body with respect to specific legislation; or

(B) Preparing routine, brief summaries of the provisions of specific legislation;

(ii) Performing an activity for purposes of complying with the requirements of any law (for example, satisfying state or federal securities law filing requirements);

(iii) Reading any publications available to the general public or viewing or listening to other mass media communications; and

(iv) Merely attending a widely attended speech.

(4) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples.

Example 1. (i) *Facts.* In 1997, Agency F issues proposed regulations relating to the business of Taxpayer W. There is no specific legislation during 1997 that is similar to the regulatory proposal. W undertakes a study of the impact of the proposed regulations on its business. W incorporates the results of that study in comments sent to Agency F in 1997. In 1998, legislation is introduced in Congress that is similar to the regulatory proposal. Also in 1998, W writes a letter to Senator P stating that it opposes the proposed legislation. W encloses with the letter a copy of the comments it sent to Agency F.

(ii) *Analysis.* W's letter to Senator P refers to and reflects a view on specific legislation and therefore is a lobbying communication. Although W's study of the impact of the proposed regulations is proximate in time and similar in subject matter to its lobbying communication, W performed the study and incorporated the results in comments sent to Agency F when no legislation with a similar subject matter was pending (a nonlobbying use). On these facts, W engaged in the study solely for a nonlobbying purpose.

Example 2. (i) *Facts.* The governor of State Q proposes a budget that includes a proposed sales tax on electricity. Using its records of electricity consumption, Taxpayer Y estimates the additional costs that the budget proposal would impose upon its business. In the same year, Y writes to members of the state legislature and explains that it opposes the proposed sales tax. In its letter, Y includes its estimate of the costs that the sales tax would impose on its business. Y does not demonstrate any other use of its estimates.

(ii) *Analysis.* The letter is a lobbying communication (because it refers to and reflects a view on specific legislation, the governor's proposed budget). Y's estimate of additional

costs under the proposal supports the lobbying communication, is proximate in time and similar in subject matter to a specific legislative proposal then in existence, and is not used for a nonlobbying purpose. Based on these facts, Y estimated its additional costs under the budget proposal solely to support the lobbying communication.

Example 3. (i) *Facts.* A senator in the State Q legislature announces her intention to introduce legislation to require health insurers to cover a particular medical procedure in all policies sold in the state. Taxpayer Y has different policies for two groups of employees, one of which covers the procedure and one of which does not. After the bill is introduced, Y's legislative affairs staff asks Y's human resources staff to estimate the additional cost to cover the procedure for both groups of employees. Y's human resources staff prepares a study estimating Y's increased costs and forwards it to the legislative affairs staff. Y's legislative staff then writes to members of the state legislature and explains that it opposes the proposed change in insurance coverage based on the study. Y's legislative affairs staff thereafter forwards the study, prepared for its use in opposing the statutory proposal, to its labor relations staff for use in negotiations with employees scheduled to begin later in the year.

(ii) *Analysis.* The letter to legislators is a lobbying communication (because it refers to and reflects a view on specific legislation). The activity of estimating Y's additional costs under the proposed legislation relate to the same subject as the lobbying communication, occurs close in time to the lobbying communication, is conducted at the request of a person making a lobbying communication, and relates to specific legislation then in existence. Although Y used the study in its labor negotiations, mere use for that purpose does not establish that Y estimated its additional costs under the proposed legislation in part for a nonlobbying purpose. Thus, based on all the facts and circumstances, Y estimated the additional costs it would incur under the proposal solely to make or support the lobbying communication.

Example 4. (i) *Facts.* After several years of developmental work under various contracts, in 1996, Taxpayer A contracts with the Department of Defense (DOD) to produce a prototype of a new generation military aircraft. A is aware that DOD will be able to fund the contract only if Congress appropriates an amount for that purpose in the upcoming appropriations process. In 1997, A conducts simulation tests of the aircraft and revises the specifications of the aircraft's expected performance capabilities, as required under the contract. A submits the results of the tests and the revised specifications to DOD. In 1998, Congress considers legislation to appropriate funds for the contract. In that connection, A summarizes the results of the simulation tests and of the aircraft's expected performance capabilities, and submits the summary to interested members of Congress with a cover letter that encourages them to support appropriations of funds for the contract.

(ii) *Analysis.* The letter is a lobbying communication (because it refers to specific legislation (*i.e.*, appropriations) and requests passage). The described activities in 1996, 1997, and 1998 relate to the same subject as the lobbying communication. The summary was prepared specifically for, and close in time to, that communication. Based on these facts, the summary was prepared solely for a lobbying purpose. In contrast, A conducted the tests and revised the

specifications to comply with its production contract with DOD. A conducted the tests and revised the specifications solely for a nonlobbying purpose.

Example 5. (i) Facts. C, president of Taxpayer W, travels to the state capital to attend a two-day conference on new manufacturing processes. C plans to spend a third day in the capital meeting with state legislators to explain why W opposes a pending bill unrelated to the subject of the conference. At the meetings with the legislators, C makes lobbying communications by referring to and reflecting a view on the pending bill.

(ii) Analysis. C's traveling expenses (transportation and meals and lodging) are partially for the purpose of making or supporting the lobbying communications and partially for a nonlobbying purpose. As a result, under paragraph (c)(2) of this section, W must reasonably allocate C's traveling expenses between these two purposes. Allocating to influencing legislation only C's incremental transportation expenses (*i.e.*, the taxi fare to meet with the state legislators) does not result in a reasonable allocation of traveling expenses.

Example 6. (i) Facts. On February 1, 1997, a bill is introduced in Congress that would affect Company E. Employees in E's legislative affairs department, as is customary, prepare a brief summary of the bill and periodically confirm the procedural status of the bill through conversations with employees and members of Congress. On March 31, 1997, the head of E's legislative affairs department meets with E's President to request that B, a chemist, temporarily help the legislative affairs department analyze the bill. The President agrees, and suggests that B also be assigned to draft a position letter in opposition to the bill. Employees of the legislative affairs department continue to confirm periodically the procedural status of the bill. On October 31, 1997, B's position letter in opposition to the bill is delivered to members of Congress.

(ii) Analysis. B's letter is a lobbying communication because it refers to and reflects a view on specific legislation. Under paragraph (c)(3)(i) of this section, the assignment of B to assist the legislative affairs department in analyzing the bill and in drafting a position letter in opposition to the bill evidences a purpose to influence legislation. Neither the activity of periodically confirming the procedural status of the bill nor the activity of preparing the routine, brief summary of the bill before March 31 constitutes influencing legislation. In contrast, periodically confirming the procedural status of the bill on or after March 31 relates to the same subject as, and is close in time to, the lobbying communication and is used for no nonlobbying purpose. Consequently, after March 31, E determined the procedural status of the bill for the purpose of supporting the lobbying communication by B.

(d) Lobbying communication made by another. If a taxpayer engages in activities for a purpose of supporting a lobbying communication to be made by another person (or by a group of persons), the taxpayer's activities are treated under paragraph (b) of this section as influencing legislation. For example, if a taxpayer or an employee of the taxpayer (as a volunteer or otherwise) engages in an activity to

assist a trade association in preparing its lobbying communication, the taxpayer's activities are influencing legislation even if the lobbying communication is made by the trade association and not the taxpayer. If, however, the taxpayer's employee, acting outside the employee's scope of employment, volunteers to engage in those activities, then the taxpayer is not influencing legislation.

(e) No lobbying communication. Paragraph (e) of this section applies if a taxpayer engages in an activity for a purpose of making or supporting a lobbying communication, but no lobbying communication that the activity supports has yet been made.

(1) Before the filing date. Under this paragraph (e)(1), if on the filing date of the return for any taxable year the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity, then the taxpayer will be treated as if it did not engage in the activity for a purpose of making or supporting a lobbying communication. Thus, the taxpayer need not treat any amount allocated to that activity for that year under §1.162-28 as an amount to which section 162(e)(1)(A) applies. The filing date for purposes of paragraph (e) of this section is the earlier of the time the taxpayer files its timely return for the year or the due date of the timely return.

(2) After the filing date—(i) In general. If, at any time after the filing date, the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity, then any amount previously allocated under §1.162-28 to the activity and disallowed under section 162(e)(1)(A) is treated as an amount that is not subject to section 162(e)(1)(A) and that is paid or incurred only at the time the taxpayer no longer expects that a lobbying communication will be made.

(ii) Special rule for certain tax-exempt organizations. For a tax-exempt organization subject to section 6033(e), the amounts described in paragraph (e)(2)(i) of this section are treated as reducing (but not below zero) its expenditures to which section 162(e)(1) applies beginning with that year and continuing for subsequent years to the extent not treated in prior years as reducing those expenditures.

(f) Anti-avoidance rule. If a taxpayer, alone or with others, structures its activities with a principal purpose of achieving results that are unreasonable in light of the purposes of section 162(e)(1)(A) and section 6033(e), the Commissioner can recast the taxpayer's activities for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of section 162(e)(1)(A), section 6033(e) (if applicable), and this section, and the pertinent facts and circumstances.

(g) Taxpayer defined. For purposes of this section, a taxpayer includes a tax-exempt organization subject to section 6033(e).

(h) Effective date. This section is effective for amounts paid or incurred on or after July 21, 1995. Taxpayers must adopt a reasonable interpretation of section 162(e)(1)(A) for amounts paid or incurred before this date.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved June 29, 1995.

Leslie Samuels,
*Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on July 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 21, 1995, 60 F.R. 37568)

26 CFR 1.162-20: Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.

Guidance is provided to organizations exempt from taxation under § 501(a) of the Code on the application of amendments made to §§ 162(e) and 6033(e) by § 13222 of the Omnibus Budget Reconciliation Act of 1993. The procedure identifies certain tax-exempt organizations that will be treated as satisfying the requirements of § 6033(e)(3). Those organizations will not be subject to the reporting and notice requirements of § 6033(e)(1) or the tax imposed by § 6033(e)(2). Procedures for other exempt organizations to establish that they satisfy the requirements of § 6033(e)(3) are also provided. See Rev. Proc. 95-35, page 391.

Section 167.—Depreciation

26 CFR 1.167(e)-1: Change in method.

If a taxpayer changes the method of computing the depreciation allowance for consumer durable property subject to rent-to-own contracts as

described in Rev. Proc. 95-38, this Bulletin, is this change a change in method of accounting? See Rev. Rul. 95-52, on this page.

Section 168.—Accelerated Cost Recovery System

(Also §§ 167, 446; 1.167(e)-1, 1.446-1.)

Depreciation; leased consumer durable property. Depreciation is determined under section 168 of the Code, and not under the income forecast method, for consumer durable property subject to rent-to-own contracts as described in Rev. Proc. 95-38 in this Bulletin.

Rev. Rul. 95-52

ISSUE

How is the depreciation allowance determined for consumer durable property subject to rent-to-own contracts as described in Rev. Proc. 95-38, this Bulletin?

FACTS

The taxpayer is a rent-to-own dealer engaged in transactions with the general public involving consumer durable property subject to rent-to-own contracts as described in Rev. Proc. 95-38. These rent-to-own contracts are treated as leases (not as sales) for federal income tax purposes.

LAW AND ANALYSIS

Section 167(a) of the Internal Revenue Code provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, and wear and tear (including a reasonable allowance for obsolescence) of property used in the trade or business, or held for the production of income. Section 168(a) provides that, except as otherwise provided in this section, the depreciation deduction provided by § 167(a) for any tangible property shall be determined by using the applicable depreciation method, recovery period, and convention.

For purposes of § 168, the recovery period of depreciable personal property generally is based on the property's class life. Section 168(i)(1) defines the term "class life" as meaning the class life (if any) that would be applicable with respect to any property as of

January 1, 1986, under § 167(m) (determined without regard to § 167(m)(4) and as if the taxpayer had made an election under § 167(m)) as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990. These class lives are currently set forth in Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785.

The business activity of leasing consumer durable property is described in asset class 57.0, Distributive Trades and Services, of Rev. Proc. 87-56. As a result, this property has a class life of 9 years and is treated as 5-year property pursuant to § 168(e)(1). Thus, for consumer durable property subject to rent-to-own contracts as described under Rev. Proc. 95-38, the recovery period is 5 years for purposes of § 168(c)(1) and 9 years for purposes of § 168(g).

Under certain circumstances, property is depreciated under methods not described in § 168. Section 168 does not apply to any property if: (1) a taxpayer elects under § 168(f)(1) to exclude the property from the application of § 168; and (2) for the first taxable year for which a depreciation deduction would be allowable for the property in the hands of the taxpayer, the property is properly depreciated under the unit-of-production method or any method of depreciation not expressed in a term of years (other than the retirement-replacement-betterment method or similar method). The income forecast method is a method of depreciation not expressed in a term of years.

Rev. Rul. 60-358, 1960-2 C.B. 68, as amplified by Rev. Rul. 64-273, 1964-2 C.B. 62, and Rev. Rul. 79-285, 1979-2 C.B. 91, allowed the use of the income forecast method for television and movie films, taped shows for reproduction, book manuscripts, patents, master recordings, and other property of a similar character. These assets of an artistic or creative character generate uneven flows of income and have unique income-producing potential. As a consequence, the passage of time generally is not an appropriate measure of the useful life of this property. For example, if a television film series is a success, additional income will be forthcoming from reruns over a period of years, but an unsuccessful film series may produce little or no income after the initial exhibition. Rev. Rul. 60-358, 1960-2 C.B. at 68.

The useful life of consumer durable property (whether or not subject to a rent-to-own contract) is appropriately measured by the passage of time and not by the income produced. Consumer durable property does not generate income in a manner similar to that of television and movie films and other property for which the income forecast method is allowed. See *ABC Rentals of San Antonio, Inc. v. Commissioner*, T.C.M. 1994-601, appeals docketed, *ABC Rentals of San Antonio, Inc. v. Commissioner*, No. 95-9008 (10th Cir. May 16, 1995), and *El Charro TV Rental, Inc. v. Commissioner*, No. 95-60301 (5th Cir. May 16, 1995) (the § 168(f)(1) election out of § 168 is not available to consumer durable property leased under rent-to-own contracts because the property is not of a character properly depreciable under the income forecast method); see also *Carland, Inc. v. Commissioner*, 90 T.C. 505 (1988), *aff'd on this issue*, 909 F.2d 1101 (8th Cir. 1990) (certain leased equipment, such as railroad rolling stock, not of a character properly depreciable under the income forecast method). Accordingly, consumer durable property is not properly depreciated under the income forecast method or any other method not expressed in a term of years, and a taxpayer may not elect under § 168(f)(1) to exclude this property from the application of § 168.

HOLDING

The depreciation allowance for consumer durable property subject to rent-to-own contracts as described under Rev. Proc. 95-38 must be determined under § 168. This property is included in asset class 57.0, Distributive Trades and Services, of Rev. Proc. 87-56 and, consequently, is treated as 5-year property under § 168 (e)(1). The recovery period is 5 years for purposes of § 168(c)(1) and 9 years for purposes of § 168(g). The income forecast method of depreciation is not a permissible method of depreciation for consumer durable property subject to rent-to-own contracts as described under Rev. Proc. 95-38.

CHANGE IN ACCOUNTING METHOD

Pursuant to § 1.167(e)-1(a), any change in the method of computing the depreciation allowance for consumer durable property subject to rent-to-own

contracts as described in Rev. Proc. 95-38 is a change in method of accounting, and will be permitted only with the consent of the Commissioner. This change in method of accounting is a change to which §§ 446(e) and 481 apply, and must be made in accordance with Rev. Proc. 92-20, 1992-1 C.B. 685.

Section 170.—Charitable, etc., Contributions and Gifts

26 CFR 1.170-1: Charitable, etc., contributions and gifts; allowance of deductions.

The Service is providing inflation adjustments to the "insubstantial benefit" guidelines for calendar year 1996. Under the guidelines, a charitable contribution is fully deductible even though the contributor receives benefits ("insubstantial benefits") from the charity. See Rev. Proc. 95-53, page 445.

26 CFR 1.170A-13: Recordkeeping and return requirements for deductions for charitable contributions.

T.D. 8623

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Substantiation Requirement for Certain Contributions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations that provide guidance regarding the substantiation requirements for charitable contributions of \$250 or more contained in section 170(f)(8) of the Internal Revenue Code. The guidance contained in these final regulations will affect organizations described in section 170(c) and individuals and entities that make payments to those organizations.

EFFECTIVE DATE: January 1, 1994.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has

been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1431. Responses to this collection of information are required to substantiate deductions under section 170 of the Internal Revenue Code for certain charitable contributions. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection displays a valid control number.

The estimated burden per record-keeper varies from 15 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 25 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attention: IRS Reports Clearance Officer, T:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington DC 20503.

Books or records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) relating to the substantiation requirements under section 170(f)(8) of the Internal Revenue Code of 1986. Section 170(f)(8) was added by section 13172 of the Omnibus Budget Reconciliation Act of 1993, Public Law 103-66 (107 Stat. 455, 1993-3 C.B. 43).

Temporary regulations (TD 8544 [1994-2 C.B. 28]) and a notice of proposed rulemaking by cross-reference to temporary regulations under section 170(f)(8) were published in the Federal Register for May 27, 1994 (59 FR 27458, 27515). The regulations primarily address the substantiation of contributions made by payroll deduction and the substantiation of a payment to a donee organization in exchange for goods or services with insubstantial value.

A public hearing was held on November 10, 1994. On March 22, 1995, the IRS released Notice 95-15, which was published in 1995-15 I.R.B. 22, dated April 10, 1995. Notice 95-15 provides transitional relief (for 1994) from the substantiation requirement of section 170(f)(8).

After consideration of the public comments regarding the proposed regulations, the regulations are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation of Statutory Provisions

Section 170 allows a deduction for certain charitable contributions to or for the use of an organization described in section 170(c). Under section 170(f)(8), taxpayers who claim a deduction for a charitable contribution of \$250 or more must obtain substantiation of that contribution from the donee organization and maintain the substantiation in their records. See H.R. Conf. Rep. 213, 103d Cong., 1st Sess. 565 (1993). Specifically, section 170(f)(8)(A) provides that no charitable contribution deduction will be allowed under section 170(a) for a contribution of \$250 or more unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment from the donee organization.

Section 170(f)(8)(B) provides that an acknowledgment meets the requirements of section 170(f)(8)(A) if it includes the following information: (a) the amount of cash and a description (but not necessarily the value) of any property other than cash contributed; (b) whether or not the donee organization provided any goods or services in consideration for the cash or other property contributed; and (c) a description and good faith estimate of the value of any goods or services provided by the donee organization in consideration for the cash or other property contributed, or if the goods or services consist solely of intangible religious benefits, a statement to that effect.

Under section 170(f)(8)(C), a written acknowledgment is contemporaneous, for purposes of section 170(f)(8)(A), if it is obtained on or before the earlier of: (a) the date the taxpayer files its original return for the taxable year in which the contribution was made, or (b) the due date, including extensions,

for filing the taxpayer's original return for that year.

Section 170(f)(8)(E) directs the Secretary to prescribe such regulations as are necessary or appropriate to carry out the purposes of section 170(f)(8), including regulations that may provide that some or all of the requirements of section 170(f)(8) do not apply in appropriate cases.

Public Comments

Contributions Made by Payroll Deduction

The proposed regulations permit a taxpayer to substantiate contributions made by payroll deduction by a combination of two documents: (a) a pay stub, Form W-2, or other document furnished by the taxpayer's employer that evidences the amount withheld from the taxpayer's wages, and (b) a pledge card or other document prepared by the donee organization that states that the donee organization did not provide any goods or services as whole or partial consideration for any contributions made by payroll deduction.

Commentators reported that pledge cards are frequently prepared by employers at the direction of the donee organization. They suggested that the IRS accept pledge cards with the required language if the pledge cards are prepared either by the employer or by the donee organization. In response to this suggestion, these final regulations provide that pledge cards prepared by the donee organization or by another party at the donee organization's direction can be used as part of the substantiation for a contribution made by payroll deduction.

Commentators asked whether a Form W-2 that reflects the total amount contributed by payroll deduction, but does not separately list each contribution of \$250 or more, can be used as evidence of the amount withheld from the employee's wages to be paid to the donee organization. Section 170(f)(8)(B) provides that an acknowledgment must reflect the amount of cash and a description of property other than cash contributed to the charitable organization. When a taxpayer makes multiple contributions to a charitable organization, the statute does not require the acknowledgment to list each contribution separately. Consequently, an acknowledgment provided for purposes of

section 170(f)(8) may substantiate multiple contributions with a statement of the total amount contributed by a taxpayer during the year, rather than an itemized list of separate contributions. Therefore, a Form W-2 reflecting an employee's total annual contribution, without separately listing the amount of each contribution, can be used as evidence of the amount withheld from the employee's wages. Because the statute does not require an itemized acknowledgment, it was unnecessary to clarify the proposed regulations to address this concern.

Commentators also asked whether the donee organization must use any particular wording on the pledge card or other document prepared for purposes of substantiating a charitable contribution made by payroll deduction. Because the IRS and the Treasury Department do not believe that any particular wording is required, these final regulations clarify that the pledge card or other document is only required to include a statement to the effect that no goods or services were provided in consideration for the contribution made by the payroll deduction.

Commentators asked for guidance regarding the proper method of substantiating lump-sum contributions made by employees through their employers other than by payroll withholding. Commentators stated that employees occasionally make contributions in the form of checks payable to their employer, who then deposits the checks in an employer account and sends the donee organization a single check drawn on the employer account. When employees' payments are transferred to a donee organization in this manner, it is difficult for the organization to identify the persons who made contributions, and thus the employees may be unable to obtain the requisite substantiation. These difficulties can be eliminated if the employees' contribution checks are made payable to the donee organization and the employer simply forwards the employees' checks to the donee organization. The donee organization can then provide substantiation as it would for any individual contribution made by check. Therefore, the final regulations have not been modified to address this point.

Goods or Services with Insubstantial Value

The proposed regulations provide that goods or services that have insub-

stantial value under the guidelines provided in Rev. Proc. 90-12 (1990-1 C.B. 471), and Rev. Proc. 92-49 (1992-1 C.B. 987), and any successor documents, are not required to be taken into account for purposes of section 170(f)(8). The IRS re-proposed this provision in proposed regulations under section 170(f)(8) that were published in the Federal Register for August 4, 1995 (60 FR 39896), and it has therefore been deleted from these final regulations. Taxpayers may rely on those proposed regulations for payments made on or after January 1, 1994.

Additional Comments Addressed in Proposed Regulations Published in the Federal Register for August 4, 1995

Commentators raised a number of other questions about the substantiation regulations, including the following: (a) whether, in calculating a charitable contribution deduction, a donor can rely on a donee organization's estimate of the fair market value of any quid pro quo provided to the donor, (b) how certain types of benefits provided to a donor are to be valued, (c) how the fair market value of goods or services sold at a charity auction can be established, (d) how goods or services are to be treated when provided to a donor who has no expectation of receiving a quid pro quo, (e) how unreimbursed out-of-pocket expenses incurred by a taxpayer incident to the rendition of services to a donee organization can be substantiated, and (f) how certain transfers to a charitable remainder trust can be substantiated. The proposed regulations published August 4, 1995, address these questions, as explained in the preamble to those proposed regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submit-

ted to the Small Business Administration for comment on its impact on small business.

* * * * *

Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for 1.170A-13T and the general authority continues to read as follows:

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

Par. 2. In §1.170A-13, paragraph (e) is added and reserved and paragraph (f) is added to read as follows:

§1.170A-13 Recordkeeping and return requirements for deductions for charitable contributions.

* * * * *

(e) [Reserved]

(f) *Substantiation of charitable contributions of \$250 or more.*

(1) through (10) [Reserved]

(11) *Contributions made by payroll deduction—(i) Form of substantiation.* A contribution made by means of withholding from a taxpayer's wages and payment by the taxpayer's employer to a donee organization may be substantiated, for purposes of section 170(f)(8), by both—

(A) A pay stub, Form W-2, or other document furnished by the employer that sets forth the amount withheld by the employer for the purpose of payment to a donee organization; and

(B) A pledge card or other document prepared by or at the direction of the donee organization that includes a statement to the effect that the organization does not provide goods or services in whole or partial consideration for any contributions made to the organization by payroll deduction.

(ii) *Application of \$250 threshold.* For the purpose of applying the \$250 threshold provided in section 170(f)(8)(A) to contributions made by the means described in paragraph (f)(11)(i) of this section, the amount withheld from each payment of wages to a taxpayer is treated as a separate contribution.

(12) *Distributing organizations as donees.* An organization described in

section 170(c), or an organization described in 5 CFR 950.105 (a Principal Combined Fund Organization for purposes of the Combined Federal Campaign) and acting in that capacity, that receives a payment made as a contribution is treated as a donee organization solely for purposes of section 170(f)(8), even if the organization (pursuant to the donor's instructions or otherwise) distributes the amount received to one or more organizations described in section 170(c). This paragraph (f)(12) does not apply, however, to a case in which the distributee organization provides goods or services as part of a transaction structured with a view to avoid taking the goods or services into account in determining the amount of the deduction to which the donor is entitled under section 170.

(13) through (15) [Reserved]

(16) *Effective date.* Paragraphs (f)(11) and (12) of this section apply to contributions made on or after January 1, 1994.

§1.170A-13T [Removed]

Par. 3. Section 1.170A-13T is removed.

Part 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (c) is amended by removing the entry for 1.170A-13T from the table and revising the entry for 1.170A-13 to read as follows:

CFR part or section where identified and described	Current OMB control number
* * * * *	
1.170A-13	1545-0074 1545-0754 1545-0908 1545-1431
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved September 22, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 11, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 12, 1995, 60 F.R. 53126)

Section 179A.—Deduction for Clean-Fuel Vehicles and Certain Refueling Property

26 CFR 1.179A-1: Recapture of deduction for qualified clean-fuel vehicle property and qualified clean-fuel vehicle refueling property.

Final regulations on the definition of a qualified electric vehicle, the recapture of any credit allowable for qualified electric vehicle, and the recapture of any deduction allowable for qualified clean-fuel vehicle property or qualified clean-fuel vehicle refueling property. See T.D. 8606, page 3.

Part IX.—Items Not Deductible

Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

26 CFR 1.263A-1: Uniform capitalization of costs.

How may certain "small resellers," "formerly small resellers," or "reseller-producers" change their method of accounting for costs subject to § 263A of the Code? See Rev. Proc. 95-33, page 380.

Section 264.—Certain Amounts Paid in Connection with Insurance Contracts

26 CFR 1.264-2: Single premium life insurance, endowment, or annuity contracts.

Annuity; mortgage; interest deduction. If a taxpayer uses a single premium annuity contract as collateral to obtain or continue a mortgage loan, section 264(a) of the Code disallows the allocable amount of interest on the loan to the extent the loan is collateralized by the annuity contract. Rev. Rul. 79-41 clarified and superseded.

Rev. Rul. 95-53

ISSUE

If a taxpayer uses a single premium annuity contract as collateral to obtain

or continue a mortgage loan, does section 264(a)(2) of the Internal Revenue Code disallow an allocable amount of interest on the loan to the extent the loan is collateralized by the annuity contract?

FACTS

A, an individual, purchases a principal residence for \$100,000 and purchases a single premium annuity contract for \$15,000. A obtains a mortgage loan of \$95,000 to finance the purchase of the residence and uses the annuity contract as additional collateral for the mortgage loan. The mortgage loan qualifies as acquisition indebtedness and the interest paid on the loan is qualified residence interest within the meaning of section 163(h).

The cash value of the annuity contract, when issued, is \$15,000. Under the collateral agreement relating to the annuity contract, if A defaults on the mortgage loan, the lender may withdraw the cash value of the annuity contract up to \$15,000 or the outstanding balance on the mortgage loan, whichever is less. Otherwise, A remains the owner of the annuity contract and, subject to the terms of the contract and applicable law, A may withdraw part of the cash value of the contract so long as the remaining cash value does not fall below \$15,000.

LAW AND ANALYSIS

Section 163(a) allows a deduction for interest paid or accrued within the taxable year on indebtedness. Section 163(h) generally denies deductions for personal interest paid by taxpayers other than corporations but provides an exception for qualified residence interest.

Section 264(a)(2) provides that no deduction shall be allowed for any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Section 1.264-2(a) of the Income Tax Regulations provides, in part, that amounts paid or accrued on indebtedness incurred or continued, directly or indirectly, to purchase or to continue in effect a single premium annuity contract are not deductible under section 163 or any other provision of chapter 1 of the Code.

In Rev. Rul. 79-41, 1979-1 C.B. 124, an annuity contract was used as

collateral to borrow funds to purchase stock. Rather than liquidate the annuity contract for its cash surrender value, the taxpayer maintained the annuity investment by borrowing, using the annuity as collateral, and then purchasing the stock. Rev. Rul. 79-41 holds that, pursuant to section 264(a)(2), no deduction is allowable for interest paid on the loan because the use of the annuity as collateral is direct evidence of a purpose to carry the annuity contract.

Rev. Rul. 79-41 cites and relies on *Wisconsin Cheeseman, Inc. v. United States*, 388 F.2d 420 (7th Cir. 1968). In that case, the court held that section 265(2) denied a deduction for interest paid on a loan where tax-exempt bonds were used as collateral for the loan. The court reasoned:

In this case, this nexus or “sufficiently direct relationship” is established by the fact that the tax-exempt securities were used as collateral for the seasonal loans. Under Section 265(2), it is clear that a taxpayer may not deduct interest on indebtedness when the proceeds of the loan are used to buy tax-exempts. 4A Mertens, *Law of Federal Income Taxation* (1966 ed.) § 26.13 and cases cited. Applying the rule that the substance of the transaction is controlling in determining the tax liability, the same result should follow when the tax-exempt securities are used as collateral for a loan. Surely one who borrows to buy tax-exempts and one who borrows against tax-exempts already owned are in virtually the same economic position. Section 265(2) makes no distinction between them.

388 F.2d at 422. See also Rev. Proc. 72-18, 1972-1 C.B. 740, section 3.03.

The annuity contract that A purchased is used as collateral for the mortgage loan. Accordingly, under *Wisconsin Cheeseman* and Rev. Rul. 79-41, the use of the annuity contract as collateral is direct evidence that a portion of the mortgage loan was incurred to carry the annuity contract, and section 264(a)(2) applies.

HOLDING

If a taxpayer uses a single premium annuity contract as collateral to obtain or continue a mortgage loan, section 264(a)(2) of the Internal Revenue Code

disallows the allocable amount of interest on the loan to the extent the loan is collateralized by the annuity contract. The allocable amount of interest expense disallowed is the current interest rate on the mortgage loan multiplied by the amount of the annuity contract used as collateral (or by the amount of the loan, if less).

In contrast to the situations in which an annuity is used as collateral for a loan, or a loan is otherwise incurred or continued to purchase or carry an annuity contract, section 264(a)(2) generally does not apply simply because (i) an individual uses available cash to purchase an annuity contract and as a result needs to take out a larger mortgage loan to purchase a residence, or (ii) an individual continues to hold an annuity contract rather than surrender it for its cash value when that surrender would make it possible to reduce the mortgage loan required to purchase a residence. In these situations, a purpose to purchase or carry an annuity contract cannot reasonably be inferred where the personal purpose of obtaining the mortgage loan is unrelated to the annuity contract and dominates the transaction. See Rev. Proc. 72-18.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 79-41 is clarified and superseded.

Section 274.—Disallowance of Certain Entertainment, etc., Expenses

26 CFR 1.274-2: Disallowance of deductions for certain expenses for entertainment, amusement, or recreation.

T.D. 8601

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Definition of Club

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating

to the definition of a *club organized for business, pleasure, recreation, or other social purpose* for purposes of the disallowance of a deduction for club dues. The regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1993 and affect persons who pay or incur club dues.

DATES: These regulations are effective July 19, 1995.

For dates of applicability, see §1.274-2(a) and (e).

SUPPLEMENTARY INFORMATION:

Background

This document provides final and temporary Income Tax Regulations (26 CFR part 1) under section 274(a)(3) of the Internal Revenue Code of 1986 (Code). This provision was added by section 13210 of the Omnibus Budget Reconciliation Act of 1993 (107 Stat. 469).

On August 12, 1994, the IRS published a notice of proposed rulemaking defining *club* in the Federal Register (59 FR 41414 [IA-30-94, 1994-2 C.B. 876]). No public hearing on the proposed regulations was requested or held, but written comments were received. After consideration of all the comments, the proposed regulations are adopted by this Treasury decision with one minor editorial change in §1.274-2(a)(2)(iii)(b).

On December 16, 1994, the IRS published a notice of proposed rulemaking in the Federal Register (59 FR 64909 [IA-17-94; EE-36-94, 1995-1 C.B. 942]) relating, in part, to the tax treatment of payment by an employer of an employee's club dues. This Treasury decision has no effect on the notice of proposed rulemaking published on December 16, 1994. Final regulations on this subject will be published at a later date.

Explanation of Provisions

Section 274(a)(3) of the Code disallows a deduction for amounts paid or incurred for membership in any club organized for business, pleasure, recreation, or other social purpose.

Under the final regulations, the dues disallowance provisions of section 274(a)(3) apply to any membership organization a principal purpose of which is to conduct entertainment

activities for members or their guests or to provide members or their guests with access to entertainment facilities. The membership organizations subject to dues disallowance under the final regulations include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussion. The dues disallowance provisions of section 274(a)(3) do not, in general, apply to (1) civic or public service organizations such as Kiwanis, Lions, Rotary, Civitan, and similar organizations; (2) professional organizations such as bar associations and medical associations; and (3) certain organizations similar to professional organizations, specifically, business leagues, trade associations, chambers of commerce, boards of trade, and real estate boards.

Under the final regulations, the three exceptions from dues disallowance listed above do not apply if a principal purpose of the organization is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities.

A commentator on the proposed regulations requested clarification of the terms *entertainment* and *a principal purpose*. The term *entertainment* is defined in existing §1.274-2(b)(1) and that definition applies for purposes of these final dues disallowance regulations. The final regulations do not provide any additional guidance with respect to determining whether a principal purpose of an organization is to conduct entertainment activities or provide access to entertainment facilities.

Two commentators objected to the proposed regulations' disallowance of all deductions for airline club dues. The commentators indicated that these clubs are used for business purposes, and little or no personal benefit is derived from airline club membership. However, the legislative history of section 274(a)(3) specifically provides that deductions are not allowed for airline club dues. Therefore, the final regulations do not change the proposed rule concerning airline clubs.

One commentator stated that the proposed regulations would permit taxpayers to deduct, as a business expense, dues paid to certain organizations described in section 501(c)(8)

because the organizations are civic or public service organizations. The commentator requested that the regulations be amended to preclude a business expense deduction for these dues because the organizations are not formed for a business purpose but, rather, to promote charitable, philanthropic, patriotic, and educational activities.

The IRS and the Treasury believe that the regulations, as proposed, adequately address the commentator's concern. Section 274 and these regulations do not expand the category of items that are deductible as business expenses. Rather, section 274 disallows certain business expense deductions that would otherwise be allowable under section 162. If dues paid to certain section 501(c)(8) organizations are not deductible under section 162 because they are not ordinary and necessary business expenses, section 274 and these regulations do not make the dues deductible.

The final regulations are effective with respect to amounts paid or incurred after December 31, 1993.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.274-2 is amended as follows:

1. Paragraph (a)(2)(ii) is revised.
2. Paragraph (a)(2)(iii) is added.
3. Paragraph (a)(3)(iii) is revised.
4. The heading of paragraph (e) and text for paragraph (e)(1) are revised.
5. Paragraph (e)(3)(ii) is revised.

The additions and revisions read as follows:

§1.274-2 Disallowance of deductions for certain expenses for entertainment, amusement, or recreation.

- (a) * * *
- (2) * * *

(ii) *Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities, or paid or incurred before January 1, 1994, with respect to clubs—(a) Requirements for deduction.* Except as provided in this section, no deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for any expenditure paid or incurred before January 1, 1979, with respect to a facility used in connection with entertainment, or for any expenditure paid or incurred before January 1, 1994, with respect to a club used in connection with entertainment, unless the taxpayer establishes—

- (1) That the facility or club was used primarily for the furtherance of the taxpayer's trade or business; and
- (2) That the expenditure was directly related to the active conduct of that trade or business.

(b) *Amount of deduction.* The deduction allowable under paragraph (a)(2)(ii)(a) of this section shall not exceed the portion of the expenditure directly related to the active conduct of the taxpayer's trade or business.

(iii) *Expenditures paid or incurred after December 31, 1993, with respect to a club—(a) In general.* No deduction otherwise allowable under chapter 1 of the Internal Revenue Code shall be allowed for amounts paid or incurred after December 31, 1993, for membership in any club organized for business, pleasure, recreation, or other social purpose. The purposes and activities of a club, and not its name, determine whether it is organized for business, pleasure, recreation, or other social purpose. Clubs organized for business, pleasure, recreation, or other social

purpose include any membership organization if a principal purpose of the organization is to conduct entertainment activities for members of the organization or their guests or to provide members or their guests with access to entertainment facilities within the meaning of paragraph (e)(2) of this section. Clubs organized for business, pleasure, recreation, or other social purpose include, but are not limited to, country clubs, golf and athletic clubs, airline clubs, hotel clubs, and clubs operated to provide meals under circumstances generally considered to be conducive to business discussion.

(b) *Exceptions.* Unless a principal purpose of the organization is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities, business leagues, trade associations, chambers of commerce, boards of trade, real estate boards, professional organizations (such as bar associations and medical associations), and civic or public service organizations will not be treated as clubs organized for business, pleasure, recreation, or other social purpose.

- (3) * * *
- (iii) "Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs", see paragraph (e) of this section, and

* * * * *

(e) *Expenditures paid or incurred before January 1, 1979, with respect to entertainment facilities or before January 1, 1994, with respect to clubs—(1) In general.* Any expenditure paid or incurred before January 1, 1979, with respect to a facility, or paid or incurred before January 1, 1994, with respect to a club, used in connection with entertainment shall not be allowed as a deduction except to the extent it meets the requirements of paragraph (a)(2)(ii) of this section.

* * * * *

- (3) * * *
- (ii) *Club dues—(a) Club dues paid or incurred before January 1, 1994.* Dues or fees paid before January 1, 1994, to any social, athletic, or sporting club or organization are considered expenditures with respect to a facility used in connection with entertainment. The purposes and activities of a club or organization, and not its name, deter-

mine its character. Generally, the phrase *social, athletic, or sporting club or organization* has the same meaning for purposes of this section as that phrase had in section 4241 and the regulations thereunder, relating to the excise tax on club dues, prior to the repeal of section 4241 by section 301 of Pub. L. 89-44. However, for purposes of this section only, clubs operated solely to provide lunches under circumstances of a type generally considered to be conducive to business discussion, within the meaning of paragraph (f)(2)(i) of this section, will not be considered social clubs.

(b) *Club dues paid or incurred after December 31, 1993.* See paragraph (a)(2)(iii) of this section with reference to the disallowance of deductions for club dues paid or incurred after December 31, 1993.

* * * * *

§1.274-5T [Amended]

Par. 3. In §1.274-5T, the first two sentences of paragraph (c)(6)(iii) are amended by removing the language "at any time" in each sentence and adding the language "before January 1, 1994," in its place.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved June 21, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 18, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 19, 1995, 60 F.R. 36993)

26 CFR 1.274-5T: *Substantiation requirements (temporary).*

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 95-54, page 450.

26 CFR 1.274(d)-1: *Substantiation requirements.*

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 95-54, page 450.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

Federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

Federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Subchapter C.—Corporate Distributions and Adjustments

Part II.—Corporate Liquidations

Subpart B.—Effects on Corporations

Section 338.—Certain Stock Purchases Treated as Asset Acquisitions

26 CFR 1.338-2: Miscellaneous issues under section 338.

T.D. 8626

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Continuity of Interest in Transfer of Target Assets After Qualified Stock Purchase of Target

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document prescribes final regulations under section 338 of the Internal Revenue Code regarding the transfer of target assets to the purchasing corporation or another member of the same affiliated group as the purchasing corporation after a

qualified stock purchase (QSP) of target stock, if a section 338 election is not made. These regulations provide guidance to parties to such transfers.

DATES: These regulations are effective October 27, 1995.

These regulations are applicable to transfers of target assets that occur on or after October 26, 1995.

SUPPLEMENTARY INFORMATION:

Explanation of Provisions

1. Background

This document contains final regulations under section 338 that govern the treatment of an intragroup merger or similar transaction following a QSP of target stock, if a section 338 election is not made for the target.

Section 338 provides that, if a corporation makes a QSP of the stock of a target, the purchasing corporation may elect to have the target treated as having sold all of its assets at the close of the acquisition date in a single transaction and as a new corporation that purchased all such assets at the beginning of the following day. Under section 338(i), the IRS and Treasury are authorized to prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 338.

On February 17, 1995, proposed regulations under section 338 were published in the Federal Register (60 FR 9309 [CO-62-94, 1995-1 C.B. 839]). The proposed rules are based on the conclusion that the result in *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973), is inconsistent with the legislative intent behind section 338 when there is a QSP of target stock.

2. Public Comments and the Final Regulations

The IRS received comments from the public on the proposed regulations, and a public hearing was held on June 7, 1995. Commentators generally support the proposed regulations. Accordingly, the final regulations adopt the proposed regulations with minor technical changes. The principal comments on the proposed regulations are discussed below.

Treatment of minority shareholders. The proposed regulations generally

treat the purchasing corporation's target stock acquired in the QSP as an interest on the part of a person who is an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization. Thus, if the purchasing corporation purchases the bulk of the stock of a target corporation in a QSP and subsequently merges the target into a subsidiary of the purchasing corporation in exchange for the subsidiary's stock, the continuity of interest requirement is treated as satisfied. However, this treatment does not extend to minority shareholders of the target whose stock is not acquired by the purchasing corporation.

Several commentators argue that the proposed regulations are inconsistent because they provide tax-free treatment to the purchasing corporation, but not minority shareholders who are the true historic owners of the target. Therefore, they suggest that the proposed regulations are contrary to traditional notions of shareholder continuity, and that the final regulations should extend tax-free treatment to minority shareholders who exchange their target stock for stock in the acquiring entity.

The final regulations do not adopt this suggestion. The legislative history of section 338 indicates a congressional intent to repeal the *Kimbell-Diamond* doctrine and protect the exclusivity of the section 338 election for obtaining a cost rather than a carryover basis in the target's assets after a QSP. See H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 467, 536 (1982), 1982-2 C.B. 600, 632. The regulations apply the reorganization rules to the target corporation and purchasing group because the IRS and Treasury believe it is the simplest and most effective means of achieving this intent, as they provide a pre-existing set of rules with well-understood consequences.

The legislative history does not indicate any intention to provide reorganization treatment for all purposes to exchanges of stock incident to asset transfers after QSPs. Under general income tax rules, an exchange of shares is only accorded reorganization treatment if the continuity of interest requirement is satisfied with respect to the target shareholders generally. This requirement is not satisfied if the acquisition of the target in a QSP and the merger of the target into the purchasing corporation's subsidiary are pursuant to an integrated transaction in which the owner of the majority stake

in the target receives solely cash. See, e.g., *Yoc Heating*, 61 T.C. 168; *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974). Thus, extension of reorganization treatment to the minority shareholders in this case would inappropriately alter general reorganization principles, and would not be grounded in the policies of section 338.

Scope of minority shareholder exclusion provision. One commentator suggests that if the final regulations continue to deny reorganization treatment to the preexisting minority shareholders, the exclusion should expressly apply to both the continuity of interest and control rules, rather than only the continuity of interest rule (as proposed). The final regulations adopt the commentator's suggestion by moving the minority shareholder exclusion to the scope section. This change is intended to clarify that the minority shareholder exclusion applies to any transaction that qualifies as a tax-free reorganization by operation of these regulations.

Effect of section 338(h)(8). Section 338(h)(8) provides that stock and asset acquisitions made by members of the same affiliated group shall be treated as made by one corporation. One commentator suggests that the final regulations should specifically provide that section 338(h)(8) does not apply in determining whether the merger of target qualifies as a reorganization. Otherwise, the commentator contends, a transaction in which target "sprinkles" its assets among several members of the purchasing corporation's affiliated group would qualify as a reorganization, because section 338(h)(8) treats the purchasing corporation and its affiliates as one corporation.

The final regulations do not adopt this suggestion because section 338(h) (including section 338(h)(8)), by its terms, only applies for purposes of section 338 (e.g., determining whether a transaction qualifies as a QSP). The final regulations only modify the continuity of interest and control requirements for reorganizations, and any transaction in which the target "sprinkles" its assets among several purchasing corporation affiliates would likely fail other reorganization requirements.

Guidance regarding mergers after a section 338 election. The Preamble to the proposed regulations requests comments on whether guidance is necessary on the proper treatment of post-

QSP mergers if a section 338 election is made for target. Because this request did not receive a strong response, the IRS and Treasury have decided not to provide such guidance in this document.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f), the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

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

Par. 2. Section 1.338-0 is amended by adding contents entries for §1.338-2(c)(3) in numerical order to read as follows:

§1.338-0 Outline of topics.

* * * * *

§1.338-2 Miscellaneous issues under section 338.

* * * * *

(c) * * *

(3) Consequences of post-acquisition elimination of target.

- (i) Scope.
- (ii) Continuity of interest.
- (iii) Control requirement.
- (iv) Example.
- (v) Effective date.

* * * * *

Par. 3. Section 1.338-2 is amended by adding paragraph (c)(3) to read as follows:

§1.338-2 Miscellaneous issues under section 338.

* * * * *

(c) * * *

(3) *Consequences of post-acquisition elimination of target*—(i) *Scope.* The rules of this paragraph (c)(3) apply to the transfer of target assets to the purchasing corporation (or another member of the same affiliated group as the purchasing corporation) (the transferee) following a qualified stock purchase of target stock, if the purchasing corporation does not make a section 338 election for target. Notwithstanding the rules of this paragraph (c)(3), section 354(a) (and so much of section 356 as relates to section 354) cannot apply to any person other than the purchasing corporation or another member of the same affiliated group as the purchasing corporation unless the transfer of target assets is pursuant to a reorganization as determined without regard to this paragraph (c)(3).

(ii) *Continuity of interest.* By virtue of section 338, in determining whether the continuity of interest requirement of §1.368-1(b) is satisfied on the transfer of assets from target to the transferee, the purchasing corporation's target stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of the target's business enterprise prior to the transfer that can be continued in a reorganization.

(iii) *Control requirement.* By virtue of section 338, the acquisition of target stock in the qualified stock purchase will not prevent the purchasing corporation from qualifying as a shareholder of the target transferor for the purpose of determining whether, immediately after the transfer of target assets, a shareholder of the transferor is in control of the corporation to which the assets are transferred within the meaning of section 368(a)(1)(D).

(iv) *Example.* This paragraph (c)(3) is illustrated by the following example:

Example. (A) *Facts.* P, T, and X are domestic corporations. T and X each operate a trade or business. A and K, individuals unrelated to P, own 85 and 15 percent, respectively, of the stock of T. P owns all of the stock of X. The total

adjusted basis of T's property exceeds the sum of T's liabilities plus the amount of liabilities to which T's property is subject. P purchases all of A's T stock for cash in a qualified stock purchase. P does not make an election under section 338(g) with respect to its acquisition of T stock. Shortly after the acquisition date, and as part of the same plan, T merges under applicable state law into X in a transaction that, but for the question of continuity of interest, satisfies all the requirements of section 368(a)(1)(A). In the merger, all of T's assets are transferred to X. P and K receive X stock in exchange for their T stock. P intends to retain the stock of X indefinitely.

(B) *Status of transfer as a reorganization.* By virtue of section 338, for the purpose of determining whether the continuity of interest requirement of §1.368-1(b) is satisfied, P's T stock acquired in the qualified stock purchase represents an interest on the part of a person who was an owner of T's business enterprise prior to the transfer that can be continued in a reorganization through P's continuing ownership of X. Thus, the continuity of interest requirement is satisfied and the merger of T into X is a reorganization within the meaning of section 368(a)(1)(A). Moreover, by virtue of section 338, the requirement of section 368(a)(1)(D) that a target shareholder control the transferee immediately after the transfer is satisfied because P controls X immediately after the transfer. In addition, all of T's assets are transferred to X in the merger and P and K receive the X stock exchanged therefor in pursuance of the plan of reorganization. Thus, the merger of T into X is also a reorganization within the meaning of section 368(a)(1)(D).

(C) *Treatment of T and X.* Under section 361(a), T recognizes no gain or loss in the merger. Under section 362(b), X's basis in the assets received in the merger is the same as the basis of the assets in T's hands. X succeeds to and takes into account the items of T as provided in section 381.

(D) *Treatment of P.* By virtue of section 338, the transfer of T assets to X is a reorganization. Pursuant to that reorganization, P exchanges its T stock solely for stock of X, a party to the reorganization. Because P is the purchasing corporation, section 354 applies to P's exchange of T stock for X stock in the merger of T into X. Thus, P recognizes no gain or loss on the exchange. Under section 358, P's basis in the X stock received in the exchange is the same as the basis of P's T stock exchanged therefor.

(E) *Treatment of K.* Because K is not the purchasing corporation (or an affiliate thereof), section 354 cannot apply to K's exchange of T stock for X stock in the merger of T into X unless the transfer of T's assets is pursuant to a reorganization as determined without regard to §1.338-2(c)(3). Under general income tax principles applicable to reorganizations, the continuity of interest requirement is not satisfied because P's stock purchase and the merger of T into X are pursuant to an integrated transaction in which A, the owner of 85 percent of the stock of T, received solely cash in exchange for A's T stock. See, e.g., *Yoc Heating v. Commissioner*, 61 T.C. 168 (1973); *Kass v. Commissioner*, 60 T.C. 218 (1973), *aff'd*, 491 F.2d 749 (3d Cir. 1974). Thus, the requisite continuity of interest under §1.368-1(b) is lacking and section 354 does not apply to K's exchange of T stock for X stock. K recognizes gain or loss, if any, pursuant to section 1001(c) with respect to its T stock.

(v) *Effective date.* The provisions of this paragraph (c)(3) are effective for transfers of target assets on or after October 26, 1995.

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Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved October 3, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on October 26, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 27, 1995, 60 F.R. 54942)

Part III.—Corporate Organizations and Reorganizations

Subpart A.—Corporate Organizations

Section 351.—Transfer to Corporation Controlled by Transferor

26 CFR 1.351-1: Transfer to corporation controlled by transferor.

Whether certain environmental liabilities assumed by a transferee in a section 351 exchange are not liabilities for purposes of sections 357(c)(1) and 358(d)? In addition, whether these liabilities assumed in the section 351 exchange are deductible by the transferee as business expenses under section 162 or are capital expenditures under section 263, as appropriate, under the transferee's method of accounting? See Rev. Rul. 95-74, on this page.

Subpart B.—Effects on Shareholders and Security Holders

Section 357.—Assumption of Liability

26 CFR 1.357-2: Liabilities in excess of basis. (Also §§ 351, 358; 1.351-1, 1.358-3, 1.358-4.)

Contingent liabilities assumed in section 351 exchanges. Certain environmental liabilities assumed by a transferee in a section 351 exchange are not liabilities for purposes of sections 357(c)(1) and 358(d) of the Code. In addition, these liabilities assumed in the section 351 exchange are deductible by the transferee as business expenses under section 162 or are capital expenditures under section 263, as appropriate, under the transferee's method of accounting.

Rev. Rul. 95-74

ISSUES

(1) Are the liabilities assumed by S in the § 351 exchange described below liabilities for purposes of §§ 357(c)(1) and 358(d)?

(2) Once assumed by S, how will the liabilities in the § 351 exchange described below be treated?

FACTS

Corporation P is an accrual basis, calendar-year corporation engaged in various ongoing businesses, one of which includes the operation of a manufacturing plant (the Manufacturing Business). The plant is located on land purchased by P many years before. The land was not contaminated by any hazardous waste when P purchased it. However, as a result of plant operations, certain environmental liabilities, such as potential soil and groundwater remediation, are now associated with the land.

In Year 1, for bona fide business purposes, P engages in an exchange to which § 351 of the Internal Revenue Code applies by transferring substantially all of the assets associated with the Manufacturing Business, including the manufacturing plant and the land on which the plant is located, to a newly formed corporation, S, in exchange for all of the stock of S and for S's assumption of the liabilities associated with the Manufacturing Business, including the environmental liabilities associated with the land. P has no plan or intention to dispose of (or have S issue) any S stock. S is an accrual basis, calendar-year taxpayer.

P did not undertake any environmental remediation efforts in connection with the land transferred to S before the transfer and did not deduct or capitalize any amount with respect to the contingent environmental liabilities associated with the transferred land.

In Year 3, S undertakes soil and groundwater remediation efforts relating to the land transferred in the § 351 exchange and incurs costs (within the meaning of the economic performance rules of § 461(h)) as a result of those remediation efforts. Of the total amount of costs incurred, a portion would have constituted ordinary and necessary business expenses that are deductible under § 162 and the remaining portion

would have constituted capital expenditures under § 263 if there had not been a § 351 exchange and the costs for remediation efforts had been incurred by *P*. See Rev. Rul. 94-38, 1994-1 C.B. 35 (discussing the treatment of certain environmental remediation costs).

LAW AND ANALYSIS

Issue 1: Section 351(a) provides that no gain or loss shall be recognized if property is transferred to a corporation solely in exchange for stock and immediately after the exchange the transferor is in control of the corporation.

Section 357(a) provides a general rule that a transferee corporation's assumption of a transferor's liability in a § 351 exchange will not be treated as money or other property received by the transferor. Section 357(b) provides an exception to the general rule of § 357(a) when it appears that the principal purpose of the transferor in having the liability assumed was avoidance of Federal income tax on the exchange or, if not such purpose, was not a bona fide business purpose.

Section 357(c)(1) provides a second exception to the general rule of § 357(a). Section 357(c)(1) provides that if the sum of the liabilities the transferee corporation assumes and takes property subject to exceeds the total of the adjusted basis of the property the transferor transfers to the corporation pursuant to the exchange, then the excess shall be considered as gain from the sale or exchange of the property.

For purposes of applying the exception in § 357(c)(1), § 357(c)(3)(A) provides that a liability the payment of which would give rise to a deduction (or would be described in § 736(a)) is excluded. This special rule does not apply, however, to any liability to the extent that the incurrence of the liability resulted in the creation of, or an increase in, the basis of any property. Section 357(c)(3)(B).

Section 358(a)(1) provides that in a § 351 exchange the basis of the property permitted to be received under § 351 without the recognition of gain or loss shall be the same as that of the property exchanged, decreased by (i) the fair market value of any other property (except money) received by the transferor, (ii) the amount of any

money received by the transferor, and (iii) the amount of loss to the transferor which was recognized on such exchange, and increased by (i) the amount which was treated as a dividend and (ii) the amount of gain to the transferor which was recognized on such exchange (not including any portion of such gain which was treated as a dividend).

Section 358(d)(1) provides that where, as part of the consideration to the transferor, another party to the exchange assumed a liability of the transferor, such assumption (in the amount of the liability) shall, for purposes of § 358, be treated as money received by the transferor on the exchange. Section 358(d)(2) provides that § 358(d)(1) does not apply to any liability excluded under § 357(c)(3).

The legislative history of § 351 indicates that Congress viewed an incorporation as a mere change in the form of the underlying business and enacted § 351 to facilitate such business adjustments generally by allowing taxpayers to incorporate businesses without recognizing gain. S. Rep. No. 398, 68th Cong., 1st Sess. 17-18 (1924); H.R. Rep. No. 350, 67th Cong., 1st Sess. 9-10 (1921); see also Rev. Rul. 94-45, 1994-2 C.B. 39 (providing for nonrecognition of gain from assumption reinsurance transactions that are undertaken as part of § 351 exchanges). Section 357(c)(1), however, provides that the transferor recognizes gain to the extent that the amount of liabilities transferred exceeds the aggregate basis of the assets transferred.

A number of cases concerning cash basis taxpayers were litigated in the 1970s with respect to the definition of "liabilities" for purposes of § 357(c)(1), with sometimes conflicting analyses and results. *Focht v. Commissioner*, 68 T.C. 223 (1977); *Thatcher v. Commissioner*, 61 T.C. 28 (1973), *rev'd in part and aff'd in part*, 533 F.2d 1114 (9th Cir. 1976); *Bongiovanni v. Commissioner*, T.C. Memo. 1971-262, *rev'd*, 470 F.2d 921 (2d Cir. 1972). In response to this litigation, Congress enacted § 357(c)(3) to address the concern that the inclusion in the § 357(c)(1) determination of certain deductible liabilities resulted in "unforeseen and unintended tax difficulties for certain cash basis taxpayers who incorporate a going business." S. Rep. No. 1263, 95th Cong., 2d Sess. 184-85 (1978), 1978-3 C.B. 482-83.

Congress concluded that including in the § 357(c)(1) determination liabilities

that have not yet been taken into account by the transferor results in an overstatement of liabilities of, and potential inappropriate gain recognition to, the transferor because the transferor has not received the corresponding deduction or other corresponding tax benefit. *Id.* To prevent this result, Congress enacted § 357(c)(3)(A) to exclude certain deductible liabilities from the scope of § 357(c), as long as the liabilities had not resulted in the creation of, or an increase in, the basis of any property (as provided in § 357(c)(3)(B)). P.L. 95-600 (Revenue Act of 1978), sec. 365, 92 Stat. 2763, 2854 (November 6, 1978); see also S. Rep. No. 1263, 95th Cong., 2d Sess. 185 (1978), 1978-3 C.B. 483.

While § 357(c)(3) explicitly addresses liabilities that give rise to deductible items, the same principle applies to liabilities that give rise to capital expenditures as well. Including in the § 357(c)(1) determination those liabilities that have not yet given rise to capital expenditures (and thus have not yet created or increased basis) with respect to the property of the transferor prior to the transfer also would result in an overstatement of liabilities. Thus, such liabilities also appropriately are excluded in determining liabilities for purposes of § 357(c)(1). *Cf.* Rev. Rul. 95-45, 1995-26 I.R.B. 4 (short sale obligation that creates basis treated as a liability for purposes of §§ 357 and 358); Rev. Rul. 88-77, 1988-2 C.B. 129 (accrued but unpaid expenses and accounts payable are not liabilities of a cash basis partnership for purposes of computing the adjusted basis of a partner's interest for purposes of § 752).

In this case, the contingent environmental liabilities assumed by *S* had not yet been taken into account by *P* prior to the transfer (and therefore had neither given rise to deductions for *P* nor resulted in the creation of, or increase in, basis in any property of *P*). As a result, the contingent environmental liabilities are not included in determining whether the amount of the liabilities assumed by *S* exceeds the adjusted basis of the property transferred by *P* pursuant to § 357(c)(1).

Due to the parallel constructions and interrelated function and mechanics of §§ 357 and 358, liabilities that are not included in the determination under § 357(c)(1) also are not included in the § 358 determination of the transferor's basis in the stock received in the § 351

exchange. See *Focht v. Commissioner*, 68 T.C. 223 (1977); S. Rep. No. 1263, 95th Cong., 2d Sess. 183–85 (1978), 1978–3 C.B. 481–83. Therefore, the contingent environmental liabilities assumed by *S* are not treated as money received by *P* under § 358 for purposes of determining *P*'s basis in the stock of *S* received in the exchange.

Issue 2: In *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946), the Court of Appeals for the Eighth Circuit held that, after a transfer pursuant to the predecessor to § 351, the payments by a transferee corporation were not deductible even though the transferor partnership would have been entitled to deductions for the payments had the partnership actually made the payments. The court stated generally that the expense of settling claims or liabilities of a predecessor entity did not arise as an operating expense or loss of the business of the transferee but was a part of the cost of acquiring the predecessor's property, and the fact that the claims were contingent and unliquidated at the time of the acquisition was not of controlling consequence.

In Rev. Rul. 80–198, 1980–2 C.B. 113, an individual transferred all of the assets and liabilities of a sole proprietorship, which included accounts payable and accounts receivable, to a new corporation in exchange for all of its stock. The revenue ruling holds, subject to certain limitations, that the transfer qualifies as an exchange within the meaning of § 351(a) and that the transferee corporation will report in its income the accounts receivable as collected and will be allowed deductions under § 162 for the payments it makes to satisfy the accounts payable. In reaching these holdings, the revenue ruling makes reference to the specific congressional intent of § 351(a) to facilitate the incorporation of an ongoing business by making the incorporation tax free. The ruling states that this intent would be equally frustrated if either the transferor were taxed on the transfer of the accounts receivable or the transferee were not allowed a deduction for payment of the accounts payable. See also Rev. Rul. 83–155, 1983–2 C.B. 38 (guaranteed payments to a retired partner made pursuant to a partnership agreement by a corporation to which the partnership had transferred all of its assets and liabilities in a § 351 exchange were deductible by the corporation as ordinary and necessary business expenses under § 162(a)).

The present case is analogous to the situation in Rev. Rul. 80–198. For business reasons, *P* transferred in a § 351 exchange substantially all of the assets and liabilities associated with the Manufacturing Business to *S*, in exchange for all of its stock, and *P* intends to remain in control of *S*. The costs *S* incurs to remediate the land would have been deductible in part and capitalized in part had *P* continued the Manufacturing Business and incurred those costs to remediate the land. The congressional intent to facilitate necessary business readjustments would be frustrated by not according to *S* the ability to deduct or capitalize the expenses of the ongoing business.

Therefore, on these facts, the Internal Revenue Service will not follow the decision in *Holdcroft Transp. Co. v. Commissioner*, 153 F.2d 323 (8th Cir. 1946). Accordingly, the contingent environmental liabilities assumed from *P* are deductible as business expenses under § 162 or are capitalized under § 263, as appropriate, by *S* under *S*'s method of accounting (determined as if *S* has owned the land for the period and in the same manner as it was owned by *P*).

HOLDINGS

(1) The liabilities assumed by *S* in the § 351 exchange described above are not liabilities for purposes of § 357(c)(1) and § 358(d) because the liabilities had not yet been taken into account by *P* prior to the transfer (and therefore had neither given rise to deductions for *P* nor resulted in the creation of, or increase in, basis in any property of *P*).

(2) The liabilities assumed by *S* in the § 351 exchange described above are deductible by *S* as business expenses under § 162 or are capital expenditures under § 263, as appropriate, under *S*'s method of accounting (determined as if *S* has owned the land for the period and in the same manner as it was owned by *P*).

LIMITATIONS

The holdings described above are subject to § 482 and other applicable sections of the Code and principles of law, including the limitations discussed in Rev. Rul. 80–198, 1980–2 C.B. 113 (limiting the scope of the revenue ruling to transactions that do not have a

tax avoidance purpose). See also Notice 95–53, page 334, this Bulletin (discussing certain tax consequences of “stripping transactions,” including the applicability of § 482).

Section 358.—Basis to Distributees

26 CFR 1.358–3: Treatment of assumption of liabilities.

Whether certain environmental liabilities assumed by a transferee in a section 351 exchange are not liabilities for purposes of sections 357(c)(1) and 358(d)? In addition, whether these liabilities assumed in the section 351 exchange are deductible by the transferee as business expenses under section 162 or are capital expenditures under section 263, as appropriate, under the transferee's method of accounting? See Rev. Rul. 95–74, page 36.

26 CFR 1.358–4: Exceptions.

Whether certain environmental liabilities assumed by a transferee in a section 351 exchange are not liabilities for purposes of sections 357(c)(1) and 358(d)? In addition, whether these liabilities assumed in the section 351 exchange are deductible by the transferee as business expenses under section 162 or are capital expenditures under section 263, as appropriate, under the transferee's method of accounting? See Rev. Rul. 95–74, page 36.

Subpart D.—Special Rule; Definitions

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1: Purpose and scope of exception of reorganization exchanges.

Continuity of interest; distribution by a partnership of stock received in a reorganization. Satisfaction of the continuity of proprietary interest requirement of section 1.368–1(b) of the regulations is not affected by a partnership's distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership.

Rev. Rul. 95–69

ISSUE

Is satisfaction of the continuity of proprietary interest requirement of § 1.368–1(b) of the Income Tax Regulations affected by a partnership's distribution of stock received in a reorganization to its partners in accord-

ance with their interests in the partnership?

FACTS

PRS, a limited partnership, holds all of the 100 outstanding shares of stock of *X* corporation. *GP* and *LP*, the partners of *PRS*, are United States individuals. *PRS* holds other assets in addition to the stock of *X*.

All of the outstanding stock of *Y* corporation is held by *A*, a United States individual. For valid business reasons, *X* will merge into *Y* and, after the merger, *Y* will elect to be treated as an S corporation. *X*, *Y*, *PRS*, *GP*, and *LP* execute a binding written agreement and plan of reorganization pursuant to which they effect the following transaction:

(1) On December 30 of Year 1, *X* merges into *Y* pursuant to state law. In the merger, *PRS* receives 100 shares of *Y* stock in exchange for its 100 shares of *X* stock. *GP* and *LP* are not in control of *Y* within the meaning of § 304(c) of the Internal Revenue Code.

(2) Immediately thereafter, *PRS* makes a non-liquidating distribution of the *Y* stock received in the merger in order that *Y* can qualify as a small business corporation eligible to elect to be an S corporation. The *Y* stock is distributed to *GP* and *LP* in accordance with their interests in *PRS*.

(3) *Y* elects to be treated as an S corporation, and the *Y* shareholders consent to such election.

LAW AND ANALYSIS

Section 368(a)(1) defines the term "reorganization." Section 1.368-1(b) provides that requisite to a reorganization under the Code is a continuity of interest in the business enterprise under modified corporate form on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. This section further explains that the purpose of this requirement is to ensure that the exceptions to the general rule of taxability are limited to readjustments of corporate structures that are required by business exigencies and that effect only a readjustment of continuing interest in property under modified corporate forms.

Prior to the merger, *GP* and *LP*, through their interests in *PRS*, owned

the *X* business enterprise indirectly within the meaning of § 1.368-1(b). After the merger and before the distribution, *GP* and *LP* remained indirect owners of the *X* business enterprise through the *Y* stock held by *PRS*. *PRS*'s distribution of the *Y* stock to *GP* and *LP* in accordance with their interest in *PRS* does not result in a change in *GP*'s and *LP*'s underlying ownership of the *X* business enterprise. Accordingly, the distribution does not affect whether the continuity of proprietary interest requirement of § 1.368-1(b) is satisfied. Cf. Rev. Rul. 84-30, 1984-1 C.B. 114.

HOLDING

Satisfaction of the continuity of proprietary interest requirement of § 1.368-1(b) is not affected by a partnership's distribution of stock received in a reorganization to its partners in accordance with their interests in the partnership.

Part V.—Carryovers

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted federal long-term rate is set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted federal long-term rate is set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted federal long-term rate is set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted federal long-term rate is set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted federal long-term rate is set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal long-term rate is set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Subchapter D.—Deferred Compensation, etc.

Part I.—Pension, Profit-Sharing, Stock Bonus Plans, etc.

Subpart A.—General Rule

Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401(l)-1: Permitted disparity in employer-provided contributions or benefits.

Covered compensation tables; 1996.

The covered compensation tables for determining contributions to defined benefit plans and permitted disparity are set forth.

Rev. Rul. 95-75

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code (the "Code") and the Income Tax Regulations, thereunder, for the 1996 plan year.

Section 401(l)(5)(E)(i) defines covered compensation with respect to an employee, as the average of the contribution and benefit bases in effect under § 230 of the Social Security Act (the "Act") for each year in the 35-year period ending with the year in which the employee attains social security retirement age.

Section 1.401(l)-1(c)(34) of the regulations defines the taxable wage base as the contribution and benefit base under § 230 of the Act.

Section 1.401(l)-1(c)(7)(i) defines covered compensation for an employee as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) social security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee's covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in effect as of the beginning of the plan year. An employee's covered compensation for a plan year beginning after the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the employee's covered compensation for a plan year during

which the 35-year period ends. An employee's covered compensation for a plan year beginning before the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

Section 1.401(l)-1(c)(7)(ii) provides

that, for purposes of determining the amount of an employee's covered compensation under § 1.401(l)-1(c)(7)(i), a plan may use tables, provided by the Commissioner, that are developed by rounding the actual Amounts of covered compensation for different years of birth.

For purposes of determining covered compensation for the 1996 year the taxable wage base is \$62,700.

The following tables provide covered compensation for 1996:

1996 COVERED COMPENSATION TABLE

CALENDAR YEAR OF BIRTH	CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE	1996 COVERED COMPENSATION
1931	1996	27,576
1932	1997	29,232
1933	1998	30,888
1934	1999	32,532
1935	2000	34,188
1936	2001	35,796
1937	2002	37,392
1938	2004	40,536
1939	2005	42,108
1940	2006	43,668
1941	2007	45,204
1942	2008	46,692
1943	2009	48,108
1944	2010	49,488
1945	2011	50,844
1946	2012	52,164
1947	2013	53,448
1948	2014	54,588
1949	2015	55,644
1950	2016	56,580
1951	2017	57,444
1952	2018	58,224
1953	2019	58,932
1954	2020	59,592
1955	2022	60,720
1956	2023	61,224
1957	2024	61,644
1958	2025	61,980
1959	2026	62,244
1960	2027	62,448
1961	2028	62,592
1962	2029	62,652
1963 or later	2030	62,700

1996
Rounded Covered
Compensation Table

Year of Birth	Covered Compensation
1930 – 1931	27,000
1932 – 1933	30,000
1934 – 1935	33,000
1936 – 1937	36,000
1938 – 1939	42,000
1940 – 1941	45,000
1942 – 1944	48,000
1945 – 1946	51,000
1947 – 1948	54,000
1949 – 1952	57,000
1953 – 1956	60,000
1957 or Later	62,700

26 CFR 1.401-1: *Qualified pension, profit-sharing and stock bonus plans.*

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 401 of the Code to certain payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Section 403.—Taxation of Employee Annuities

26 CFR 1.403(b)-2: *Eligible rollover distributions; questions and answers.*

T.D. 8619

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1, 31 and 602

Direct Rollovers and 20-Percent Withholding upon Eligible Rollover Distributions from Qualified Plans

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to eligible rollover distributions from tax-qualified retirement plans and section 403(b) annuities. These regulations reflect the changes made by the Unemployment Compensation Amendments of 1992 and affect the administrators, sponsors, payors of, and participants in tax-qualified retirement plans and section 403(b) annuities.

EFFECTIVE DATE: These regulations are effective on October 19, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1341. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per plan administrator/payor/recordkeeper varies from .05 hour to 330 hours, depending on individual circumstances, with an estimated average of .50 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books and records relating to this collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On October 22, 1992, Temporary Income Tax Regulations (TD 8443 [1992-2 C.B. 80]) under sections 401(a)(31), 402(c), 402(f), 403(b), and 3405(c) of the Internal Revenue Code (Code) were published in the Federal Register (57 FR 48163). A notice of proposed rulemaking (EE-43-92 [1992-2 C.B. 678]) cross-referencing the temporary regulations was published in the Federal Register (57 FR 48194) on the same day. The temporary regulations provide guidance for complying with the Unemployment Compensation Amendments of 1992

(UCA). In addition, Notice 92-48 (1992-2 C.B. 377), provides a safe harbor explanation that can be used in order to satisfy section 402(f) of the Code. Written comments were received on the proposed and temporary regulations and a public hearing on the proposed and temporary regulations was held on January 15, 1993.

In response to initial comments on the proposed and temporary regulations, the IRS provided additional guidance under UCA in Notice 93-3 (1993-1 C.B. 293), and Notice 93-26 (1993-1 C.B. 308). The notices solicited public comments concerning the additional guidance.

After consideration of all the comments, the temporary regulations are replaced and the proposed regulations under sections 401(a)(31), 402(c), 402(f), 403(b), and 3405(c) are adopted as revised by this Treasury decision.

Explanation of Provisions

1. Overview

UCA significantly changed the treatment of distributions from qualified plans and section 403(b) annuities. First, under section 402(c), as amended by UCA, all distributions from qualified plans to an employee (or to the employee's spouse after the employee's death) from the "balance to the credit" of the employee are "eligible rollover distributions" to the extent includible in gross income, except (1) substantially equal periodic payments over life or life expectancy or for a period of ten years or more, and (2) required minimum distributions under section 401(a)(9).

Second, UCA added a new qualification provision under section 401(a)(31) that requires qualified plans to provide employees with a direct rollover option. Under a direct rollover option, an employee may elect to have an eligible rollover distribution paid directly to an individual retirement account or individual retirement annuity, or to another qualified plan that accepts rollovers (collectively referred to as eligible retirement plans). The direct rollover option is provided in addition to the pre-existing rollover provisions under section 402. Thus, an employee who receives an eligible rollover distribution but who does not elect a direct rollover still has the option to subsequently roll over the distribution to an eligible retirement plan within 60 days of receipt.

Third, UCA amended section 3405 to impose mandatory 20-percent income tax withholding on any eligible rollover distribution that the employee does not elect to have paid in a direct rollover. This withholding applies even if the employee receives a distribution and then rolls it over within the 60-day period. (However, where employer securities are distributed, a special rule limits withholding to the value of cash and other property received in the distribution.) To the extent that a distribution is both includible in gross income and not an eligible rollover distribution, the elective withholding rules under section 3405 and §35.3405-1 continue to apply.

Finally, section 402(f), as amended by UCA, requires that, within a reasonable period of time before making a distribution, the plan administrator give a written explanation (the section 402(f) notice) to the employee of: 1) the availability of the direct rollover option; 2) the rules that require income tax withholding on distributions; 3) the rules under which the employee may roll over the distribution within 60 days of receipt; and, 4) if applicable, the other special tax rules (e.g., five-year averaging) that may apply to the distribution.

Similar rules are provided for section 403(b) annuities. However, a distribution from a section 403(b) annuity may only be rolled over to another section 403(b) annuity or individual retirement plan and not to a qualified plan.

UCA requirements generally apply to distributions from qualified plans and section 403(b) annuities that are made on or after January 1, 1993. (A special delayed effective date applies to certain section 403(b) annuities sponsored by state or local governments.)

In general, comments received on the proposed and temporary regulations were favorable. Thus, the final regulations retain the general structure and substance of the proposed and temporary regulations.

2. Notice 93-3 and Notice 93-26

As discussed above, in response to initial comments on the proposed and temporary regulations, additional guidance under UCA was provided by Notice 93-3, 1993-1 C.B. 293, and Notice 93-26, 1993-1 C.B. 308. The major issues addressed in these notices include the following:

- A distribution that occurs when a participant's accrued benefit is offset by the amount of a plan loan is an eligible rollover distribution if it otherwise qualifies as such. However, the plan need not offer a direct rollover of the offset distribution. For purposes of determining the amount that must be withheld, the offset distribution is treated in the same manner as a distribution of employer securities.

- In determining whether a distribution is a required minimum distribution for purposes of section 402(c), any distribution prior to the year an employee attains (or would have attained) age 70½ is not treated as a required minimum distribution and any annuity distribution paid from a defined benefit plan or an annuity contract in that year or a subsequent year is treated as a required minimum distribution.

- A participant may affirmatively elect to make an immediate direct rollover or receive an immediate payment, provided that the participant has been informed of the right to take at least 30 days, after receiving the appropriate notices, to make this decision.

- Amounts paid under an annuity contract distributed by a qualified plan are payments of the balance to the credit in the qualified plan for purposes of section 402(c) and, thus, are subject to the same UCA rules as distributions from qualified plans (e.g., permitting direct rollover and requiring 20-percent withholding).

The commentary on Notices 93-3 and 93-26 was favorable. Accordingly, the guidance contained in the notices has been incorporated into these final regulations. In addition, certain other revisions have been made to the regulations in response to comments, to clarify certain issues, and to facilitate administration and compliance. The most significant of these revisions are discussed below.

3. Section 402(f) and other participant notices

a. Timing of notice

As discussed above, the Code requires that the plan administrator provide the section 402(f) notice within a reasonable period of time prior to making an eligible rollover distribution.

The temporary regulations provide that this reasonable time period is the same period required for obtaining consent to a distribution under section 411(a)(11). The regulations under section 411(a)(11) provide that a participant's consent to a distribution is not valid unless the participant receives a notice of his or her rights under the plan, including the right to defer the distribution, no more than 90 days and no less than 30 days prior to the annuity starting date.

The 90/30-day time period was adopted in the temporary regulations under section 402(f) because the IRS and Treasury believed that it was appropriate for the section 402(f) notice to be provided within the same time period in which plan administrators are required to provide other distribution information. In response to initial comments, the IRS and Treasury issued Notice 93-26, which modified the 30-day time period to allow a participant to affirmatively elect to make an immediate direct rollover or receive an immediate payment, but did not change the 90-day time period for either section 402(f) or section 411(a)(11). As discussed above, the final regulations are modified in a manner consistent with the additional guidance provided in Notice 93-26.

Commentators requested an expansion of the 90-day time period. More broadly, commentators asked that the requirements of sections 411(a)(11), 417, and 402(f) be addressed in the context of new technologies that use electronic media, such as telephone or computer systems, to automate plan administrative functions that traditionally have been processed manually by use of paper-based systems (e.g., notices to participants and participant distribution requests). For example, some commentators suggested that plans be permitted to provide an annual written notice if a summary of the notice is provided through these new technologies. In addition, commentators asked that the modification to the 30-day rule permitting immediate payment after an affirmative election, announced in Notice 93-26, be applied to distributions subject to section 401(a)(11) and 417.

The IRS and Treasury continue to believe that the section 402(f) notice (as well as the section 411(a)(11) and section 417 notices) should be provided close to the time participants are considering the distribution to which

the notice applies. Therefore, no change to the 90-day rule is made in these final regulations.

Although no additional guidance on the use of electronic media is provided in these final regulations, the IRS and Treasury will continue to consider modifications of the notice and consent requirements that might be appropriate to accommodate new technologies, if adequate safeguards are provided. The IRS and Treasury continue to invite comments on this issue. These final regulations specifically delegate authority to the Commissioner to modify or provide additional guidance in the Internal Revenue Bulletin with respect to the notice requirements of section 402(f). A parallel delegation of authority is provided in the proposed and temporary regulations under sections 411(a)(11) and 417 which are being published in connection with these final regulations.

The proposed and temporary regulations under section 411(a)(11) are modified in a manner consistent with the changes to the 30-day rule described in Notice 93-26. The proposed and temporary regulations under section 417 modify the timing requirement with respect to the notice required by that section. Under this modification, if a participant affirmatively elects a distribution (whether a qualified joint and survivor annuity or an optional form of benefit), the plan may permit the distribution to commence at any time more than seven days after the section 417 notice is given, provided that the distributee has the right to revoke the election until the later of the annuity starting date or the expiration of the seven-day period that begins the day after the section 417 notice is provided.

b. Posting of notice

In response to questions from commentators, the final regulations clarify that section 402(f) notices must be provided directly to each distributee rather than by posting at the place of employment.

c. Additions to model notice

Notice 92-48, 1992-2 C.B. 381, contains the model section 402(f) notice that serves as a "Safe Harbor Explanation" for purposes of complying with section 402(f). The IRS is considering developing additional model language to address specific

subjects not addressed in the current model notice, including withholding on employer securities, treatment of plan loan offset amounts (including withholding and the timing and availability of a right to roll over), and the \$5,000 death benefit exclusion. Until this additional language is published, plan administrators may continue to satisfy section 402(f) by providing the current model notice, even if issues not addressed in the current notice (such as those listed in the preceding sentence) are relevant to the distributee. Plan administrators are encouraged, however, to supplement the model notice with language addressing these issues when applicable to a distributee. The IRS and Treasury invite comments or suggestions concerning possible additions or modifications to the notice.

4. Definition of eligible rollover distribution

As noted above, under section 402(c) and section 403(b), as amended by UCA, all distributions from qualified plans and section 403(b) annuities to an employee (or to the employee's spouse after the employee's death) of any portion of the "balance to the credit" of the employee are "eligible rollover distributions" to the extent includible in gross income, except (1) substantially equal periodic payments over life or life expectancy or for a period of ten years or more, and (2) required minimum distributions under section 401(a)(9).

a. Benefits included in the balance to the credit

Based on the broad statutory definition of an eligible rollover distribution and the UCA legislative history, the final regulations provide that generally all plan benefits are included in the "balance to the credit" of an employee, including ancillary benefits not protected by section 411(d)(6). Therefore, the final regulations do not adopt commentators' suggestions to exclude various items from the definition, such as qualified disability benefits, hardship distributions, and distributions that are includible in gross income but that are made to a distributee reasonably expected to have no income tax liability.

b. Substantially equal periodic payments from a defined contribution plan

The final regulations retain the rule

that the principles of section 72(t) apply for purposes of determining whether distributions constitute a series of substantially equal periodic payments. The preamble to the temporary regulations provides that, in determining whether payments in a series are substantially equal for purposes of section 402(c)(4), the principles of Notice 89-25, 1989-1 C.B. 662, are applicable. Notice 89-25 provides guidance for determining whether distributions from a separate account are substantially equal for purposes of section 72(t). Commentators requested guidance on applying the three methods in Notice 89-25 for determining whether payments are substantially equal over life or life expectancy to payments for a period other than life or life expectancy. In response to these comments, the final regulations provide that payments from a qualified defined contribution plan that are calculated on a declining balance of years will be considered substantially equal. In addition, if a distribution from a defined contribution plan consists of payments of a fixed amount each year until the account balance is exhausted, reasonable actuarial assumptions must be used to determine the period of years over which the payments will be made.

c. Disregard of contingencies

The final regulations retain the rule that the determination of whether payments are substantially equal for a given period is made when payments commence, without regard to contingencies or modifications that have not yet occurred. Recovery from a disability is added to the final regulations as an example of a contingency that is disregarded until it occurs. In addition, although not addressed in the regulations, it should be noted that a mere change in the type (as opposed to the amount) of benefit being paid in a series of payments is not relevant in determining whether the payments are substantially equal and are being paid for a period described in section 402(c)(4)(A). Thus, if a distributee receives a series of disability benefits followed by a series of retirement benefits, and the two benefits are reasonably expected to be substantially equal, the retirement benefits may be combined with the disability benefits in determining whether a series of payments are substantially equal and are for a period described in section 402(c)(4)(A).

In response to comments, the final regulations also clarify that a mere change in distributee upon the death of an employee is not a modification that requires a redetermination of whether the remaining payments under the annuity are substantially equal periodic payments over a period described in section 402(c)(4)(A) and, thus, excluded from the definition of eligible rollover distribution.

d. *Coordination with Social Security Benefits*

The final regulations expand the scope of the rule in the temporary regulations permitting social security benefits to be taken into account in determining whether a series of periodic payments are substantially equal. Under the final regulations, if the amount paid annually from the plan is reduced upon attainment of social security retirement age (or commencement of social security benefits), the payments after the reduction will be treated as substantially equal to the payments prior to the reduction, even if the reduction is not equal to the distributee's annual social security benefits, provided that the reduction does not exceed the annual social security benefits and the post-reduction payments are substantially equal.

e. *Supplements and adjustments to annuity payments*

The final regulations retain the rule that a payment will be treated as independent, and thus as not part of a series of substantially equal periodic payments, if the payment is substantially larger or smaller than the other payments in the series. However, in response to comments, the final regulations clarify that adjustments to the amount of annuity payments that result solely from correction of reasonable administrative error or delay in payment will not cause any payment in a series of payments that are otherwise substantially equal to fail to be treated as a payment in the series.

Further, in response to comments concerning the payment of "13th checks" and other supplemental annuity payments, the regulations provide an additional rule for defined benefit plans. If a defined benefit plan provides a benefit increase for annuitants (e.g., retirees or beneficiaries) that supplements a series of substantially

equal annuity payments in a consistent manner for all similarly situated annuitants, the benefit increase will not constitute an independent payment (and will not cause the series of payments to be treated as not substantially equal), if the payment either is not more than 10 percent of the annual rate of payment or is not more than \$750.

f. *Required minimum distributions*

As noted above, the final regulations incorporate the guidance in Notice 93-3 concerning the determination of the required minimum distribution for purposes of section 402(c). Also, in response to questions concerning the allocation of basis in the case of a required minimum distribution, the final regulations clarify that if part (but not all) of a payment is required under section 401(a)(9) and if part (but not all) of the same payment represents return of basis, the plan must first allocate the return of basis toward satisfaction of the section 401(a)(9) required minimum distribution. This rule has the effect of maximizing the amount that is eligible to be rolled over.

g. *Corrective distributions and deemed distributions*

The final regulations retain the rule that certain corrective distributions and deemed distributions are excluded from the definition of an eligible rollover distribution. The regulations also clarify that, to the extent corrective distributions are properly made from a section 403(b) annuity, they are not eligible rollover distributions.

With respect to deemed distributions under section 72(p), the final regulations include the clarifications provided in Notice 93-3 with respect to the distinction between plan loan offset amounts and deemed distributions under section 72(p), except for the portion of Example 6 from Notice 93-3 that addressed issues relating to the tax treatment of a distribution that occurs after a deemed distribution. This portion of the example generated numerous questions and comments concerning the proper interpretation of section 72(p). Those questions and comments are best addressed in the context of guidance under section 72(p) rather than section 402(c). No inference should be drawn from the deletion of a portion of the example.

h. *\$5,000 death benefit exclusions*

The final regulations clarify that, to the extent that a death benefit is a distribution from a qualified plan, the portion of the distribution that is excluded from gross income under section 101(b) is not an eligible rollover distribution. However, recognizing that a surviving spouse or former spouse may be entitled to more than one death benefit that might qualify for the death benefit exclusion, the final regulations permit the plan administrator of a qualified plan to assume, for purposes of section 401(a)(31) and section 3405, that any death benefit being distributed from the plan to the surviving spouse or former spouse of an employee that qualifies for the exclusion is the only benefit that so qualifies.

5. *Direct rollover requirement*

a. *Procedures for accomplishing a direct rollover*

The final regulations under section 401(a)(31) retain the rules that permit the employer to accomplish an employee's direct rollover by any reasonable means of delivery to an eligible retirement plan, including delivery of a check to the eligible retirement plan by the employee (provided that the payee line of the check is made out in a manner that will ensure that the check is negotiable solely by the trustee or custodian of the recipient plan). The preamble to the temporary regulations requested comments on whether a standard notation, such as "Direct Rollover," should be required to appear on the face of any check provided to an employee for delivery. The comments received were divided, and the final regulations do not require any standard notation.

b. *Procedures that substantially impair the availability of direct rollover*

The temporary regulations provide that it would not be reasonable, and thus would not satisfy section 401(a)(31), for a plan administrator to require information or documentation or to establish procedures that "effectively eliminate" the right to take a direct rollover. The final regulations broaden this language to include procedures that "substantially impair" the

right to take a direct rollover, and provide additional examples illustrating violations of section 401(a)(31).

c. Qualification protection for recipient plans

The temporary regulations do not address qualification protection for qualified plans accepting rollovers. Comments were received asking for criteria that, if satisfied, would permit a receiving plan to assume that the plan from which it is accepting a rollover is qualified. To encourage plans to accept rollovers, these final regulations provide a safe harbor for receiving plans that reasonably determine that the distributing plan is qualified. The regulations also provide an example of a reasonable determination in this respect. The example illustrates that a reasonable determination will have been made if, prior to accepting a rollover contribution, the receiving plan obtains a plan administrator's letter indicating that the distributing plan had a favorable determination letter regarding qualification. However, if the receiving plan later obtains actual knowledge that the distributing plan was not qualified at the time of the direct rollover, corrective distributions with respect to the rollover amount would be required.

In addition, the final regulations under section 3405 retain the rule that no withholding liability will be imposed on a plan administrator that reasonably relies on "adequate information" provided by the distributee. Commentators asked whether this "adequate information" protection under section 3405 could also be extended to section 401(a)(31). Specifically, they asked if the distributing plan is protected from being treated as violating section 401(a)(31) where the distributee purports to elect a direct rollover but the distribution made in accordance with the information provided by the distributee does not in fact result in a direct rollover. The IRS and Treasury do not believe any special relief is needed in this case because there is no violation of section 401(a)(31) if the plan follows the distributee's directions after providing a direct rollover option.

d. Direct rollovers to qualified defined benefit plans

The definition of eligible retirement plan under section 402(c) includes all

qualified trusts (defined contribution plans and defined benefit plans) as well as qualified annuity plans under section 403(a) and individual retirement plans. For purposes of section 401(a)(31), section 401(a)(31)(D) provides that the only qualified trusts that are treated as eligible retirement plans are defined contribution plans. Commentators asked whether a plan may permit direct rollovers to qualified defined benefit plans. The final regulations clarify that the limitation in section 401(a)(31)(D) applies only for purposes of determining the scope of the requirement under section 401(a)(31), while the definition of eligible retirement plan in section 402(c)(8)(B) controls the types of plans to which direct rollovers are permitted. Thus, under section 401(a)(31), a plan is required to offer a direct rollover to any defined contribution plan, and is permitted (but not required) to offer a direct rollover to a qualified trust that is a defined benefit plan. In addition, the final regulations clarify that an eligible rollover distribution that is paid in a direct rollover to a defined benefit plan is not subject to withholding.

e. Default procedures

The final regulations retain the rules permitting a plan administrator to establish a procedure for a participant who fails to make any election. However, the regulations clarify that if a default procedure is implemented, the distributee must receive an explanation of the procedure in conjunction with the section 402(f) notice.

f. Valuation of distributed property

Some commentators raised concerns about the valuation of property in order to determine the portion of the distribution eligible for direct rollover or subject to withholding. The IRS and Treasury recognize the difficulties in satisfying the rollover, withholding, and reporting requirements where property is involved and invite comments regarding these issues, including suggested approaches for addressing the valuation and taxation of property distributed by qualified plans. While these regulations include no changes with respect to these issues, they continue to permit use of the rules provided in Q&A F-1 and Q&A F-3 of §35.3405-1 for purposes of withholding.

g. Plan amendments

The final regulations retain the rule that, although plans must comply in operation with section 401(a)(31) beginning January 1, 1993, plans need not be amended to comply with section 401(a)(31) until the end of the remedial amendment period for amending the plan to comply with the amendments to section 401(a) made by the Tax Reform Act of 1986 (TRA '86). Notice 92-36 (1992-2 C.B. 364), specifies the remedial amendment period for most employers. Announcement 95-48 (1995-23 I.R.B. 11), dated June 5, 1995, extends this period for plans maintained by tax exempt organizations and governments.

Plans may continue to use the model amendment published in Rev. Proc. 93-12 (1993-1 C.B. 479), to comply in form with section 401(a)(31) and these final regulations. For plans that have received favorable determination letters, see the relevant guidance for the timing of plan amendments, e.g., section 21.04 of Rev. Proc. 95-6 (1995-1 C.B. 452).

6. Other rollover rules

a. Rollover elections are irrevocable

The final regulations incorporate the rule in §1.402(a)(5)-1T that, in order for a contribution of an eligible rollover distribution to an individual retirement plan to qualify for exclusion from gross income as a rollover contribution, the participant must irrevocably elect to treat the contribution as a rollover contribution at the time the contribution is made to the individual retirement plan. A direct rollover election is deemed to be such an irrevocable election.

b. 60-day rule

The final regulations clarify that the 60-day period for a distributee to roll over a distribution commences on the date of that distribution regardless of the number of distributions during the taxable year. Because section 402, as amended by UCA, no longer requires that the distribution constitute a specified portion of the balance to the credit of the employee in order to be eligible for rollover, there is no longer any need for the prior administrative rule under which the 60-day period began as of the date of the last distribution during the taxable year.

c. *Rollover from plan not counted in one-year-look-back rule*

The final regulations clarify that a rollover (whether or not it is a direct rollover) from a qualified plan is not treated as a rollover contribution for purposes of the one-year-look-back rule in section 408(d)(3)(B).

7. *20-percent mandatory withholding*

a. *Additional withholding*

In response to comments, the regulations clarify that a plan administrator or payor may (but is not required to) permit a distributee to elect to have more than 20 percent withheld from an eligible rollover distribution.

b. *Limitation of withholding to cash and property distributed*

Section 3405(e)(8) limits the maximum amount that may be withheld on any designated distribution to the sum of the amount of money and the fair market value of property (other than employer securities) that is received in the distribution. Commentators asked whether 20-percent withholding applies if the portion of the distribution that is a designated distribution is allocated to employer stock and paid to the employee, while the portion of the distribution that is the return of basis is allocated to cash. The final regulations clarify that the section 3405(e)(8) provision limiting withholding to the sum of cash and property (other than employer securities) applies to the total distribution (including, for example, return of basis) and not just to the designated distribution.

Effective date

These final regulations apply to distributions made on or after October 19, 1995. The text of these regulations replaces the temporary regulations published in the Federal Register on October 22, 1992. Although they will be removed from the Code of Federal Regulations (CFR), the temporary regulations, as they appear in the April 1, 1995 edition of 26 CFR part 1, retain their effectiveness with respect to distributions made on or after January 1, 1993, but before October 19, 1995. However, for any distribution made on or after January 1, 1993 but before

October 19, 1995, plans may comply with the provisions of UCA by substituting all or part of the provisions of these final regulations for the corresponding provisions of the temporary regulations, if any.

In addition, no penalties or sanctions will apply for failure to satisfy section 401(a)(31) or section 402(f), or for failure to withhold in accordance with section 3405(c), if the requirements of UCA are satisfied with respect to a distribution, made on or after October 19, 1995 but before January 1, 1996, by substituting all or part of the provisions of the temporary regulations for the corresponding provisions of these final regulations. For any distribution made on or after October 19, 1995 but before January 1, 1996, a distributee may roll over the distribution if it qualifies as an eligible rollover distribution if all or part of the provisions of the temporary regulations are substituted for the corresponding provisions of these final regulations. Moreover, during this period, the plan administrator and the employee (or spousal distributee) need not apply the provisions in the same manner with respect to any distribution.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Accordingly, 26 CFR parts 1, 31, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

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

§§1.401(a)(31)–1T, 1.402(c)–2T, 1.402(f)–2T, and 1.403(b)–2T [Removed]

Par. 2. Sections 1.401(a)(31)–1T, 1.402(c)–2T, 1.402(f)–2T, and 1.403(b)–2T are removed.

Par. 3. Sections 1.401(a)(31)–1, 1.402(c)–2, and 1.403(b)–2 are added and §1.402(f)–1 is revised to read as follows:

§1.401(a)(31)–1 Requirement to offer direct rollover of eligible rollover distributions; questions and answers.

The following questions and answers relate to the qualification requirement imposed by section 401(a)(31) of the Internal Revenue Code of 1986, pertaining to the direct rollover option for eligible rollover distributions from pension, profit-sharing, and stock bonus plans. Section 401(a)(31) was added by section 522(a) of the Unemployment Compensation Amendments of 1992, Public Law 102–318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 402(c), 402(f), 403(b)(8) and (10), and 3405(c), see §§1.402(c)–2, 1.402(f)–1, and 1.403(b)–2, and §31.3405(c)–1 of this chapter, respectively.

LIST OF QUESTIONS

Q-1: What are the direct rollover requirements under section 401(a)(31)?

Q-2: Does section 401(a)(31) require that a qualified plan permit a direct rollover to be made to a qualified trust that is not part of a defined contribution plan?

Q-3: What is a *direct rollover* that satisfies section 401(a)(31), and how is it accomplished?

Q-4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

Q-5: Is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover currently includible in gross income or subject to 20-percent withholding?

Q-6: What procedures may a plan administrator prescribe for electing a direct rollover, and what information may the plan administrator require a distributee to provide when electing a direct rollover?

Q-7: May the plan administrator treat a distributee as having made an elec-

tion under a default procedure where the distributee does not affirmatively elect to make or not make a direct rollover within a certain time period?

Q-8: May the plan administrator establish a deadline after which the distributee may not revoke an election to make or not make a direct rollover?

Q-9: Must the plan administrator permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

Q-10: Must the plan administrator allow a distributee to divide an eligible rollover distribution into two or more separate distributions to be paid in direct rollovers to two or more eligible retirement plans?

Q-11: Will a plan satisfy section 401(a)(31) if the plan administrator does not permit a distributee to elect a direct rollover if his or her eligible rollover distributions during a year are reasonably expected to total less than \$200?

Q-12: Is a plan administrator permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series?

Q-13: Is the eligible retirement plan designated by a distributee to receive a direct rollover distribution required to accept the distribution?

Q-14: For purposes of applying the plan qualification requirements of section 401(a), is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover a distribution and rollover or is it a transfer of assets and liabilities?

Q-15: Must a direct rollover option be provided for an eligible rollover distribution that is in the form of a plan loan offset amount?

Q-16: Must a direct rollover option be provided for an eligible rollover distribution from a qualified plan distributed annuity contract?

Q-17: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution?

Q-18: When must a qualified plan be amended to comply with section 401(a)(31)?

QUESTIONS AND ANSWERS

Q-1: What are the direct rollover requirements under section 401(a)(31)?

A-1: (a) *General rule.* To satisfy section 401(a)(31), added by UCA, a plan must provide that if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan, and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover described in Q&A-3 of this section. Thus, the plan must give the distributee the option of having his or her distribution paid in a direct rollover to an eligible retirement plan specified by the distributee. For purposes of section 401(a)(31) and this section, eligible rollover distribution has the meaning set forth in section 402(c)(4) and §1.402(c)-2, Q&A-3 through Q&A-10 and Q&A-14, except as otherwise provided in Q&A-2 of this section, eligible retirement plan has the meaning set forth in section 402(c)-(8)(B) and §1.402(c)-2, Q&A-2.

(b) *Related Internal Revenue Code provisions*—(1) *Mandatory withholding.* If a distributee of an eligible rollover distribution does not elect to have the eligible rollover distribution paid directly from the plan to an eligible retirement plan in a direct rollover under section 401(a)(31), the eligible rollover distribution is subject to 20-percent income tax withholding under section 3405(c). See §31.3405(c)-1 of this chapter for guidance concerning the withholding requirements applicable to eligible rollover distributions.

(2) *Notice requirement.* Section 402(f) requires the plan administrator of a qualified plan to provide, within a reasonable period of time before making an eligible rollover distribution, a written explanation to the distributee of the distributee's right to elect a direct rollover and the withholding consequences of not making that election. The explanation also is required to provide certain other relevant information relating to the taxation of distributions. See §1.402(f)-1 for guidance concerning the written explanation required under section 402(f).

(3) *Section 403(b) annuities.* Section 403(b)(10) provides that requirements similar to those imposed by section 401(a)(31) apply to annuities described in section 403(b). See §1.403(b)-2 for guidance concerning the direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date.* Section 401(a)(31) ap-

plies to eligible rollover distributions made on or after January 1, 1993.

(2) *Regulatory effective date.* This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, §1.401(a)(31)-1T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan may satisfy section 401(a)(31) by substituting any or all provisions of this section for the corresponding provisions of §1.401(a)(31)-1T, if any.

Q-2: Does section 401(a)(31) require that a qualified plan permit a direct rollover to be made to a qualified trust that is not part of a defined contribution plan?

A-2: No. Section 401(a)(31)(D) limits the types of qualified trusts that are treated as eligible retirement plans to defined contribution plans that accept eligible rollover distributions. Therefore, although a plan is permitted, at a participant's election, to make a direct rollover to any type of eligible retirement plan, as defined in section 402(c)(8)(B) (including a defined benefit plan), a plan will not fail to satisfy section 401(a)(31) solely because the plan will not permit a direct rollover to a qualified trust that is part of a defined benefit plan. In contrast, if a distributee elects a direct rollover of an eligible rollover distribution to an annuity plan described in section 403(a), that distribution must be paid to the annuity plan, even if the recipient annuity plan is a defined benefit plan.

Q-3: What is a *direct rollover* that satisfies section 401(a)(31), and how is it accomplished?

A-3: A direct rollover that satisfies section 401(a)(31) is an eligible rollover distribution that is paid directly to an eligible retirement plan for the benefit of the distributee. A direct rollover may be accomplished by any reasonable means of direct payment to an eligible retirement plan. Reasonable means of direct payment include, for example, a wire transfer or the mailing of a check to the eligible retirement plan. If payment is made by check, the check must be negotiable only by the trustee of the eligible retirement plan. If the payment is made by wire transfer, the wire transfer must be directed only to the trustee of the eligible

retirement plan. In the case of an eligible retirement plan that does not have a trustee (such as a custodial individual retirement account or an individual retirement annuity), the custodian of the plan or issuer of the contract under the plan, as appropriate, should be substituted for the trustee for purposes of this Q&A-3, and Q&A-4 of this section.

Q-4: Is providing a distributee with a check for delivery to an eligible retirement plan a reasonable means of accomplishing a direct rollover?

A-4: Providing the distributee with a check and instructing the distributee to deliver the check to the eligible retirement plan is a reasonable means of direct payment, provided that the check is made payable as follows: [Name of the trustee] as trustee of [name of the eligible retirement plan]. For example, if the name of the eligible retirement plan is "Individual Retirement Account of John Q. Smith," and the name of the trustee is "ABC Bank," the payee line of a check would read "ABC Bank as trustee of Individual Retirement Account of John Q. Smith." Unless the name of the distributee is included in the name of the eligible retirement plan, the check also must indicate that it is for the benefit of the distributee. If the eligible retirement plan is not an individual retirement account or an individual retirement annuity, the payee line of the check need not identify the trustee by name. For example, the payee line of a check for the benefit of distributee Jane Doe might read, "Trustee of XYZ Corporation Savings Plan FBO Jane Doe."

Q-5: Is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover currently includible in gross income or subject to 20-percent withholding?

A-5: No. An eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover is not currently includible in the distributee's gross income under section 402(c) and is exempt from the 20-percent withholding imposed under section 3405(c)(2). However, when any portion of the eligible rollover distribution is subsequently distributed from the eligible retirement plan, that portion will be includible in gross income to the extent required under section 402, 403, or 408.

Q-6: What procedures may a plan administrator prescribe for electing a

direct rollover, and what information may the plan administrator require a distributee to provide when electing a direct rollover?

A-6: (a) *Permissible procedures.* Except as otherwise provided in paragraph (b) of this Q&A-6, the plan administrator may prescribe any procedure for a distributee to elect a direct rollover under section 401(a)(31), provided that the procedure is reasonable. The procedure may include any reasonable requirement for information or documentation from the distributee in addition to the items of adequate information specified in §31.3405(c)-1(b), Q&A-7 of this chapter. For example, it would be reasonable for the plan administrator to require that the distributee provide a statement from the designated recipient plan that the plan will accept the direct rollover for the benefit of the distributee and that the recipient plan is, or is intended to be, an individual retirement account, an individual retirement annuity, a qualified annuity plan described in section 403(a), or a qualified trust described in section 401(a), as applicable. In the case of a designated recipient plan that is a qualified trust, it also would be reasonable for the plan administrator to require a statement that the qualified trust is not excepted from the definition of an eligible retirement plan by section 401(a)(31)(D) (*i.e.*, is not a defined benefit plan).

(b) *Impermissible procedures.* A plan will fail to satisfy section 401(a)(31) if the plan administrator prescribes any unreasonable procedure, or requires information or documentation, that effectively eliminates or substantially impairs the distributee's ability to elect a direct rollover. For example, it would effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the recipient plan required the distributee to obtain an opinion of counsel stating that the eligible retirement plan receiving the rollover is a qualified plan or individual retirement account. Similarly, it would effectively eliminate or substantially impair the distributee's ability to elect a direct rollover if the distributing plan required a letter from the recipient eligible retirement plan stating that, upon request by the distributing plan, the recipient plan will automatically return any direct rollover amount that the distributing plan advises the recipient plan was paid incorrectly. It would also effectively

eliminate or substantially impair the distributee's ability to elect a direct rollover if the distributing plan required, as a condition for making a direct rollover, a letter from the recipient eligible retirement plan indemnifying the distributing plan for any liability arising from the distribution.

Q-7: May the plan administrator treat a distributee as having made an election under a default procedure where the distributee does not affirmatively elect to make or not make a direct rollover within a certain time period?

A-7: Yes, the plan administrator may establish a default procedure whereby any distributee who fails to make an affirmative election is treated as having either made or not made a direct rollover election. However, the plan administrator may not make a distribution under any default procedure unless the distributee has received an explanation of the default procedure and an explanation of the direct rollover option as required under section 402(f) and §1.402(f)-1, Q&A-1 and unless the timing requirements described in §1.402(f)-1, Q&A-2 and Q&A-3 have been satisfied with respect to the explanations of both the default procedure and the direct rollover option.

Q-8: May the plan administrator establish a deadline after which the distributee may not revoke an election to make or not make a direct rollover?

A-8: Yes, but the plan administrator is not permitted to prescribe any deadline or time period with respect to revocation of a direct rollover election that is more restrictive for the distributee than that which otherwise applies under the plan to revocation of the form of distribution elected by the distributee.

Q-9: Must the plan administrator permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

A-9: Yes, the plan administrator must permit a distributee to elect to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder paid to the distributee. However, the plan administrator is permitted to require that, if the distributee elects to have only a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct

rollover, that portion be equal to at least a specified minimum amount, provided the specified minimum amount is less than or equal to \$500 or any greater amount as prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter. If the entire amount of the eligible rollover distribution is less than or equal to the specified minimum amount, the plan administrator need not allow the distributee to divide the distribution.

Q-10: Must the plan administrator allow a distributee to divide an eligible rollover distribution into two or more separate distributions to be paid in direct rollovers to two or more eligible retirement plans?

A-10: No. The plan administrator is not required (but is permitted) to allow the distributee to divide an eligible rollover distribution into separate distributions to be paid to two or more eligible retirement plans in direct rollovers. Thus, the plan administrator may require that the distributee select a single eligible retirement plan to which the eligible rollover distribution (or portion thereof) will be distributed in a direct rollover.

Q-11: Will a plan satisfy section 401(a)(31) if the plan administrator does not permit a distributee to elect a direct rollover if his or her eligible rollover distributions during a year are reasonably expected to total less than \$200?

A-11: Yes. A plan will satisfy section 401(a)(31) even though the plan administrator does not permit any distributee to elect a direct rollover with respect to eligible rollover distributions during a year that are reasonably expected to total less than \$200 or any lower minimum amount specified by the plan administrator. The rules described in §31.3405(c)-1, Q&A-14 of this chapter (relating to whether withholding under section 3405(c) is required for an eligible rollover distribution that is less than \$200) also apply for purposes of determining whether a direct rollover election under section 401(a)(31) must be provided for an eligible rollover distribution that is less than \$200 or the lower specified amount.

Q-12: Is a plan administrator permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of

periodic payments as applying to all subsequent payments in the series?

A-12: (a) Yes. A plan administrator is permitted to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applying to all subsequent payments in the series, provided that:

(1) The employee is permitted at any time to change, with respect to subsequent payments, a previous election to make or not make a direct rollover; and

(2) The written explanation provided under section 402(f) explains that the election to make or not make a direct rollover will apply to all future payments unless the employee subsequently changes the election.

(b) See §1.402(f)-1, Q&A-3 for further guidance concerning the rules for providing section 402(f) notices when eligible rollover distributions are made in a series of periodic payments.

Q-13: Is the eligible retirement plan designated by a distributee to receive a direct rollover distribution required to accept the distribution?

A-13: (a) *General rule.* No. Although section 401(a)(31) requires qualified plans to provide distributees the option to make a direct rollover of their eligible rollover distributions to an eligible retirement plan, it imposes no requirement that any eligible retirement plan accept rollovers. Thus, a plan can refuse to accept rollovers. Alternatively, a plan can limit the circumstances under which it will accept rollovers. For example, a plan can limit the types of plans from which it will accept a rollover or limit the types of assets it will accept in a rollover (such as accepting only cash or its equivalent).

(b) *Qualification of receiving plan.* A plan that accepts a direct rollover from another plan will not fail to satisfy section 401(a) merely because the plan making the distribution is, in fact, not qualified under section 401(a) or section 403(a) at the time of the distribution, if, prior to accepting the rollover, the receiving plan reasonably concluded that the distributing plan was qualified under section 401(a) or section 403(a). For example, the receiving plan may reasonably conclude that the distributing plan was qualified under section 401(a) or section 403(a) if, prior to accepting the rollover, the plan administrator of the distributing plan provided the receiving plan with a

statement that the distributing plan had received a determination letter from the Commissioner indicating that the plan was qualified.

Q-14: For purposes of applying the plan qualification requirements of section 401(a), is an eligible rollover distribution that is paid to an eligible retirement plan in a direct rollover a distribution and rollover or is it a transfer of assets and liabilities?

A-14: For purposes of applying the plan qualification requirements of section 401(a), a direct rollover is a distribution and rollover of the eligible rollover distribution and not a transfer of assets and liabilities. For example, if the consent requirements under section 411(a)(11) or sections 401(a)(11) and 417(a)(2) apply to the distribution, they must be satisfied before the eligible rollover distribution may be distributed in a direct rollover. Similarly, the direct rollover is not a transfer of assets and liabilities that must satisfy the requirements of section 414(l). Finally, a direct rollover is not a transfer of benefits for purposes of applying the requirements under section 411(d)(6), as described in §1.411(d)-4, Q&A-3. Therefore, for example, the eligible retirement plan is not required to provide, with respect to amounts paid to it in a direct rollover, the same optional forms of benefits that were provided under the plan that made the direct rollover. The direct rollover requirements of section 401(a)(31) do not affect the ability of a qualified plan to make an elective or nonelective transfer of assets and liabilities to another qualified plan in accordance with applicable law (such as section 414(l)).

Q-15: Must a direct rollover option be provided for an eligible rollover distribution that is in the form of a plan loan offset amount?

A-15: A plan will not fail to satisfy section 401(a)(31) merely because the plan does not permit a distributee to elect a direct rollover of an eligible rollover distribution in the form of a plan loan offset amount. Section 1.402(c)-2(b), Q&A-9 defines a plan loan offset amount, in general, as a distribution that occurs when, under the terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan. A plan administrator is permitted to allow a direct rollover of a participant note for a plan loan to a qualified trust described in section 401(a) or a

qualified annuity plan described in section 403(a). See §1.402(c)-2, Q&A-9 for examples illustrating the rules for plan loan offset amounts that are set forth in this Q&A-15. See §31.3405(c)-1, Q&A-11 of this chapter for guidance concerning special withholding rules that apply to a distribution in the form of a plan loan offset amount.

Q-16: Must a direct rollover option be provided for an eligible rollover distribution from a qualified plan distributed annuity contract?

A-16: Yes. If any amount to be distributed under a qualified plan distributed annuity contract is an eligible rollover distribution (in accordance with §1.402(c)-2), Q&A-10 the annuity contract must satisfy section 401(a)(31) in the same manner as a qualified plan under section 401(a). Section 1.402(c)-2, Q&A-10 defines a qualified plan distributed annuity contract as an annuity contract purchased for a participant, and distributed to the participant, by a qualified plan. In the case of a qualified plan distributed annuity contract, the payor under the contract is treated as the plan administrator. See §31.3405(c)-1, Q&A-13 of this chapter concerning the application of mandatory 20-percent withholding requirements to distributions from a qualified plan distributed annuity contract.

Q-17: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution?

A-17: (a) *General rule.* For purposes of section 401(a)(31), a plan administrator may make the assumptions described in paragraphs (b) and (c) of this Q&A-17 in determining the amount of a distribution that is an eligible rollover distribution for which a direct rollover option must be provided. Section 31.3405(c)-1, Q&A-10 of this chapter provides assumptions for purposes of complying with section 3405(c). See §1.402(c)-2, Q&A-15 concerning the effect of these assumptions for purposes of section 402(c).

(b) *\$5,000 death benefit.* A plan administrator is permitted to assume that a distribution from the plan that qualifies for the \$5,000 death benefit exclusion under section 101(b) is the only death benefit being paid with respect to a deceased employee that qualifies for that exclusion. Thus, to the extent that such a distribution would be excludible from gross income based on this assumption, the plan

administrator is permitted to assume that it is not an eligible rollover distribution.

(c) *Determination of designated beneficiary.* For the purpose of determining the amount of the minimum distribution required to satisfy section 401(a)(9)(A) for any calendar year, the plan administrator is permitted to assume that there is no designated beneficiary.

Q-18: When must a qualified plan be amended to comply with section 401(a)(31)?

A-18: Even though section 401(a)(31) applies to distributions from qualified plans made after on or after January 1, 1993, a qualified plan is not required to be amended before the last day by which amendments must be made to comply with the Tax Reform Act of 1986 and related provisions, as permitted in other administrative guidance of general applicability, provided that:

(a) In the interim period between January 1, 1993, and the date on which the plan is amended, the plan is operated in accordance with the requirements of section 401(a)(31); and

(b) The amendment applies retroactively to January 1, 1993.

§1.402(c)-2 Eligible rollover distributions; questions and answers.

The following questions and answers relate to the rollover rules under section 402(c) of the Internal Revenue Code of 1986, as added by sections 521 and 522 of the Unemployment Compensation Amendments of 1992, Public Law 102-318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 401(a)(31), 402(f), 403(b)(8) and (10), and 3405(c), see §§1.401(a)(31)-1, 1.402(f)-1, and 1.403(b)-2, and §31.3405(c)-1 of this chapter, respectively.

LIST OF QUESTIONS

Q-1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan?

Q-2: What is an *eligible retirement plan* and a *qualified plan*?

Q-3: What is an *eligible rollover distribution*?

Q-4: Are there other amounts that are not eligible rollover distributions?

Q-5: For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is

a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?

Q-6: What types of variations in the amount of a payment cause the payment to be independent of a series of substantially equal periodic payments and thus not part of the series?

Q-7: When is a distribution from a plan a required minimum distribution under section 401(a)(9)?

Q-8: How are amounts that are not includible in gross income allocated for purposes of determining the required minimum distribution?

Q-9: What is a distribution of a plan loan offset amount and is it an eligible rollover distribution?

Q-10: What is a qualified plan distributed annuity contract, and is an amount paid under such a contract a distribution of the balance to the credit of the employee in a qualified plan for purposes of section 402(c)?

Q-11: If an eligible rollover distribution is paid to an employee, and the employee contributes all or part of the eligible rollover distribution to an eligible retirement plan within 60 days, is the amount contributed not currently includible in gross income?

Q-12: How does section 402(c) apply to a distributee who is not the employee?

Q-13: Must an employee's (or spousal distributee's) election to treat a contribution of an eligible rollover distribution to an individual retirement plan as a rollover contribution be irrevocable?

Q-14: How is the \$5,000 death benefit exclusion under section 101(b) treated for purposes of determining the amount that is an eligible rollover distribution?

Q-15: May an employee (or spousal distributee) roll over more than the plan administrator determines to be an eligible rollover distribution using an assumption described in §1.401(a)(31)-1, Q&A-17?

Q-16: Is a rollover from a qualified plan to an individual retirement account or individual retirement annuity treated as a rollover contribution for purposes of the one-year look-back rollover limitation of section 408(d)(3)(B)?

QUESTIONS AND ANSWERS

Q-1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan?

A-1: (a) *General rule.* Under section 402(c), as added by UCA, any portion

of a distribution from a qualified plan that is an eligible rollover distribution described in section 402(c)(4) may be rolled over to an eligible retirement plan described in section 402(c)(8)(B). For purposes of section 402(c) and this section, a rollover is either a direct rollover as described in §1.401(a)(31)-1, Q&A-3 or a contribution of an eligible rollover distribution to an eligible retirement plan that satisfies the time period requirement in section 402(c)(3) and Q&A-11 of this section and the designation requirement described in Q&A-13 of this section. See Q&A-2 of this section for the definition of an eligible retirement plan and a qualified plan.

(b) *Related Internal Revenue Code provisions*—(1) *Direct rollover option.* Section 401(a)(31), added by UCA, requires qualified plans to provide a distributee of an eligible rollover distribution the option to elect to have the distribution paid directly to an eligible retirement plan in a direct rollover. See §1.401(a)(31)-1 for further guidance concerning this direct rollover option.

(2) *Notice requirement.* Section 402(f) requires the plan administrator of a qualified plan to provide, within a reasonable time before making an eligible rollover distribution, a written explanation to the distributee of the distributee's right to elect a direct rollover and the withholding consequences of not making that election. The explanation also is required to provide certain other relevant information relating to the taxation of distributions. See §1.402(f)-1 for guidance concerning the written explanation required under section 402(f).

(3) *Mandatory income tax withholding.* If a distributee of an eligible rollover distribution does not elect to have the eligible rollover distribution paid directly from the plan to an eligible retirement plan in a direct rollover under section 401(a)(31), the eligible rollover distribution is subject to 20-percent income tax withholding under section 3405(c). See §31.3405(c)-1 of this chapter for provisions relating to the withholding requirements applicable to eligible rollover distributions.

(4) *Section 403(b) annuities.* See §1.403(b)-2 for guidance concerning the direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date.* Section 402(c), added by

UCA, applies to eligible rollover distributions made on or after January 1, 1993, even if the event giving rise to the distribution occurred on or before January 1, 1993 (e.g. termination of the employee's employment with the employer maintaining the plan before January 1, 1993), and even if the eligible rollover distribution is part of a series of payments that began before January 1, 1993.

(2) *Regulatory effective date.* This section applies to any distribution made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, §1.402(c)-2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, any or all of the provisions of this section may be substituted for the corresponding provisions of §1.402(c)-2T, if any.

Q-2: What is an *eligible retirement plan* and a *qualified plan*?

A-2: An eligible retirement plan, under section 402(c)(8)(B), means a qualified plan or an individual retirement plan. For purposes of section 402(c) and this section, a qualified plan is an employees' trust described in section 401(a) which is exempt from tax under section 501(a) or an annuity plan described in section 403(a). An individual retirement plan is an individual retirement account described in section 408(a) or an individual retirement annuity (other than an endowment contract) described in section 408(b).

Q-3: What is an *eligible rollover distribution*?

A-3: (a) *General rule.* Unless specifically excluded, an eligible rollover distribution means any distribution to an employee (or to a spousal distributee described in Q&A-12(a) of this section) of all or any portion of the balance to the credit of the employee in a qualified plan. Thus, except as specifically provided in Q&A-4(b) of this section, any amount distributed to an employee (or such a spousal distributee) from a qualified plan is an eligible rollover distribution, regardless of whether it is a distribution of a benefit that is protected under section 411(d)(6).

(b) *Exceptions.* An eligible rollover distribution does not include the following:

(1) Any distribution that is one of a series of substantially equal periodic

payments made (not less frequently than annually) over any one of the following periods—

(i) The life of the employee (or the joint lives of the employee and the employee's designated beneficiary);

(ii) The life expectancy of the employee (or the joint life and last survivor expectancy of the employee and the employee's designated beneficiary); or

(iii) A specified period of ten years or more;

(2) Any distribution to the extent the distribution is a required minimum distribution under section 401(a)(9); or

(3) The portion of any distribution that is not includible in gross income (determined without regard to the exclusion for net unrealized appreciation described in section 402(e)(4)). Thus, for example, an eligible rollover distribution does not include the portion of any distribution that is excludible from gross income under section 72 as a return of the employee's investment in the contract (e.g., a return of the employee's after-tax contributions), but does include net unrealized appreciation.

Q-4: Are there other amounts that are not eligible rollover distributions?

A-4: Yes. The following amounts are not eligible rollover distributions:

(a) Elective deferrals, as defined in section 402(g)(3), that, pursuant to §1.415-6(b)(6)(iv), are returned as a result of the application of the section 415 limitations, together with the income allocable to these corrective distributions.

(b) Corrective distributions of excess deferrals as described in §1.402(g)-1(e)(3), together with the income allocable to these corrective distributions.

(c) Corrective distributions of excess contributions under a qualified cash or deferred arrangement described in §1.401(k)-1(f)(4) and excess aggregate contributions described in §1.401(m)-1(e)(3), together with the income allocable to these distributions.

(d) Loans that are treated as deemed distributions pursuant to section 72(p).

(e) Dividends paid on employer securities as described in section 404(k).

(f) The costs of life insurance coverage (P.S. 58 costs).

(g) Similar items designated by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

Q-5: For purposes of determining whether a distribution is an eligible rollover distribution, how is it determined whether a series of payments is a series of substantially equal periodic payments over a period specified in section 402(c)(4)(A)?

A-5: (a) *General rule.* Generally, whether a series of payments is a series of substantially equal periodic payments over a specified period is determined at the time payments begin, and by following the principles of section 72(t)(2)(A)(iv), without regard to contingencies or modifications that have not yet occurred. Thus, for example, a joint and 50-percent survivor annuity will be treated as a series of substantially equal payments at the time payments commence, as will a joint and survivor annuity that provides for increased payments to the employee if the employee's beneficiary dies before the employee. Similarly, for purposes of determining if a disability benefit payment is part of a series of substantially equal payments for a period described in section 402(c)(4)(A), any contingency under which payments cease upon recovery from the disability may be disregarded.

(b) *Certain supplements disregarded.* For purposes of determining whether a distribution is one of a series of payments that are substantially equal, social security supplements described in section 411(a)(9) are disregarded. For example, if a distributee receives a life annuity of \$500 per month, plus a social security supplement consisting of payments of \$200 per month until the distributee reaches the age at which social security benefits of not less than \$200 a month begin, the \$200 supplemental payments are disregarded and, therefore, each monthly payment of \$700 made before the social security age and each monthly payment of \$500 made after the social security age is treated as one of a series of substantially equal periodic payments for life. A series of payments that are not substantially equal solely because the amount of each payment is reduced upon attainment of social security retirement age (or, alternatively, upon commencement of social security early retirement, survivor, or disability benefits) will also be treated as substantially equal as long as the reduction in the actual payments is level and does not exceed the applicable social security benefit.

(c) *Changes in the amount of payments or the distributee.* If the amount

(or, if applicable, the method of calculating the amount) of the payments changes so that subsequent payments are not substantially equal to prior payments, a new determination must be made as to whether the remaining payments are a series of substantially equal periodic payments over a period specified in Q&A-3(b)(1) of this section. This determination is made without taking into account payments made or the years of payment that elapsed prior to the change. However, a new determination is not made merely because, upon the death of the employee, the spouse or former spouse of the employee becomes the distributee. Thus, once distributions commence over a period that is at least as long as either the first annuitant's life or 10 years (e.g., as provided by a life annuity with a five-year or ten-year-certain guarantee), then substantially equal payments to the survivor are not eligible rollover distributions even though the payment period remaining after the death of the employee is or may be less than the period described in section 402(c)(4)(A). For example, substantially equal periodic payments made under a life annuity with a five-year term certain would not be an eligible rollover distribution even when paid after the death of the employee with three years remaining under the term certain.

(d) *Defined contribution plans.* The following rules apply in determining whether a series of payments from a defined contribution plan constitute substantially equal periodic payments for a period described in section 402(c)(4)(A):

(1) *Declining balance of years.* A series of payments from an account balance under a defined contribution plan will be considered substantially equal payments over a period if, for each year, the amount of the distribution is calculated by dividing the account balance by the number of years remaining in the period. For example, a series of payments will be considered substantially equal payments over 10 years if the series is determined as follows. In year 1, the annual payment is the account balance divided by 10; in year 2, the annual payment is the remaining account balance divided by 9; and so on until year 10 when the entire remaining balance is distributed.

(2) *Reasonable actuarial assumptions.* If an employee's account balance under a defined contribution plan is to be distributed in annual installments of

a specified amount until the account balance is exhausted, then, for purposes of determining if the period of distribution is a period described in section 402(c)(4)(A), the period of years over which the installments will be distributed must be determined using reasonable actuarial assumptions. For example, if an employee has an account balance of \$100,000, elects distributions of \$12,000 per year until the account balance is exhausted, and the future rate of return is assumed to be 8% per year, the account balance will be exhausted in approximately 14 years. Similarly, if the same employee elects a fixed annual distribution amount and the fixed annual amount is less than or equal to \$10,000, it is reasonable to assume that a future rate of return will be greater than 0% and, thus, the account will not be exhausted in less than 10 years.

(e) *Series of payments beginning before January 1, 1993.* Except as provided in paragraph (c) of this Q&A, if a series of periodic payments began before January 1, 1993, the determination of whether the post-December 31, 1992 payments are a series of substantially equal periodic payments over a specified period is made by taking into account all payments made, including payments made before January 1, 1993. For example, if a series of substantially equal periodic payments beginning on January 1, 1983, is scheduled to be paid over a period of 15 years, payments in the series that are made after December 31, 1992, will not be eligible rollover distributions even though they will continue for only five years after December 31, 1992, because the pre-January 1, 1993 payments are taken into account in determining the specified period.

Q-6: What types of variations in the amount of a payment cause the payment to be independent of a series of substantially equal periodic payments and thus not part of the series?

A-6: (a) *Independent payments.* Except as provided in paragraph (b) of this Q&A, a payment is treated as independent of the payments in a series of substantially equal payments, and thus not part of the series, if the payment is substantially larger or smaller than the other payments in the series. An independent payment is an eligible rollover distribution if it is not otherwise excepted from the definition of eligible rollover distribution. This is the case regardless of whether the pay-

ment is made before, with, or after payments in the series. For example, if an employee elects a single payment of half of the account balance with the remainder of the account balance paid over the life expectancy of the distributee, the single payment is treated as independent of the payments in the series and is an eligible rollover distribution unless otherwise excepted. Similarly, if an employee's surviving spouse receives a survivor life annuity of \$1,000 per month plus a single payment on account of death of \$7,500, the single payment is treated as independent of the payments in the annuity and is an eligible rollover distribution unless otherwise excepted (e.g., \$5,000 of the \$7,500 might qualify to be excluded from gross income as a death benefit under section 101(b)).

(b) *Special rules*—(1) *Administrative error or delay*. If, due solely to reasonable administrative error or delay in payment, there is an adjustment after the annuity starting date to the amount of any payment in a series of payments that otherwise would constitute a series of substantially equal payments described in section 402(c)(4)(A) and this section, the adjusted payment or payments will be treated as part of the series of substantially equal periodic payments and will not be treated as independent of the payments in the series. For example, if, due solely to reasonable administrative delay, the first payment of a life annuity is delayed by two months and reflects an additional two months worth of benefits, that payment will be treated as a substantially equal payment in the series rather than as an independent payment. The result will not change merely because the amount of the adjustment is paid in a separate supplemental payment.

(2) *Supplemental payments for annuitants*. A supplemental payment from a defined benefit plan to annuitants (e.g., retirees or beneficiaries) will be treated as part of a series of substantially equal payments, rather than as an independent payment, provided that the following conditions are met—

(i) The supplement is a benefit increase for annuitants;

(ii) The amount of the supplement is determined in a consistent manner for all similarly situated annuitants;

(iii) The supplement is paid to annuitants who are otherwise receiving payments that would constitute substantially equal periodic payments; and

(iv) The aggregate supplement is less than or equal to the greater of 10% of the annual rate of payment for the annuity, or \$750 or any higher amount prescribed by the Commissioner in revenue rulings, notices, and other guidance published in the Federal Register. See §601.601(d)(2)(ii)(b) of this chapter.

(3) *Final payment in a series*. If a payment in a series of payments from an account balance under a defined contribution plan represents the remaining balance to the credit and is substantially less than the other payments in the series, the final payment must nevertheless be treated as a payment in the series of substantially equal payments and may not be treated as an independent payment if the other payments in the series are substantially equal and the payments are for a period described in section 402(c)(4)(A) based on the rules provided in paragraph (d)(2) of Q&A-5 of this section. Thus, such final payment will not be an eligible rollover distribution.

Q-7: When is a distribution from a plan a required minimum distribution under section 401(a)(9)?

A-7: (a) *General rule*. Except as provided in paragraphs (b) and (c) of this Q&A, if a minimum distribution is required for a calendar year, the amounts distributed during that calendar year are treated as required minimum distributions under section 401(a)(9), to the extent that the total required minimum distribution under section 401(a)(9) for the calendar year has not been satisfied. Accordingly, these amounts are not eligible rollover distributions. For example, if an employee is required under section 401(a)(9) to receive a required minimum distribution for a calendar year of \$5,000 and the employee receives a total of \$7,200 in that year, the first \$5,000 distributed will be treated as the required minimum distribution and will not be an eligible rollover distribution and the remaining \$2,200 will be an eligible rollover distribution if it otherwise qualifies. If the total section 401(a)(9) required minimum distribution for a calendar year is not distributed in that calendar year (e.g., when the distribution for the calendar year in which the employee reaches age 70½ is made on the following April 1), the amount that was required but not distributed is added to the amount required to be distributed for the next calendar year in determining the por-

tion of any distribution in the next calendar year that is a required minimum distribution.

(b) *Distribution before age 70½*. Any amount that is paid before January 1 of the year in which the employee attains (or would have attained) age 70½ will not be treated as required under section 401(a)(9) and, thus, is an eligible rollover distribution if it otherwise qualifies.

(c) *Special rule for annuities*. In the case of annuity payments from a defined benefit plan, or under an annuity contract purchased from an insurance company (including a qualified plan distributed annuity contract (as defined in Q&A-10 of this section)), the entire amount of any such annuity payment made on or after January 1 of the year in which an employee attains (or would have attained) age 70½ will be treated as an amount required under section 401(a)(9) and, thus, will not be an eligible rollover distribution.

Q-8: How are amounts that are not includible in gross income allocated for purposes of determining the required minimum distribution?

A-8: If section 401(a)(9) has not yet been satisfied by the plan for the year with respect to an employee, a distribution is made to the employee that exceeds the amount required to satisfy section 401(a)(9) for the year for the employee, and a portion of that distribution is excludible from gross income, the following rule applies for purposes of determining the amount of the distribution that is an eligible rollover distribution. The portion of the distribution that is excludible from gross income is first allocated toward satisfaction of section 401(a)(9) and then the remaining portion of the required minimum distribution, if any, is satisfied from the portion of the distribution that is includible in gross income. For example, assume an employee is required under section 401(a)(9) to receive a minimum distribution for a calendar year of \$4,000 and the employee receives a \$4,800 distribution, of which \$1,000 is excludible from income as a return of basis. First, the \$1,000 return of basis is allocated toward satisfying the required minimum distribution. Then, the remaining \$3,000 of the required minimum distribution is satisfied from the \$3,800 of the distribution that is includible in gross income, so that the remaining balance of the distribution,

\$800, is an eligible rollover distribution if it otherwise qualifies.

Q-9: What is a distribution of a plan loan offset amount, and is it an eligible rollover distribution?

A-9: (a) *General rule.* A distribution of a plan loan offset amount, as defined in paragraph (b) of this Q&A, is an eligible rollover distribution if it satisfies Q&A-3 of this section. Thus, an amount equal to the plan loan offset amount can be rolled over by the employee (or spousal distributee) to an eligible retirement plan within the 60-day period under section 402(c)(3), unless the plan loan offset amount fails to be an eligible rollover distribution for another reason. See §1.401(a)(31)-1, Q&A-15 for guidance concerning the offering of a direct rollover of a plan loan offset amount. See §31.3405(c)-1, Q&A-11 of this chapter for guidance concerning special withholding rules with respect to plan loan offset amounts.

(b) *Definition of plan loan offset amount.* For purposes of section 402(c), a distribution of a plan loan offset amount is a distribution that occurs when, under the plan terms governing a plan loan, the participant's accrued benefit is reduced (offset) in order to repay the loan (including the enforcement of the plan's security interest in a participant's accrued benefit). A distribution of a plan loan offset amount can occur in a variety of circumstances, e.g., where the terms governing a plan loan require that, in the event of the employee's termination of employment or request for a distribution, the loan be repaid immediately or treated as in default. A distribution of a plan loan offset amount also occurs when, under the terms governing the plan loan, the loan is cancelled, accelerated, or treated as if it were in default (e.g., where the plan treats a loan as in default upon an employee's termination of employment or within a specified period thereafter). A distribution of a plan loan offset amount is an actual distribution, not a deemed distribution under section 72(p).

(c) *Examples.* The rules with respect to a plan loan offset amount in this Q&A-9, §1.401(a)(31)-1, Q&A-15 and §31.3405(c)-1, Q&A-11 of this chapter are illustrated by the following examples:

Example 1. (a) In 1996, Employee A has an account balance of \$10,000 in Plan Y, of which \$3,000 is invested in a plan loan to Employee A

that is secured by Employee A's account balance in Plan Y. Employee A has made no after-tax employee contributions to Plan Y. Plan Y does not provide any direct rollover option with respect to plan loans. Upon termination of employment in 1996, Employee A, who is under age 70½, elects a distribution of Employee A's entire account balance in Plan Y, and Employee A's outstanding loan is offset against the account balance on distribution. Employee A elects a direct rollover of the distribution.

(b) In order to satisfy section 401(a)(31), Plan Y must pay \$7,000 directly to the eligible retirement plan chosen by Employee A in a direct rollover. When Employee A's account balance was offset by the amount of the \$3,000 unpaid loan balance, Employee A received a plan loan offset amount (equivalent to \$3,000) that is an eligible rollover distribution. However, under §1.401(a)(31)-1, Q&A-15 Plan Y satisfies section 401(a)(31), even though a direct rollover option was not provided with respect to the \$3,000 plan loan offset amount.

(c) No withholding is required under section 3405(c) on account of the distribution of the \$3,000 plan loan offset amount because no cash or other property (other than the plan loan offset amount) is received by Employee A from which to satisfy the withholding. Employee A may roll over \$3,000 to an eligible retirement plan within the 60 day period provided in section 402(c)(3).

Example 2. (a) The facts are the same as in *Example 1*, except that the terms governing the plan loan to Employee A provide that, upon termination of employment, Employee A's account balance is automatically offset by the amount of any unpaid loan balance to repay the loan. Employee A terminates employment but does not request a distribution from Plan Y. Nevertheless, pursuant to the terms governing the plan loan, Employee A's account balance is automatically offset by the amount of the \$3,000 unpaid loan balance.

(b) The \$3,000 plan loan offset amount attributable to the plan loan in this example is treated in the same manner as the \$3,000 plan loan offset amount in *Example 1*.

Example 3. (a) The facts are the same as in *Example 2*, except that, instead of providing for an automatic offset upon termination of employment to repay the plan loan, the terms governing the plan loan require full repayment of the loan by Employee A within 30 days of termination of employment. Employee A terminates employment, does not elect a distribution from Plan Y, and also fails to repay the plan loan within 30 days. The plan administrator of Plan Y declares the plan loan to Employee A in default and executes on the loan by offsetting Employee A's account balance by the amount of the \$3,000 unpaid loan balance.

(b) The \$3,000 plan loan offset amount attributable to the plan loan in this example is treated in the same manner as the \$3,000 plan loan offset amount in *Example 1* and in *Example 2*. The result in this *Example 3* is the same even though the plan administrator treats the loan as in default before offsetting Employee A's accrued benefit by the amount of the unpaid loan.

Example 4. (a) The facts are the same as in *Example 1*, except that Employee A elects to receive the distribution of the account balance that remains after the \$3,000 offset to repay the plan loan, instead of electing a direct rollover of the remaining account balance.

(b) In this case, the amount of the distribution received by Employee A is \$10,000, not \$3,000.

Because the amount of the \$3,000 offset attributable to the loan is included in determining the amount that equals 20 percent of the eligible rollover distribution received by Employee A, withholding in the amount of \$2,000 (20 percent of \$10,000) is required under section 3405(c). The \$2,000 is required to be withheld from the \$7,000 to be distributed to Employee A in cash, so that Employee A actually receives a check for \$5,000.

Example 5. The facts are the same as in *Example 4*, except that the \$7,000 distribution to Employee A after the offset to repay the loan consists solely of employer securities within the meaning of section 402(e)(4)(E). In this case, no withholding is required under section 3405(c) because the distribution consists solely of the \$3,000 plan loan offset amount and the \$7,000 distribution of employer securities. This is the result because the total amount required to be withheld does not exceed the sum of the cash and the fair market value of other property distributed, excluding plan loan offset amounts and employer securities. Employee A may roll over the employer securities and \$3,000 to an eligible retirement plan within the 60-day period provided in section 402(c)(3).

Example 6. Employee B, who is age 40, has an account balance in Plan Z, a profit sharing plan qualified under section 401(a) that includes a qualified cash or deferred arrangement described in section 401(k). Plan Z provides for no after-tax employee contributions. In 1990, Employee B receives a loan from Plan Z, the terms of which satisfy section 72(p)(2), and which is secured by elective contributions subject to the distribution restrictions in section 401(k)(2)(B). In 1996, the loan fails to satisfy section 72(p)(2) because Employee B stops repayment. In that year, pursuant to section 72(p), Employee B is taxed on a deemed distribution equal to the amount of the unpaid loan balance. Under Q&A-4 of this section, the deemed distribution is not an eligible rollover distribution. Because Employee B has not separated from service or experienced any other event that permits the distribution under section 401(k)(2)(B) of the elective contributions that secure the loan, Plan Z is prohibited from executing on the loan. Accordingly, Employee B's account balance is not offset by the amount of the unpaid loan balance at the time Employee B stops repayment on the loan. Thus, there is no distribution of an offset amount that is an eligible rollover distribution in 1996.

Q-10: What is a qualified plan distributed annuity contract, and is an amount paid under such a contract a distribution of the balance to the credit of the employee in a qualified plan for purposes of section 402(c)?

A-10: (a) *Definition of a qualified plan distributed annuity contract.* A qualified plan distributed annuity contract is an annuity contract purchased for a participant, and distributed to the participant, by a qualified plan.

(b) *Treatment of amounts paid as eligible rollover distributions.* Amounts paid under a qualified plan distributed annuity contract are payments of the balance to the credit of the employee

for purposes of section 402(c) and are eligible rollover distributions, if they otherwise qualify. Thus, for example, if the employee surrenders the contract for a single sum payment of its cash surrender value, the payment would be an eligible rollover distribution to the extent it is includible in gross income and not a required minimum distribution under section 401(a)(9). This rule applies even if the annuity contract is distributed in connection with a plan termination. See §1.401(a)(31)-1, Q&A-16 and §31.3405(c)-1, Q&A-13 of this chapter concerning the direct rollover requirements and 20-percent withholding requirements, respectively, that apply to eligible rollover distributions from such an annuity contract.

Q-11: If an eligible rollover distribution is paid to an employee, and the employee contributes all or part of the eligible rollover distribution to an eligible retirement plan within 60 days, is the amount contributed not currently includible in gross income?

A-11: Yes, the amount contributed is not currently includible in gross income, provided that it is contributed to the eligible retirement plan no later than the 60th day following the day on which the employee received the distribution. If more than one distribution is received by an employee from a qualified plan during a taxable year, the 60-day rule applies separately to each distribution. Because the amount withheld as income tax under section 3405(c) is considered an amount distributed under section 402(c), an amount equal to all or any portion of the amount withheld can be contributed as a rollover to an eligible retirement plan within the 60-day period, in addition to the net amount of the eligible rollover distribution actually received by the employee. However, if all or any portion of an amount equal to the amount withheld is not contributed as a rollover, it is included in the employee's gross income to the extent required under section 402(a), and also may be subject to the 10-percent additional income tax under section 72(t).

Q-12: How does section 402(c) apply to a distributee who is not the employee?

A-12: (a) *Spousal distributee*. If any distribution attributable to an employee is paid to the employee's surviving spouse, section 402(c) applies to the distribution in the same manner as if the spouse were the employee. The

same rule applies if any distribution attributable to an employee is paid in accordance with a qualified domestic relations order (as defined in section 414(p)) to the employee's spouse or former spouse who is an alternate payee. Therefore, a distribution to the surviving spouse of an employee (or to a spouse or former spouse who is an alternate payee under a qualified domestic relations order), including a distribution of ancillary death benefits attributable to the employee, is an eligible rollover distribution if it meets the requirements of section 402(c)(2) and (4) and Q&A-3 through Q&A-10 and Q&A-14 of this section. However, a qualified plan (as defined in Q&A-2 of this section) is not treated as an eligible retirement plan with respect to a surviving spouse. Only an individual retirement plan is treated as an eligible retirement plan with respect to an eligible rollover distribution to a surviving spouse.

(b) *Non-spousal distributee*. A distributee other than the employee or the employee's surviving spouse (or a spouse or former spouse who is an alternate payee under a qualified domestic relations order) is not permitted to roll over distributions from a qualified plan. Therefore, those distributions do not constitute eligible rollover distributions under section 402(c)(4) and are not subject to the 20-percent income tax withholding under section 3405(c).

Q-13: Must an employee's (or spousal distributee's) election to treat a contribution of an eligible rollover distribution to an individual retirement plan as a rollover contribution be irrevocable?

A-13: (a) *In general*. Yes. In order for a contribution of an eligible rollover distribution to an individual retirement plan to constitute a rollover and, thus, to qualify for current exclusion from gross income, a distributee must elect, at the time the contribution is made, to treat the contribution as a rollover contribution. An election is made by designating to the trustee, issuer, or custodian of the eligible retirement plan that the contribution is a rollover contribution. This election is irrevocable. Once any portion of an eligible rollover distribution has been contributed to an individual retirement plan and designated as a rollover distribution, taxation of the withdrawal of the contribution from the individual retirement plan is determined under

section 408(d) rather than under section 402 or 403. Therefore, the eligible rollover distribution is not eligible for capital gains treatment, five-year or ten-year averaging, or the exclusion from gross income for net unrealized appreciation on employer stock.

(b) *Direct rollover*. If an eligible rollover distribution is paid to an individual retirement plan in a direct rollover at the election of the distributee, the distributee is deemed to have irrevocably designated that the direct rollover is a rollover contribution.

Q-14: How is the \$5,000 death benefit exclusion under section 101(b) treated for purposes of determining the amount that is an eligible rollover distribution?

A-14: To the extent that a death benefit is a distribution from a qualified plan, the portion of the distribution that is excluded from gross income under section 101(b) is not an eligible rollover distribution. See §1.401(a)(31)-1, Q&A-17 for guidance concerning assumptions that a plan administrator may make with respect to whether and to what extent a distribution of a survivor benefit is excludible from gross income under section 101(b).

Q-15: May an employee (or spousal distributee) roll over more than the plan administrator determines to be an eligible rollover distribution using an assumption described in §1.401(a)(31)-1, Q&A-17?

A-15: Yes. The portion of any distribution that an employee (or spousal distributee) may roll over as an eligible rollover distribution under section 402(c) is determined based on the actual application of section 402 and other relevant provisions of the Internal Revenue Code. The actual application of these provisions may produce different results than any assumption described in §1.401(a)(31)-1, Q&A-17 that is used by the plan administrator. Thus, for example, even though the plan administrator calculates the portion of a distribution that is a required minimum distribution (and thus is not made eligible for direct rollover under section 401(a)(31)), by assuming that there is no designated beneficiary, the portion of the distribution that is actually a required minimum distribution and thus not an eligible rollover distribution is determined by taking into account the designated beneficiary,

if any. If, by taking into account the designated beneficiary, a greater portion of the distribution is an eligible rollover distribution, the distributee may rollover the additional amount. Similarly, even though a plan administrator assumes that a distribution from a qualified plan is the only death benefit with respect to an employee that qualifies for the \$5,000 death benefit exclusion under section 101(b), to the extent that the death benefit exclusion is allocated to a different death benefit, a greater portion of the distribution may actually be includible in gross income and, thus, be an eligible rollover distribution, and the surviving spouse may roll over the additional amount if it otherwise qualifies.

Q-16: Is a rollover from a qualified plan to an individual retirement account or individual retirement annuity treated as a rollover contribution for purposes of the one-year look-back rollover limitation of section 408(d)(3)(B)?

A-16: No. A distribution from a qualified plan that is rolled over to an individual retirement account or individual retirement annuity is not treated for purposes of section 408(d)(3)(B) as an amount received by an individual from an individual retirement account or individual retirement annuity which is not includible in gross income because of the application of section 408(d)(3).

§1.402(f)-1 Required explanation of eligible rollover distributions; questions and answers.

The following questions and answers concern the written explanation requirement imposed by section 402(f) of the Internal Revenue Code of 1986 relating to distributions eligible for rollover treatment. Section 402(f) was amended by section 521(a) of the Unemployment Compensation Amendments of 1992, Public Law 102-318, 106 Stat. 290 (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 403(b)(8) and (10), and 3405(c), see §§1.401(a)(31)-1, 1.402(c)-2, 1.403(b)-2, and 31.3405(c)-1 of this chapter, respectively.

LIST OF QUESTIONS

Q-1: What are the requirements for a written explanation under section 402(f)?

Q-2: When must the plan administrator provide the section 402(f) notice to a distributee?

Q-3: Must the plan administrator provide a separate section 402(f) notice for each distribution in a series of periodic payments that are eligible rollover distributions?

Q-4: May a plan administrator post the section 402(f) notice as a means of providing it to distributees?

QUESTIONS AND ANSWERS

Q-1: What are the requirements for a written explanation under section 402(f)?

A-1: (a) *General rule.* Under section 402(f), as amended by UCA, the plan administrator of a qualified plan is required, within a reasonable period of time before making an eligible rollover distribution, to provide the distributee with the written explanation described in section 402(f) (section 402(f) notice). The section 402(f) notice must be designed to be easily understood and must explain the following: the rules under which the distributee may elect that the distribution be paid in the form of a direct rollover to an eligible retirement plan; the rules that require the withholding of tax on the distribution if it is not paid in a direct rollover; the rules under which the distributee may defer tax on the distribution if it is contributed in a rollover to an eligible retirement plan within 60 days of the distribution; and if applicable, certain special rules regarding the taxation of the distribution as described in section 402(d) (averaging with respect to lump sum distributions) and (e) (other rules including treatment of net unrealized appreciation). See §1.401(a)(31)-1, Q&A-7 for additional information that must be provided if a plan provides a default procedure regarding the election of a direct rollover.

(b) *Model section 402(f) notice.* The plan administrator will be deemed to have complied with the requirements of paragraph (a) of this Q&A-1 relating to the contents of the section 402(f) notice if the plan administrator provides the applicable model section 402(f) notice published by the Internal Revenue Service for this purpose in a revenue ruling, notice, or other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(c) *Delegation to Commissioner.* The Commissioner, in revenue rulings,

notices, and other guidance, published in the Internal Revenue Bulletin, may modify, or provide any additional guidance with respect to, the notice requirement of this section. See §601.601(d)(2)(ii)(b) of this chapter.

(d) *Effective date*—(1) *Statutory effective date.* Section 402(f) applies to eligible rollover distributions made after December 31, 1992.

(2) *Regulatory effective date.* This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, §1.402(c)-2T, Q&A-11 through 15 (as it appeared in the April 1, 1995 edition of 26 CFR part 1), apply. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan administrator or payor may satisfy the requirements of section 402(f) by substituting any or all provisions of this section for the corresponding provisions of §1.402(c)-1T, Q&A-11 through 15, if any.

Q-2: When must the plan administrator provide the section 402(f) notice to a distributee?

A-2: The plan administrator must provide a distributee with the section 402(f) notice no less than 30 days and no more than 90 days before the date of distribution. However, if the distributee, after having received the section 402(f) notice, affirmatively elects a distribution, a plan will not fail to satisfy section 402(f) merely because the distribution is made less than 30 days after the section 402(f) notice was provided to the distributee, provided that the following requirement is met. The plan administrator must provide information to the distributee clearly indicating that (in accordance with the first sentence of this Q&A-2) the distributee has a right to consider the decision of whether or not to elect a direct rollover for at least 30 days after the notice is provided. The plan administrator may use any method to inform the distributee of the relevant time period, provided that the method is reasonably designed to attract the attention of the distributee. For example, this information could be provided either in the section 402(f) notice or stated in a separate document (e.g., attached to the election form) that is provided at the same time as the notice. For purposes of satisfying the requirement in the first sentence of this Q&A-2, the plan administrator may

substitute the annuity starting date, within the meaning of §1.401(a)-20, Q&A-10, for the date of distribution.

Q-3: Must the plan administrator provide a separate section 402(f) notice for each distribution in a series of periodic payments that are eligible rollover distributions?

A-3: No. In the case of a series of periodic payments that are eligible rollover distributions, the plan administrator is permitted to satisfy section 402(f) with respect to each payment in the series by providing the section 402(f) notice prior to the first payment in the series, in accordance with the rules in Q&A-1 and Q&A-2 of this section, and providing the notice at least once annually for as long as the payments continue. However, see §1.401(a)(31)-1, Q&A-12 for additional guidance if the plan administrator intends to treat a distributee's election to make or not make a direct rollover with respect to one payment in a series of periodic payments as applicable to all subsequent payments in the series (absent a subsequent change of election).

Q-4: May a plan administrator post the section 402(f) notice as a means of providing it to distributees?

A-4: No. The posting of the section 402(f) notice will not be considered provision of the notice. The written notice must be provided individually to any distributee of an eligible rollover distribution within the time period described in Q&A-2 and Q&A-3 of this section.

§1.403(b)-2 Eligible rollover distributions; questions and answers.

The following questions and answers relate to eligible rollover distributions from annuities, custodial accounts, and retirement income accounts described in section 403(b) of the Internal Revenue Code of 1986, as amended by sections 521 and 522 of the Unemployment Compensation Amendments of 1992 (Public Law 102-318, 106 Stat. 290) (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 402(f), and 3405(c), see §§1.401(a)(31)-1, 1.402(c)-2, 1.402(f)-1, and §31.3405(c)-1 of this chapter, respectively.

LIST OF QUESTIONS

Q-1: What is the rule regarding distributions that may be rolled over to

an eligible retirement plan from annuities, custodial accounts, and retirement income accounts described in section 403(b)?

Q-2: Is a section 403(b) annuity required to provide the direct rollover option described in section 401(a)(31) as a distribution option?

Q-3: Is the payor of a section 403(b) annuity required to provide a distributee of an eligible rollover distribution with an explanation of the direct rollover option?

Q-4: When do sections 403(b)(8) and 403(b)(10), as amended by UCA, and this §1.403(b)-2 apply to distributions from section 403(b) annuities?

QUESTIONS AND ANSWERS

Q-1: What is the rule regarding distributions that may be rolled over to an eligible retirement plan from annuities, custodial accounts, and retirement income accounts described in section 403(b)?

A-1: Under section 403(b)(8), as amended by UCA, any eligible rollover distribution from a section 403(b) annuity is permitted to be rolled over to an eligible retirement plan. For purposes of this section, a section 403(b) annuity includes an annuity contract, a custodial account, and a retirement income account described in section 403(b). For purposes of section 403(b)(8) and this section, an eligible retirement plan means another section 403(b) annuity or an individual retirement plan (as defined in §1.402(c)-2), Q&A-2 but does not include a qualified plan (as defined in §1.402(c)-2), Q&A-2. Except to the extent otherwise provided in this section, an eligible rollover distribution from a section 403(b) annuity is an eligible rollover distribution described in section 402(c)(2) and (4) and §1.402(c)-2, Q&A-3 through Q&A-10 and Q&A-14, except that the distribution is from a section 403(b) annuity rather than a qualified plan. Thus, for example, to the extent that corrective distributions described in §1.402(c)-2, Q&A-4 are properly made from a section 403(b) annuity, such distributions are not eligible rollover distributions. Similarly, in the case of annuity distributions from an annuity contract described in section 403(b), the entire amount of any such annuity payment made on or after January 1 of the year in which an employee attains (or would have at-

tained) age 70½ will be treated as an amount required under section 401(a)(9) and, thus, will not be an eligible rollover distribution. The rules with respect to rollovers in sections 402(c)(1), (c)(3), and (c)(9) and §1.402(c)-2, Q&A-11 through Q&A-13 and Q&A-15 also apply to eligible rollover distributions from section 403(b) annuities.

Q-2: Is a section 403(b) annuity required to provide the direct rollover option described in section 401(a)(31) as a distribution option?

A-2: (a) *General rule.* Yes. Pursuant to section 403(b)(10), section 403(b) does not apply to an annuity contract, custodial account, or retirement income account unless the annuity contract, custodial account, or retirement income account provides that if the distributee of any eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan (as defined in Q&A-1 of this section) and specifies the eligible retirement plan to which the distribution is to be paid, then the distribution will be paid to that eligible retirement plan in a direct rollover. For purposes of determining whether a section 403(b) annuity has satisfied this direct rollover requirement, the provisions of §1.401(a)(31)-1 apply to the section 403(b) annuity as though it were a plan qualified under section 401(a) unless otherwise provided in this section. For example, as described in §1.401(a)(31)-1, Q&A-14 a direct rollover from a section 403(b) annuity to another section 403(b) annuity is a distribution and a rollover and not a transfer of funds between section 403(b) annuities and, thus, is not subject to the applicable law governing transfers of funds between section 403(b) annuities. In applying the provisions of §1.401(a)(31)-1, the payor of the eligible rollover distribution is treated as the plan administrator.

(b) *Mandatory withholding.* As in the case of an eligible rollover distribution from a qualified plan, if a distributee of an eligible rollover distribution from a section 403(b) annuity does not elect to have the eligible rollover distribution paid directly to an eligible retirement plan in a direct rollover, the eligible rollover distribution is subject to 20-percent income tax withholding imposed under section 3405(c). See §31.3405(c)-1 of this chapter for provisions regarding the withholding requirements relating to eligible rollover distributions.

Q-3: Is the payor of a section 403(b) annuity required to provide the distributee of an eligible rollover distribution with an explanation of the direct rollover option?

A-3: Yes. In order to ensure that the distributee of an eligible rollover distribution from a section 403(b) annuity has a meaningful right to elect a direct rollover, the distributee must be informed of the option. Thus, within a reasonable time period before making an eligible rollover distribution, the payor must provide an explanation to the distributee of his or her right to elect a direct rollover and the income tax withholding consequences of not electing a direct rollover. For purposes of satisfying the reasonable time period, the qualified plan timing rule provided in §1.402(f)-1, Q&A-2 does not apply to section 403(b) annuities. However, a payor of a section 403(b) annuity will be deemed to have provided the explanation within a reasonable time period if the payor complies with the time period in that rule.

Q-4: When do sections 403(b)(8) and 403(b)(10), as amended by UCA, and this §1.403(b)-2 apply to distributions from section 403(b) annuities?

A-4: (a) *General rule*—(1) *Statutory effective date*. Section 403(b)(8), as amended by UCA, and section 403(b)(10), as amended by UCA, apply to distributions made on or after January 1, 1993. In addition, the underlying section 403(b) annuity document must be amended at the time provided in, and the section 403(b) annuity must operate in accordance with the requirements of §1.401(a)(31)-1, Q&A-18. Section 522 of UCA provides a special effective date for governmental section 403(b) annuities. This special effective date is specified in §1.403(b)-2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1).

(2) *Regulatory effective date*. This section applies to distributions made on or after October 19, 1995. For distributions made on or after January 1, 1993 and before October 19, 1995, §1.403(b)-2T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for distributions made on or after January 1, 1993 but before October 19, 1995, a section 403(b) annuity may satisfy section 403(b)(10) by substituting any or all provisions of this section for the corresponding provisions of §1.403(b)-2T, if any.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 4. The authority citation for part 31 continues to read in part as follows:

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

§31.3405(c)-1T [Removed]

Par. 5. Section 31.3402(p)-1 is amended by adding a sentence at the end of paragraph (a) to read as follows:

§31.3402(p)-1 Voluntary withholding agreements.

(a) * * * See §31.3405(c)-1, Q&A-3 concerning agreements to have more than 20-percent Federal income tax withheld from eligible rollover distributions within the meaning of section 402.

* * * * *

Par. 6. Section 31.3405(c)-1 is added to read as follows:

§31.3405(c)-1 Withholding on eligible rollover distributions; questions and answers.

The following questions and answers relate to withholding on eligible rollover distributions under section 3405(c) of the Internal Revenue Code of 1986, as added by section 522(b) of the Unemployment Compensation Amendments of 1992 (Public Law 102-318, 106 Stat. 290) (UCA). For additional UCA guidance under sections 401(a)(31), 402(c), 402(f), and 403(b)(8) and (10), see §§1.401(a)(31)-1, 1.402(c)-2, 1.402(f)-1, and 1.403(b)-2 of this chapter, respectively.

LIST OF QUESTIONS

Q-1: What are the withholding requirements under section 3405 for distributions from qualified plans and section 403(b) annuities?

Q-2: May a distributee elect under section 3405(c) not to have Federal income tax withheld from an eligible rollover distribution?

Q-3: May a distributee be permitted to elect to have more than 20-percent Federal income tax withheld from an eligible rollover distribution?

Q-4: Who has responsibility for complying with section 3405(c) relating

to the 20-percent income tax withholding on eligible rollover distributions?

Q-5: May the plan administrator shift the withholding responsibility to the payor and, if so, how?

Q-6: How does the 20-percent withholding requirement under section 3405(c) apply if a distributee elects to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

Q-7: Will the plan administrator be subject to liability for tax, interest, or penalties for failure to withhold 20 percent from an eligible rollover distribution that, because of erroneous information provided by a distributee, is not paid to an eligible retirement plan even though the distributee elected a direct rollover?

Q-8: Is an eligible rollover distribution that is paid to a qualified defined benefit plan subject to 20-percent withholding?

Q-9: If property other than cash, employer securities, or plan loans is distributed, how is the 20-percent income tax withholding required under section 3405(c) accomplished?

Q-10: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution for purposes of determining the amount of a distribution that is subject to 20-percent mandatory withholding?

Q-11: Are there special rules for applying the 20-percent withholding requirement to employer securities and a plan loan offset amount distributed in an eligible rollover distribution?

Q-12: How does the mandatory withholding rule apply to net unrealized appreciation from employer securities?

Q-13: Does the 20-percent withholding requirement apply to eligible rollover distributions from a qualified plan distributed annuity contract?

Q-14: Must a payor or plan administrator withhold tax from an eligible rollover distribution for which a direct rollover election was not made if the amount of the distribution is less than \$200?

Q-15: If eligible rollover distributions are made from a qualified plan, who has responsibility for making the returns and reports required under these regulations?

Q-16: What eligible rollover distributions must be reported on Form 1099-R?

Q-17: Must the plan administrator, trustee or custodian of the eligible retirement plan report amounts received in a direct rollover?

QUESTIONS AND ANSWERS

Q-1: What are the withholding requirements under section 3405 for distributions from qualified plans and section 403(b) annuities?

A-1: (a) *General rule.* Section 3405(c), added by UCA, provides that any designated distribution that is an eligible rollover distribution (as defined in section 402(f)(2)(A)) from a qualified plan or a section 403(b) annuity is subject to income tax withholding at the rate of 20 percent unless the distributee of the eligible rollover distribution elects to have the distribution paid directly to an eligible retirement plan in a direct rollover. See §1.402(c)-2, Q&A-2 of this chapter for the definition of a qualified plan and §1.403(b)-2, Q&A-1 of this chapter for the definition of a section 403(b) annuity. For purposes of section 3405 and this section, with respect to a distribution from a qualified plan, an eligible retirement plan is a trust qualified under section 401(a), an annuity plan described in section 403(a), or an individual retirement plan (as described in §1.402(c)-2, Q&A-2 of this chapter). For purposes of section 3405 and this section, with respect to a distribution from a section 403(b) annuity, an eligible retirement plan is an annuity contract, a custodial account, a retirement income account described in section 403(b), or an individual retirement plan. If a designated distribution is not an eligible rollover distribution, it is subject to the elective withholding provisions of section 3405(a) and (b) and §35.3405-1 of this chapter and is not subject to the mandatory withholding provisions of section 3405(c) and this section.

(b) *Application of other statutory provisions.* See §1.401(a)(31)-1 of this chapter concerning the requirements and the procedures for electing a direct rollover under section 401(a)(31). See section 402(c)(2) and (4), and §1.402(c)-2, Q&A-3 through Q&A-10 and Q&A-14 of this chapter for rules to determine what constitutes an eligible rollover distribution. See §1.402(f)-1, Q&A-1 through Q&A-3 and §1.403(b)-2, Q&A-3 of this chapter concerning the notice that must be provided to a distributee, within a reasonable period

of time before making an eligible rollover distribution. See §1.403(b)-2, Q&A-1 and Q&A-2 of this chapter for guidance concerning the rollover provisions and direct rollover requirements for distributions from annuities described in section 403(b).

(c) *Effective date*—(1) *Statutory effective date*—(i) *General rule.* Section 3405(c), as added by UCA, applies to eligible rollover distributions made on or after January 1, 1993, even if the employee's employment with the employer maintaining the plan terminated before January 1, 1993 and even if the eligible rollover distribution is part of a series of payments that began before January 1, 1993.

(ii) *Special rule for governmental section 403(b) annuities.* Section 522 of UCA provides a special effective date for governmental section 403(b) annuities. This special effective date appears in §1.403(b)-2T of this chapter (as it appeared in the April 1, 1995 edition of 26 CFR part 1).

(2) *Regulatory effective date.* This section applies to eligible rollover distributions made on or after October 19, 1995. For eligible rollover distributions made on or after January 1, 1993 and before October 19, 1995, §31.3405(c)-1T (as it appeared in the April 1, 1995 edition of 26 CFR part 1), applies. However, for any distribution made on or after January 1, 1993 but before October 19, 1995, a plan administrator or payor may comply with the withholding requirements of section 3405(c) by substituting any or all provisions of this section for the corresponding provisions of §31.3405(c)-1T, if any.

Q-2: May a distributee elect under section 3405(c) not to have Federal income tax withheld from an eligible rollover distribution?

A-2: No. The 20-percent income tax withholding imposed under section 3405(c)(1) applies to an eligible rollover distribution unless the distributee elects under section 401(a)(31) to have the eligible rollover distribution paid directly to an eligible retirement plan in a direct rollover. See §1.401(a)(31)-1 and §1.403(b)-2, Q&A-2 of this chapter for provisions concerning the requirement that a distributee of an eligible rollover distribution be permitted to elect a distribution in the form of a direct rollover.

Q-3: May a distributee be permitted to elect to have more than 20-percent

Federal income tax withheld from an eligible rollover distribution?

A-3: Yes. Under section 3402(p), a distributee of an eligible rollover distribution and the plan administrator or payor are permitted to enter into an agreement to provide for withholding in excess of 20 percent from an eligible rollover distribution. Any agreement must be made in accordance with applicable forms and instructions. However, no request for withholding will be effective between the plan administrator or payor and the distributee until the plan administrator or payor accepts the request by commencing to withhold from the amounts with respect to which the request was made. An agreement under section 3402(p) shall be effective for such period as the plan administrator or payor and the distributee mutually agree upon. However, either party to the agreement may terminate the agreement prior to the end of such period by furnishing a signed written notice to the other.

Q-4: Who has responsibility for complying with section 3405(c) relating to the 20-percent income tax withholding on eligible rollover distributions?

A-4: Section 3405(d) generally requires the plan administrator of a qualified plan and the payor of a section 403(b) annuity to withhold under section 3405(c)(1) an amount equal to 20 percent of the portion of an eligible rollover distribution that the distributee does not elect to have paid in a direct rollover. When an amount is paid under a qualified plan distributed annuity contract as defined in §1.402(c)-2, Q&A-10 of this chapter, the payor is treated as the plan administrator. See Q&A-13 of this section concerning eligible rollover distributions from a qualified plan distributed annuity contract.

Q-5: May the plan administrator shift the withholding responsibility to the payor and, if so, how?

A-5: Yes. The plan administrator may shift the withholding responsibility to the payor by following the procedures set forth in §35.3405-1, Q&A E-2 through E-5 of this chapter (relating to elective withholding on pensions, annuities and certain other deferred income) with appropriate adjustments, including the plan administrator's identification of amounts that constitute required minimum distributions.

Q-6: How does the 20-percent withholding requirement under section

3405(c) apply if a distributee elects to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to have the remainder of that distribution paid to the distributee?

A-6: If a distributee elects to have a portion of an eligible rollover distribution paid to an eligible retirement plan in a direct rollover and to receive the remainder of the distribution, the 20-percent withholding requirement under section 3405(c) applies only to the portion of the eligible rollover distribution that the distributee receives and not to the portion that is paid in a direct rollover.

Q-7: Will the plan administrator be subject to liability for tax, interest, or penalties for failure to withhold 20 percent from an eligible rollover distribution that, because of erroneous information provided by a distributee, is not paid to an eligible retirement plan even though the distributee elected a direct rollover?

A-7: (a) *General rule.* If the plan administrator reasonably relied on adequate information provided by the distributee (as described in paragraph (b) of this Q&A), the plan administrator will not be subject to liability for taxes, interest, or penalties for failure to withhold income tax from an eligible rollover distribution solely because the distribution is paid to an account or plan that is not an eligible retirement plan (as defined, with respect to distributions from qualified plans, in section 402(c)(8)(B) and §1.402(c)-2, Q&A-2 of this chapter and, with respect to a distributions from section 403(b) annuities, in §1.403(b)-2), Q&A-1 of this chapter. Although the plan administrator is not required to verify independently the accuracy of information provided by the distributee, the plan administrator's reliance on the information furnished must be reasonable. For example, it is not reasonable for the plan administrator to rely on information that is clearly erroneous on its face.

(b) *Adequate information.* The plan administrator has obtained from the distributee adequate information on which to rely in making a direct rollover if the distributee furnishes to the plan administrator: the name of the eligible retirement plan; a representation that the recipient plan is an individual retirement plan, a qualified plan, or a section 403(b) annuity, as appropriate; and any other information that is

necessary in order to permit the plan administrator to accomplish the direct rollover by the means it has selected. This information must include any information needed to comply with the specific requirements of §1.401(a)(31)-1, Q&A-3 and Q&A-4 of this chapter. For example, if the direct rollover is to be made by mailing a check to the trustee of an individual retirement account, the plan administrator must obtain, in addition to the name of the individual retirement account and the representation described above, the name and address of the trustee of the individual retirement account.

Q-8: Is an eligible rollover distribution that is paid to a qualified defined benefit plan subject to 20-percent withholding?

A-8: No. If an eligible rollover distribution is paid in a direct rollover to an eligible retirement plan within the meaning of section 402(c)(8), including a qualified defined benefit plan, it is reasonable to believe that the distribution is not includible in gross income pursuant to section 402(c)(1). Accordingly, pursuant to section 3405(e)-(1)(B), the distribution is not a designated distribution and is not subject to 20-percent withholding.

Q-9: If property other than cash, employer securities, or plan loans is distributed, how is the 20-percent income tax withholding required under section 3405(c) accomplished?

A-9: When all or a portion of an eligible rollover distribution subject to 20-percent income tax withholding under section 3405(c) consists of property other than cash, employer securities, or plan loan offset amounts, the plan administrator or payor must apply §35.3405-1, Q&A F-2 of this chapter and may apply §35.3405-1, Q&A F-3 of this chapter in determining how to satisfy the withholding requirements.

Q-10: What assumptions may a plan administrator make regarding whether a benefit is an eligible rollover distribution for purposes of determining the amount of a distribution that is subject to 20-percent mandatory withholding?

A-10: (a) *In general.* For purposes of determining the amount of a distribution that is subject to 20-percent mandatory withholding, a plan administrator may make the assumptions described in paragraphs (b), (c), and (d) of this Q&A in determining the amount of a distribution that is an eligible rollover distribution and a designated

distribution. Q&A-17 of §1.401(a)(31)-1 of this chapter provides assumptions for purposes of complying with section 401(a)(31). See §1.402(c)-2, Q&A-15 of this chapter concerning the effect of these assumptions for purposes of section 402(c).

(b) *\$5,000 death benefit.* A plan administrator may assume that a distribution that qualifies for the \$5,000 death benefit exclusion under section 101(b) is the only death benefit being paid with respect to a deceased employee that qualifies for that exclusion. Thus, in such a case, the plan administrator may assume that the distribution is not an eligible rollover distribution to the extent that it would be excludible from gross income based on this assumption.

(c) *Required minimum distributions.* The plan administrator is permitted to determine the amount of the minimum distribution required to satisfy section 401(a)(9)(A) for any calendar year by assuming that there is no designated beneficiary.

(d) *Valuation of property.* In the case of a distribution that includes property, in calculating the amount of the distribution for purposes of applying section 3405(c), the value of the property may be determined in accordance with §35.3405-1, Q&A F-1 of this chapter.

Q-11: Are there special rules for applying the 20-percent withholding requirement to employer securities and a plan loan offset amount distributed in an eligible rollover distribution?

A-11: Yes. The maximum amount to be withheld on any designated distribution (including any eligible rollover distribution) under section 3405(c) must not exceed the sum of the cash and the fair market value of property (excluding employer securities) received in the distribution. The amount of the sum is determined without regard to whether any portion of the cash or property is a designated distribution or an eligible rollover distribution. For purposes of this rule, any plan loan offset amount, as defined in §1.402(c)-2, Q&A-9 of this chapter, is treated in the same manner as employer securities. Thus, although employer securities and plan loan offset amounts must be included in the amount that is multiplied by 20-percent, the total amount required to be withheld for an eligible rollover distribution is limited to the sum of the cash and the fair

market value of property received by the distributee, excluding any amount of the distribution that is a plan loan offset amount or that is distributed in the form of employer securities. For example, if the only portion of an eligible rollover distribution that is not paid in a direct rollover consists of employer securities or a plan loan offset amount, withholding is not required. In addition, if a distribution consists solely of employer securities and cash (not in excess of \$200) in lieu of fractional shares, no amount is required to be withheld as income tax from the distribution under section 3405 (including section 3405(c) and this section). For purposes of section 3405 and this section, employer securities means securities of the employer corporation within the meaning of section 402(e)(4)(E)(ii).

Q-12: How does the mandatory withholding rule apply to net unrealized appreciation from employer securities?

A-12: An eligible rollover distribution can include net unrealized appreciation from employer securities, within the meaning of section 402(e)(4), even if the net unrealized appreciation is excluded from gross income under section 402(e)(4). However, to the extent that it is excludible from gross income pursuant to section 402(e)(4), net unrealized appreciation is not a designated distribution pursuant to section 3405(e)(1)(B) because it is reasonable to believe that it is not includible in gross income. Thus, to the extent that net unrealized appreciation is excludible from gross income pursuant to section 402(e)(4), net unrealized appreciation is not included in the amount of an eligible rollover distribution that is subject to 20-percent withholding.

Q-13: Does the 20-percent withholding requirement apply to eligible rollover distributions from a qualified plan distributed annuity contract?

A-13: The 20-percent withholding requirement applies to eligible rollover distributions from a qualified plan distributed annuity contract as defined in Q&A-10 of §1.402(c)-2 of this chapter. In the case of an eligible rollover distribution from such an annuity contract, the payor is treated as the plan administrator for purposes of section 3405. See §1.401(a)(31)-1, Q&A-16 of this chapter concerning the direct rollover requirements that apply to distributions from such an annuity contract and see §1.402(c)-2, Q&A-10

of this chapter concerning the treatment of distributions from such annuity contracts as eligible rollover distributions.

Q-14: Must a payor or plan administrator withhold tax from an eligible rollover distribution for which a direct rollover election was not made if the amount of the distribution is less than \$200?

A-14: No. However, all eligible rollover distributions received within one taxable year of the distributee under the same plan must be aggregated for purposes of determining whether the \$200 floor is reached. If the plan administrator or payor does not know at the time of the first distribution (that is less than \$200) whether there will be additional eligible rollover distributions during the year for which aggregation is required, the plan administrator need not withhold from the first distribution. If distributions are made within one taxable year under more than one plan of an employer, the plan administrator or payor may, but need not, aggregate distributions for purposes of determining whether the \$200 floor is reached. However, once the \$200 threshold has been reached, the sum of all payments during the year must be used to determine the applicable amount to be withheld from subsequent payments during the year.

Q-15: If eligible rollover distributions are made from a qualified plan, who has responsibility for making the returns and reports required under these regulations?

A-15: Generally, the plan administrator, as defined in section 414(g), is responsible for maintaining the records and making the required reports with respect to eligible rollover distributions from qualified plans. However, if the plan administrator fails to keep the required records and make the required reports, the employer maintaining the plan is responsible for the reports and returns.

Q-16: What eligible rollover distributions must be reported on Form 1099-R?

A-16: Each eligible rollover distribution, including each eligible rollover distribution that is paid directly to an eligible retirement plan in a direct rollover, must be reported on Form 1099-R in accordance with the instructions for Form 1099-R. For purposes of the reporting required under section 6047(e), a direct rollover is treated as a distribution that is immediately rolled over to an eligible retirement plan.

Distributions that are not eligible rollover distributions are subject to the reporting requirements set forth in §35.3405-1 of this chapter and applicable forms and instructions.

Q-17: Must the plan administrator, trustee or custodian of the eligible retirement plan report amounts received in a direct rollover?

A-17: (a) *Individual retirement plan.* If a distributee elects to have an eligible rollover distribution paid to an individual retirement plan in a direct rollover, the eligible rollover distribution is reported on Form 5498 as a rollover contribution to the individual retirement plan, in accordance with the instructions for Form 5498.

(b) *Qualified plan or section 403(b) annuity.* If a distributee elects to have an eligible rollover distribution paid to a qualified plan or section 403(b) annuity, the recipient plan or annuity is not required to report the receipt of the rollover contribution.

Par. 7. Section 31.3405(c)-1T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In §602.101, paragraph (c) is amended as follows:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

CFR part or section where identified and described	Current OMB control No.
* * * * *	
(c) * * *	
* * * * *	
1.401(a)(31)-1T	1545-1341
* * * * *	
1.402(c)-2T	1545-1341
* * * * *	
1.402(f)-2T	1545-1341
* * * * *	
1.403(b)-2T	1545-1341
* * * * *	
31.3405(c)-1T	1545-1341

* * * * *

2. Revising the entry for 1.402(f)-1 and adding entries to the table in numerical order to read as follows

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
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* * * * *

1.401(a)(31)-1 1545-1341

* * * * *

1.402(c)-2 1545-1341

1.402(f)-1 1545-1341

* * * * *

1.403(b)-2 1545-1341

* * * * *

31.3405(c)-1 1545-1341

* * * * *

Margaret Milner Richardson, Commissioner of Internal Revenue.

Approved August 29, 1995.

Cynthia G. Beerbower, Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 15, 1995, 4:00 p.m., and published in the issue of the Federal Register for September 22, 1995, 60 F.R. 49199)

Section 404.—Deduction, For Contributions Of An Employer To An Employees' Trust Or Annuity Plan And Compensation Under A Deferred-Payment Plan

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 404 of the Code to certain payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Section 408.—Individual Retirement Accounts

26 CFR 1.408-5: Annual reports by trustees or issuers.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.408-7: Reports on distributions from individual retirement plans.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 409.—Qualifications for Tax Credit Employee Stock Ownership Plans

Employee stock ownership plan (ESOP); voting rights. This ruling describes a situation where an ESOP will not violate section 409(e) of the Code merely because the trustee of the ESOP votes the shares of stock allocated to participants' accounts for which no directions were timely received from the participants.

Rev. Rul. 95-57

ISSUE

Does an employee stock ownership plan (ESOP) fail to comply with the pass-through voting requirements of § 409(e)(2) or (3) of the Internal Revenue Code merely because the trustee of the ESOP votes the shares of stock allocated to participants' or beneficiaries' accounts for which no directions are timely received from the participants or beneficiaries?

FACTS

X Corporation established ESOP Y for the benefit of its eligible employees. X Corporation has a registration-type class of securities within the meaning of § 409(e)(4) of the Code. The provisions of ESOP Y governing the voting of X Corporation securities (X Corporation shares) specify that participants and beneficiaries are entitled to direct the ESOP trustee as to the manner in which to vote X Corporation shares allocated to their accounts, and require that the trustee vote the shares in accordance with the timely directions of these participants

and beneficiaries. ESOP Y also provides that if the trustee does not timely receive voting directions from a participant or beneficiary with respect to any X Corporation shares allocated to that participant's or beneficiary's account, the shares shall be voted by the trustee. This procedure, with respect to voting of the allocated but non-directed shares, is disclosed in information provided to participants and beneficiaries prior to the deadline for participants or beneficiaries to submit directions for voting shares. Pursuant to this procedure, the trustee of ESOP Y votes the X Corporation shares allocated to the accounts of participants or beneficiaries for which no voting directions are timely received from the participants or beneficiaries.

LAW AND ANALYSIS

Section 4975(e)(7) of the Code provides, in part, that a plan shall not be treated as an ESOP unless it meets the requirements of § 409(h), § 409(o), and, if applicable, § 409(n). Section 4975(e)(7) of the Code also provides that, if the employer has a registration-type class of securities (as defined in § 409(e)(4)), the ESOP must meet the requirements of § 409(e).

Section 401(a)(22) of the Code provides, in general, that a defined contribution plan (other than a profit-sharing plan) must meet the requirements of § 409(e) in order to be qualified if (1) the plan is established by an employer whose stock is not readily tradable on an established market, and (2) more than 10 percent of the total assets of the plan are securities of the employer.

Section 409(e)(1) of the Code provides that, in general, a plan meets the requirements of § 409(e) if it meets the requirements of § 409(e)(2) or (3), whichever is applicable. Section 409(e)(2) of the Code provides that if the employer has a registration-type class of securities, the plan meets the requirements of § 409(e) only if each participant or beneficiary in the plan is entitled to direct the plan as to the manner in which to vote securities of the employer that are entitled to vote and are allocated to the account of such participant or beneficiary.

Section 409(e)(3) of the Code provides that if the employer does not have a registration-type class of securities, the plan meets the requirements of § 409(e) only if each

participant or beneficiary in the plan is entitled to direct the plan as to the manner in which to exercise voting rights, under securities of the employer that are allocated to the account of such participant or beneficiary, with respect to any corporate matter which involves the voting of such shares with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all the assets of a trade or business, or such similar transaction as the Secretary may prescribe in regulations.

While § 409(e)(2) and (3) of the Code require that ESOP participants and beneficiaries be entitled to direct the plan as to the manner in which to vote the shares of employer securities allocated to their accounts, neither § 409(e) nor § 4975(e)(7) prohibits the voting of allocated shares for which no directions have been timely received from the participant or beneficiary. Accordingly, the voting of the allocated but non-directed shares of employer securities by the trustee is not inconsistent with § 409(e)(2) and (3) of the Code.

HOLDING

The voting by the ESOP Y trustee of the X Corporation shares allocated to the accounts of participants or beneficiaries for which no directions are timely received from the participant or beneficiary will not cause ESOP Y to have failed to comply in operation with the pass-through voting requirements of § 409(e)(2). The result would be the same if Corporation X did not have a registration-type class of securities and ESOP Y participants and beneficiaries were entitled, pursuant to § 409(e) of the Code, to direct the voting of X Corporation securities allocated to their accounts.

Subpart B.—Special Rules

Section 411.—Minimum Vesting Standards

26 CFR 1.411(a)–11: Restriction and valuation of distributions.

T.D. 8620

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Notice, Consent, and Election Requirements of Sections 411(a)(11) and 417

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations that provide guidance concerning the notice and consent requirements under section 411(a)(11) and the notice and election requirements under section 417. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [EE–24–93, page 468, this Bulletin].

EFFECTIVE DATE: These regulations are effective September 22, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are 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 these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1471. Responses to this collection of information are required to assure that the rights of qualified plan participants are protected.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in *** [EE–24–93, page 468, this Bulletin].

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally,

tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 411(a)(11) and section 417(e). Section 1.411(a)–11(c) provides that a participant's consent to a distribution under section 411(a)(11) is not valid unless the participant receives a notice of his or her rights under the plan no more than 90 and no less than 30 days prior to the annuity starting date. Section 1.417(e)–1 sets forth the same 90/30-day time period for providing the notice explaining the qualified joint and survivor annuity and waiver rights required under section 417(a)(3).

The October 1992 temporary regulations that provided guidance on the amendment to section 402(f) made by the Unemployment Compensation Amendments of 1992 (UCA), published in the Federal Register at 57 FR 48163, generally prescribed this 90/30-day time period for purposes of the notice requirement under that section. In the preamble to those regulations, the IRS and Treasury requested comments on the appropriateness of this time period for section 411(a)(11), as well as for section 402(f).

In response to initial comments on the UCA proposed and temporary regulations, additional guidance was provided in Notice 93–26 (1993–1 C.B. 293), which modified the 30-day time period for purposes of sections 402(f) and 411(a)(11). These temporary regulations modify the 30-day time period in §1.411(a)–11 in a manner consistent with Notice 93–26 and also provide a more limited modification to the 30-day time period in §1.417(e)–1. These temporary regulations are being published in conjunction with the final regulations implementing the UCA changes, published elsewhere in *** [T.D. 8619, page 41, this Bulletin].

Explanation of provisions

1. Overview

Section 411(a)(11) provides that, if the value of a participant's accrued benefit exceeds \$3,500, a qualified plan generally may not distribute the benefit to the participant without the participant's consent.

Section 401(a)(11) requires that certain distributions be made in the form of a qualified joint and survivor annuity (QJSA) unless, in accordance with section 417, the participant waives the QJSA and elects a different form of benefit. Profit-sharing plans and stock bonus plans that meet the requirements of sections 401(a)(11)(B)(iii)(I) through (III) are not subject to the survivor annuity requirements of sections 401(a)(11) and 417.

Section 417 sets forth the requirements applicable to a waiver of the QJSA. Section 417(a) requires the participant to obtain the consent of the participant's spouse, if any, to any waiver of the QJSA and election of a form of benefit other than a QJSA. Any election made by the participant must be revocable during the 90-day period ending on the annuity starting date. Section 417(a)(3) requires that, within a reasonable period of time before the participant's annuity starting date, a plan provide the participant with a notice explaining the participant's right to the QJSA and the participant's right to waive the QJSA.

2. Implementation of Notice 93-26 modification of 30-day period

Under Notice 93-26, if, after having received the notice of distribution rights described in §1.411(a)-11, a participant affirmatively elects a distribution, a plan will not fail to satisfy the consent requirement of section 411(a)(11) merely because the distribution is made less than 30 days after the notice was provided to the participant. However, the participant must be notified that he or she has the opportunity to consider whether to elect a distribution (and, if applicable, a particular distribution option) for at least 30 days after the notice is provided. The plan administrator may provide this information to the participant using any method that is reasonably designed to attract the attention of the participant.

The comments on the guidance in Notice 93-26 with respect to section 411(a)(11) were generally favorable. Accordingly, these temporary regulations amend §1.411(a)-11 by modifying the 30-day rule in a manner consistent with Notice 93-26.

The final UCA regulations and these temporary regulations are structured to allow plan administrators to provide the participant notices required under sec-

tions 402(f), 411(a)(11) and 417 at the same time. Under the final UCA regulations, the section 402(f) notice must be provided no more than 90 and no less than 30 days before the date of distribution. Similarly, these temporary regulations provide that the 30-day and 90-day periods for purposes of the section 411(a)(11) notice are measured from the date that the distribution commences.

Alternatively, the plan administrator may substitute the annuity starting date, as defined in §1.401(a)-20, Q&A-10, for the date the distribution commences for purposes of both the section 402(f) notice and the section 411(a)(11) notice. If a plan administrator uses this alternative, the 90/30-day time period will be the same for the notices required under sections 402(f), 411(a)(11) and 417.

3. Modification of 30-day time period for QJSA explanation

Notice 93-26 did not affect the requirements that sections 401(a)(11) and 417 and related regulations impose on distributions subject to those sections. Some commentators requested that the modification provided in Notice 93-26 with respect to section 411(a)(11) be made to the 30-day time period in the regulations under section 417. These temporary regulations under section 417 provide substantial relief from the constraints imposed by the 30-day time period but, for the reasons noted below, do not adopt a rule that is identical to that provided under section 411(a)(11).

After careful consideration, the IRS and Treasury have concluded that it would not be consistent with the statutory purpose of section 417 to adopt the same modification to the 30-day time period that was adopted by Notice 93-26 under section 411(a)(11). Plans subject to section 417 often provide a variety of distribution options that may have different actuarial values and can be difficult to evaluate. In addition, section 417 establishes a revocation period for a waiver of the QJSA and provides explicit safeguards to ensure informed consent of the participant and the participant's spouse. For example, section 417 requires witnessed or notarized spousal consent that acknowledges the effect of the election to waive the QJSA. This statutory structure reflects Congressional recognition that a distribution

election with respect to annuity benefits is an important financial decision that affects the retirement security of the participant and the participant's spouse. In view of these concerns, these temporary regulations retain a minimum period for participants and spouses to consider or reconsider the distribution options after the section 417 notice is provided.

However, the IRS and Treasury are also aware that, if a plan provides an unreduced early retirement annuity, the application of the current 30-day election and revocation period might cause the participant to lose a month's benefit. Moreover, a full 30-day election and revocation period may not be necessary for a participant (and where applicable, the participant's spouse) who, after being provided with the opportunity to carefully consider the decision, affirmatively elects a form of distribution.

In order to address these concerns, while still providing sufficient time to consider (or reconsider) the decision whether to waive the QJSA, these temporary regulations permit the plan (or, where not inconsistent with the terms of the plan, the plan administrator) to commence distributions before the end of the 30-day time period, if certain requirements are met. Specifically, after an affirmative distribution election, with any applicable spousal consent, the plan may permit the distribution to commence at any time more than seven days after the explanation of the QJSA was provided to the participant. The annuity starting date must be a date after the explanation of the QJSA is provided to the participant, but may precede the date the participant affirmatively elects a distribution or the date the distribution commences. Any distribution election must remain revocable until the later of the annuity starting date or the expiration of the seven-day period that begins the day after the QJSA explanation is provided. For example, if a married participant receives the explanation of the QJSA on November 28 and elects (with spousal consent) on December 2 to waive the QJSA and receive an immediate single life annuity, the annuity starting date is permitted to be December 1, provided that the first payment is made no earlier than December 6 and the participant does not revoke the election before that date.

4. 90-day time period and method of providing notice

Some commentators requested an expansion of the 90-day time period. More broadly, commentators asked that the requirements of sections 411(a)(11), 417, and 402(f) be addressed in the context of new technologies that use electronic media, such as telephone or computer systems, to automate plan administrative functions that traditionally have been processed manually by use of paper-based systems (e.g., notices to participants and participant distribution requests). For example, some commentators have suggested that plans be permitted to provide an annual written notice if a summary of the notice is provided through these new technologies.

The IRS and Treasury continue to believe that the section 411(a)(11) and section 417 notices, as well as the section 402(f) notice, should be provided close to the time participants are considering the distribution to which the notice applies. Therefore, these temporary regulations do not change the 90-day time period.

Although these temporary regulations provide no additional guidance on the use of electronic media, the IRS and Treasury will continue to consider possible modifications to the notice and consent requirements that might be appropriate to accommodate new technologies, if adequate safeguards are provided, and invite comments on this issue. These final regulations specifically delegate authority to the Commissioner to modify the notice, consent, and election requirements or provide additional guidance, in the Internal Revenue Bulletin, with respect to those requirements.

5. Effective date

Because these temporary regulations relax the requirements that plans must satisfy, they are effective September 22, 1995.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C.

chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

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

Par. 2. §1.411(a)–11 is amended as follows:

- 1. Paragraph (c)(2)(ii) is revised to read as set forth below.
2. Paragraph (c)(2)(iii) is removed.

§1.411(a)–11 Restriction and valuation of distributions.

* * * * *

- (c) * * *
(2) * * *

(ii) For additional rules concerning the consent requirement of section 411(a)(11), see §1.411(a)–11T(c)(2)(ii) through (v) and (c)(8).

* * * * *

Par. 3. §1.411(a)–11T is added to read as follows:

§1.411(a)–11T Restriction and valuation of distributions (temporary).

- (a) and (b) [Reserved]
(c) Consent, etc. requirements—(1) General rule. [Reserved]
(2) Consent—(i) [Reserved]
(ii) Written consent of the participant to the distribution must not be made before the participant receives the notice of his or her rights specified in this paragraph (c)(2) and must not be made more than 90 days before the date the distribution commences.

(iii) A plan must provide participants with notice of their rights spec-

ified in this paragraph (c)(2) no less than 30 days and no more than 90 days before the date the distribution commences. However, if the participant, after having received this notice, affirmatively elects a distribution, a plan will not fail to satisfy the consent requirement of section 411(a)(11) merely because the distribution commences less than 30 days after the notice was provided to the participant, provided that the following requirement is met. The plan administrator must provide information to the participant clearly indicating that (in accordance with the first sentence of this paragraph (c)(2)(iii)) the participant has a right to at least 30 days to consider whether to consent to the distribution.

(iv) For purposes of satisfying the requirements of this paragraph (c)(2), the plan administrator may substitute the annuity starting date, within the meaning of §1.401(a)–20, Q&A-10, for the date the distribution commences.

(v) See §1.401(a)–20, Q&A-24 for a special rule applicable to consents to plan loans.

(3) through (7) [Reserved].

(8) Delegation to Commissioner. The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may modify, or provide additional guidance with respect to, the notice and consent requirements of this section. See §601.601(d)(2)(ii)(b) of this chapter.

Par. 4. §1.417(e)–1 is amended by revising paragraph (b)(3) to read as follows:

§1.417(e)–1 Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417.

* * * * *

(b) * * *

(3) Time of consent. For distributions on or after September 22, 1995, the additional rules concerning the notice and consent requirements of section 417 in §1.417(e)–1T(b)(3) and (4) also apply. For distributions before September 22, 1995, the additional rules concerning the notice and consent requirements of section 417 in §1.417(e)–1(b)(3) (as it appeared in the April 1, 1995 edition of 26 CFR part 1) apply.

* * * * *

Par. 5. Section 1.417(e)–1T is amended by adding paragraph (b) to read as follows:

§1.417(e)—IT Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417 (temporary).

* * * * *

(b) *Consent, etc. requirements*—(1) *General rule.* [Reserved]

(2) *Consent.* [Reserved]

(3) *Time of consent*—(i) Written consent of the participant and the participant's spouse to the distribution must be made not more than 90 days before the annuity starting date.

(ii) A plan must provide participants with the written explanation of the QJSA required by section 417(a)(3) no less than 30 days and no more than 90 days before the annuity starting date. However, if the participant, after having received the written explanation of the QJSA, affirmatively elects a form of distribution and the spouse consents to that form of distribution (if necessary), a plan will not fail to satisfy the requirements of section 417(a) merely because the annuity starting date is less than 30 days after the written explanation was provided to the participant, provided that the following requirements are met:

(A) The plan administrator provides information to the participant clearly indicating that (in accordance with the first sentence of this paragraph (b)(3)(ii)) the participant has a right to at least 30 days to consider whether to waive the QJSA and consent to a form of distribution other than a QJSA.

(B) The participant is permitted to revoke an affirmative distribution election at least until the annuity starting date, or, if later, at any time prior to the expiration of the 7-day period that begins the day after the explanation of the QJSA is provided to the participant.

(C) The annuity starting date is after the date that the explanation of the QJSA is provided to the participant. However, the plan may permit the annuity starting date to be before the date that any affirmative distribution election is made by the participant and before the date that the distribution is permitted to commence under paragraph (b)(3)(ii)(D) of this section.

(D) Distribution in accordance with the affirmative election does not commence before the expiration of the 7-day period that begins the day after the explanation of the QJSA is provided to the participant.

(iii) The following example illustrates the provisions of this paragraph (b)(3):

Example. Employee E, a married participant in a defined benefit plan who has terminated employment, is provided with the explanation of the QJSA on November 28. Employee E elects (with spousal consent) on December 2 to waive the QJSA and receive an immediate distribution in the form of a single life annuity. The plan may permit Employee E to receive payments with an annuity starting date of December 1, provided that the first payment is made no earlier than December 6 and the participant does not revoke the election before that date. The plan can make the remaining monthly payments on the first day of each month thereafter in accordance with its regular payment schedule.

(4) *Delegation to Commissioner.* The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin, may modify, or provide additional guidance with respect to, the notice and consent requirements of this section. See §601.601(d)(2)(ii)(b) of this chapter.

* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 7. In §602.101, paragraph (c) is amended by adding to the table the following entries in numerical order to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
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* * * * *

1.411(a)—11T.....	1545—1471
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1.417(e)—1T.....	1545—1471
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* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved August 29, 1995.

Cynthia G. Beerbower,
Deputy Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 15, 1995, 4:00 p.m., and published in the issue of the Federal Register for September 22, 1995, 60 F.R. 49218)

Section 412.—Minimum Funding Standards

A revenue procedure describes certain changes to the funding method used to determine the minimum funding standard for defined benefit plans for plan years beginning on or after January 1, 1995. See Rev. Proc. 95-51, page 430.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Section 415.—Limitations on Benefits and Contributions Under Qualified Plans.

Limitations on benefits and contributions. Answer 3 of Rev. Rul. 95-29, 1995-1 C.B. 81, pertaining to the limitations on benefits and contributions under section 415 of the Code is corrected.

Rev. Rul. 95-29A

Rev. Rul. 95-29, 1995-1 C.B. 81, consists of a series of questions

and answers pertaining to §§ 415 and 417 of the Internal Revenue Code as amended by the Retirement Protection Act of 1994. Rev. Rul. 95-29 contains an omission in the answer to Q&A-3 on page 11. The answer to A&A-3 is corrected to read as follows:

“A-3. The new interest rate under § 415(b)(2)(E)(ii) applies to a benefit payable in the form of a benefit subject to § 417(e)(3). Under § 417(c)(3) and the Income Tax Regulations thereunder, benefits subject to § 417(c)(3) include all forms of benefit except non-decreasing annuity benefits payable for a period not less than the life of the participant or, in the case of a QPSA, the life of the surviving spouse. For this purpose, a non-decreasing annuity includes a QJSA, a QPSA, and an annuity that decreases merely because of the cessation or reduction of Social Security supplements or qualified disability payments (as defined in § 411(a)(9)).”

26 CFR 1.415-6. *Limitation for defined contribution plans.*

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 415 of the Code to certain payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Subchapter E.—Accounting Periods and Methods of Accounting
Part II.—Methods of Accounting
Subpart A.—Methods of Accounting in General

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-1: *General rule for methods of accounting.*
(Also Section 481.)

T.D. 8608

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Adjustments Required by Changes in Method of Accounting

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the require-

ments for changes in method of accounting. These regulations clarify the Commissioner's authority to prescribe terms and conditions for effecting a change in method of accounting. The regulations affect taxpayers changing a method of accounting for federal income tax purposes.

DATES: These regulations are effective August 4, 1995.

For dates of applicability see §§1.446-1(e)(3)(iii) and 1.481-5.

SUPPLEMENTARY INFORMATION:

Background

On December 28, 1994, the IRS published a notice of proposed rulemaking in the Federal Register (59 FR 66825 [IA-42-93, 1995-1 C.B. 938]), relating to the requirements for changes in method of accounting. That document proposed clarifying amendments to the regulations under sections 446 and 481. No public hearing was requested or held.

Two comments responding to this notice were received. After consideration of the comments, the amendments proposed by IA-42-93 are adopted with minor editorial revisions by this Treasury decision.

Summary of Comments

The notice of proposed rulemaking proposes to conform the existing regulations under sections 446(e) and 481(c) to long-standing IRS administrative practices regarding the use of adjustment periods under section 481(a) and the use of a cut-off method. Under the general rule of the proposed regulations, any section 481(a) adjustment attributable to a voluntary or an involuntary change in method of accounting is taken into account in the taxable year of change, whether the adjustment increases or decreases taxable income. However, the regulations also propose to amend §§1.446-1(e)(3) and 1.481-5 to clarify the Commissioner's authority to prescribe the terms and conditions for effecting a change in method of accounting. Under the regulations, the terms and conditions that may be prescribed by the Commissioner include the taxable year or years in which a section 481(a) adjustment is taken into account and the use of a cut-off method to effect a change in method of accounting.

Two comments were received in response to the notice. The comments questioned IRS authority to require the use of a cut-off method, and whether to require it is sound administrative practice. After considering the comments, the IRS and the Treasury Department continue to believe that the IRS has the authority under section 446(e) to impose a cut-off method, and that it is consistent with section 481(a). Furthermore, the IRS and the Treasury Department believe that requiring a change in method of accounting on a cut-off basis in appropriate circumstances is administratively sound. For example, the application of a cut-off method to effect a change within the last-in, first-out (LIFO) inventory method is justified on the basis of simplicity because it eliminates the need to revalue LIFO increments.

The amendments proposed by IA-42-93 are adopted by this Treasury decision.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for section 1.446-1 and by adding the following citations in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *
Section 1.446-1 also issued under 26 U.S.C. 446 and 461(h).* * *

Section 1.481-1 also issued under 26 U.S.C. 481.

Section 1.481-2 also issued under 26 U.S.C. 481.

Section 1.481-3 also issued under 26 U.S.C. 481.

Section 1.481-4 also issued under 26 U.S.C. 481.

Section 1.481-5 also issued under 26 U.S.C. 481. * * *

Par. 2. Section 1.446-1 is amended by revising paragraph (e)(3) to read as follows:

§1.446-1 General rule for methods of accounting.

* * * * *

(e) * * *

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)-(ii) of this section, to secure the Commissioner's consent to a taxpayer's change in method of accounting the taxpayer must file an application on Form 3115 with the Commissioner within 180 days after the beginning of the taxable year in which the taxpayer desires to make the change in method of accounting. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer's computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer's method of accounting will not be granted unless the taxpayer agrees to the Commissioner's prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method.

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe ad-

ministrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner's consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) is effective for Consent Agreements signed on or after December 27, 1994. For Consent Agreements signed before December 27, 1994, see §1.446-1(e)(3) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

Par. 3. Section 1.481-1 is amended as follows:

1. Paragraph (a)(2) is amended by adding the phrase "(hereinafter referred to as pre-1954 years)" to the end of the paragraph.

2. The third sentence of paragraph (c)(1) is amended by removing "pre-1954 Code years" and replacing it with "pre-1954 years".

3. Paragraphs (c)(2), (3), and (4) are revised.

4. Paragraphs (c)(6) and (7) are removed.

5. Paragraph (d) is revised.

6. Paragraph (e) is removed.

The revised paragraphs read as follows:

§1.481-1 Adjustments in general.

* * * * *

(c) ***
(2) If a change in method of accounting is voluntary (i.e., initiated by the taxpayer), the entire amount of the adjustments required by section 481(a) is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§1.446-1(e)(3) and 1.481-4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account.

(3) If the change in method of accounting is involuntary (i.e., not

initiated by the taxpayer), then only the amount of the adjustments required by section 481(a) that is attributable to taxable years beginning after December 31, 1953, and ending after August 16, 1954, (hereinafter referred to as post-1953 years) is taken into account. This amount is generally taken into account in computing taxable income in the taxable year of the change, regardless of whether the adjustments increase or decrease taxable income. See, however, §§1.446-1(e)(3) and 1.481-4 which provide that the Commissioner may prescribe the taxable year or years in which the adjustments are taken into account. See also §1.481-3 for rules relating to adjustments attributable to pre-1954 years.

(4) For any adjustments attributable to post-1953 years that are taken into account entirely in the year of change and that increase taxable income by more than \$3,000, the limitations on tax provided in section 481(b)(1) or (2) apply. See §1.481-2 for rules relating to the limitations on tax provided by sections 481(b)(1) and (2).

* * * * *

(d) Any adjustments required under section 481(a) that are taken into account during a taxable year must be properly taken into account for purposes of computing gross income, adjusted gross income, or taxable income in determining the amount of any item of gain, loss, deduction, or credit that depends on gross income, adjusted gross income, or taxable income.

Par. 4. Section 1.481-2 is amended as follows:

1. The first and second sentences of paragraph (a) are revised.

2. The first sentence of paragraph (b) introductory text is revised.

3. The first sentence of paragraph (c)(1) is revised.

4. The first sentence of paragraph (c)(2) is amended by removing "subparagraph (1) of this paragraph" and replacing it with "paragraph (c)(1) of this section".

5. Paragraph (c)(3) introductory text is amended by removing "subparagraph (1) of this paragraph" and replacing it with "paragraph (c)(1) of this section".

6. Paragraph (c)(4) is revised.

7. Paragraph (c)(6) is amended by removing "Internal Revenue Code of 1954" and replacing it with "Internal Revenue Code of 1986".

8. The second sentence of paragraph (d) is amended by removing "Internal Revenue Code of 1954" and replacing it with "Internal Revenue Code of 1986".

9. Example (1) of paragraph (d) introductory text is amended by removing "pre-1954 Code years" from the 8th and 10th sentences and replacing it with "pre-1954 years" in each place that it appears.

The revised paragraphs read as follows:

§1.481-2 Limitation on tax.

(a) *Three-year allocation.* Section 481(b)(1) provides a limitation on the tax under chapter 1 of the Internal Revenue Code for the taxable year of change that is attributable to the adjustments required under section 481(a) and §1.481-1 if the entire amount of the adjustments is taken into account in the year of change. If such adjustments increase the taxpayer's taxable income for the taxable year of the change by more than \$3,000, then the tax for such taxable year that is attributable to the adjustments shall not exceed the lesser of the tax attributable to taking such adjustments into account in computing taxable income for the taxable year of the change under section 481(a) and §1.481-1, or the aggregate of the increases in tax that would result if the adjustments were included ratably in the taxable year of the change and the two preceding taxable years. * * *

(b) *Allocation under new method of accounting.* Section 481(b)(2) provides a second alternative limitation on the tax for the taxable year of change under chapter 1 of the Internal Revenue Code that is attributable to the adjustments required under section 481(a) and §1.481-1 where such adjustments increase taxable income for the taxable year of change by more than \$3,000. * * *

(c) *Rules for computation of tax.* (1) The first step in determining whether either of the limitations described in section 481(b)(1) or (2) applies is to compute the increase in tax for the taxable year of the change that is attributable to the increase in taxable income for such year resulting solely from the adjustments required under section 481(a) and §1.481-1.

* * * * *

(4) The tax for the taxable year of

the change shall be the tax for such year, computed without taking any of the adjustments referred to in paragraph (c)(1) of this section into account, increased by the smallest of the following amounts—

(i) The amount of tax for the taxable year of the change attributable solely to taking into account the entire amount of the adjustments required by section 481(a) and §1.481-1;

(ii) The sum of the increases in tax liability for the taxable year of the change and the two immediately preceding taxable years that would have resulted solely from taking into account one-third of the amount of such adjustments required for each of such years as though such amounts had been properly attributable to such years (computed in accordance with paragraph (c)(2) of this section); or

(iii) The net increase in tax attributable to allocating such adjustments under the new method of accounting (computed in accordance with paragraph (c)(3) of this section).

* * * * *

Par. 5. Section 1.481-3 is amended as follows:

1. The language "pre-1954 Code years" is removed and the language "pre-1954 years" is added in its place in the section heading and the first, second and third sentences of the section.

2. Remove the last sentence of the section.

§1.481-4 [Removed].

Par. 6. Section 1.481-4 is removed.

Par. 7. Section 1.481-5 is redesignated as §1.481-4 and is revised to read as follows:

§1.481-4 Adjustments taken into account with consent.

(a) In addition to the terms and conditions prescribed by the Commissioner under §1.446-1(e)(3) for effecting a change in method of accounting, including the taxable year or years in which the amount of the adjustments required by section 481(a) is to be taken into account, or the methods of allocation described in section 481(b), a taxpayer may request approval of an alternative method of allocating the amount of the adjustments under sec-

tion 481. See section 481(c). Requests for approval of an alternative method of allocation shall set forth in detail the facts and circumstances upon which the taxpayer bases its request. Permission will be granted only if the taxpayer and the Commissioner agree to the terms and conditions under which the allocation is to be effected. See §1.446-1(e) for the rules regarding how to secure the Commissioner's consent to a change in method of accounting.

(b) An agreement to the terms and conditions of a change in method of accounting under §1.446-1(e)(3), including the taxable year or years prescribed by the Commissioner under that section (or an alternative method described in paragraph (a) of this section) for taking the amount of the adjustments under section 481(a) into account, shall be in writing and shall be signed by the Commissioner and the taxpayer. It shall set forth the items to be adjusted, the amount of the adjustments, the taxable year or years for which the adjustments are to be taken into account, and the amount of the adjustments allocable to each year. The agreement shall be binding on the parties except upon a showing of fraud, malfeasance, or misrepresentation of material fact.

Par. 8. Section 1.481-5 is added to read as follows:

§1.481-5 Effective dates.

Sections 1.481-1, 1.481-2, 1.481-3, and 1.481-4 are effective for Consent Agreements signed on or after December 27, 1994. For Consent Agreements signed before December 27, 1994, see §§1.481-1, 1.481-2, 1.481-3, 1.481-4, and 1.481-5 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

§1.481-6 [Removed].

Par. 9. Section 1.481-6 is removed.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved July 26, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 4, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 7, 1995, 60 F.R. 40077)

26 CFR 1.446-1: General rule for methods of accounting.

How many certain "small resellers," "formerly small resellers," or "reseller-producers" change their method of accounting for costs subject to § 263A of the Code? See Rev. Proc. 95-33, page 380.

26 CFR 1.446-1: General rule for methods of accounting.

Guidance is provided concerning the use of an optional method of accounting that treats certain rent-to-own contracts as leases for federal income tax purposes. See Rev. Proc. 95-38, page 397.

26 CFR 1.446-1: General rule for methods of accounting.

If a taxpayer changes the method of computing the depreciation allowance for consumer durable property subject to rent-to-own contracts as described in Rev. Proc. 95-38, this Bulletin, is this change a change in method of accounting? See Rev. Rul. 95-52, page 27.

26 CFR 1.446-1: General rule for methods of accounting.

A taxpayer may not use an inventory method under section 417 of the Code to account for REMIC residual interests. See Rev. Rul. 95-81, on this page.

Subpart C.—Taxable Year for Which Deductions Taken

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Subpart D.—Inventories

Section 471.—General Rule for Inventories

26 CFR 1.471-1: Need for inventories. (Also §§ 446, 860C, 860E, 860G, 7805; 1.446-1, 1.860C-1, 1.860E-1, 1.860G-1, 301.7805-1.)

Inventories; REMIC residual interests. A taxpayer may not use an inventory method under section 471 of the Code to account for REMIC residual interests.

Rev. Rul. 95-81

ISSUE

If a taxpayer holds residual interests in Real Estate Mortgage Investment Conduits (REMICs), may the taxpayer use an inventory method under § 471 of the Internal Revenue Code to account for the interests?

FACTS

X is a financial institution. As part of its business, X holds "residual interests" (as defined in § 860G(a)(2)) in REMICs. X acquires residual interests either through transfers from other parties or through the formation of REMICs. To form a REMIC, X exchanges a pool of real estate mortgages for the "regular interests" (as defined in § 860G(a)(1)) and residual interests in the REMIC. Without regard to how it acquires the residual interests, X holds some of the residual interests for investment and holds the remainder for sale to customers in the ordinary course of business.

LAW AND ANALYSIS

Inventory accounting is governed principally by §§ 446 and 471. Section 446(a) states the general rule that taxable income is to be computed by a taxpayer under the method of accounting it regularly uses in keeping its books. Section 446(b), however, provides that if a taxpayer's accounting method does not clearly reflect income, the computation of taxable income is made under such method as, in the Secretary's opinion, does clearly reflect income.

Section 471 provides that, whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by that taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income. The Commissioner has authority under § 471 to disallow the use of inventories if the use of inventories is not in conformity with the best accounting practice in the trade or business or if the use of inventories would not clearly reflect income.

Under §§ 446 and 471, the Commissioner has wide discretion in determin-

ing whether an inventory method clearly reflects income, and that determination will not be overturned unless it is "clearly unlawful." *Thor Power Tool Co. v. Commissioner*, 439 U.S. 522, 532 (1979), 1979-1 C.B. 167, 171 (quoting *Lucas v. American Code Co.*, 280 U.S. 445, 449 (1930), IX-1 C.B. 314, 315 (1930)).

Sections 860A through 860G set forth comprehensive rules for the treatment of REMICs and for the treatment of persons who hold interests in REMICs. In general, a REMIC holds a pool of real estate mortgages that is used to support the issuance of regular interests, which are treated as debt. A REMIC may issue numerous classes of regular interests. In addition, a REMIC must issue one and only one class of residual interest.

The income of a REMIC is not ordinarily taxable to the REMIC itself. Instead, § 860C(a) allocates to the residual interest holders ratable, daily portions of the taxable income or net loss of the REMIC, determined for each quarter. In most cases, part of this income, referred to as "excess inclusion," cannot be offset by losses. Specifically, under § 860E(a), the taxable income of a residual interest holder (other than a financial institution described in § 860E(a)(2)) must be no less than the holder's excess inclusion for the taxable year. A holder's excess inclusion for any calendar quarter is generally the excess of the income allocated to the residual interest under § 860C(a) over the income that would have accrued on the residual interest if it had yielded, from the time of its issuance, 120 percent of the long-term Federal rate.

Section 860C(d) requires that a residual interest holder adjust the basis in its interest to account for certain events. See also § 1.860C-1(b) of the Income Tax Regulations. A holder increases basis for the taxable income allocated to the holder under 860C(a), including any part of that income constituting excess inclusion. In addition, basis is increased for certain contributions made to the REMIC. Conversely, a holder decreases basis for its share of the REMIC's net losses and for any distributions from the REMIC.

Congress intended that the provisions of §§ 860A through 860G, which include the provisions for taxing REMIC income and for adjusting the basis of residual interests, be "the exclusive set of rules for the treatment of all trans-

actions relating to the REMIC and of holders of interests therein." 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-230 (1986), 1986-3 (Vol. 4) C.B. 230. In addition, § 860E embodies a Congressional mandate to tax currently a residual holder's excess inclusion. Using an inventory method to account for residual interests undermines these Congressional directives. It not only introduces other rules for the treatment of holders of residual interests but also may prevent current taxation of the holders' excess inclusions.

These directives are not undermined, however, by treating REMIC residual interests, where appropriate, as property being held primarily for sale to customers in the ordinary course of business for purposes of § 1221(1).

HOLDING

If a taxpayer holds residual interests in REMICs, the taxpayer may not use an inventory method under § 471 to account for those interests. Therefore, X cannot use an inventory method to account for any of its residual interests.

PROSPECTIVE APPLICATION

Under § 7805(b), this revenue ruling will not be applied to require a change in method of accounting for taxable years beginning before January 1, 1995.

APPLICATION

A taxpayer required to change its method of accounting to comply with this revenue ruling must secure the consent of the Commissioner in accordance with the requirements of § 1.446-1(e) and Rev. Proc. 92-20, 1992-1 C.B. 685. A taxpayer filing a Form 3115 pursuant to this revenue ruling should either type or legibly print the following statement at the top of page 1 of the Form 3115: "FILED UNDER REV. RUL. 95-81." It is anticipated that, as one condition of granting the consent to change, the Commissioner will require that any adjustment under § 481 be taken into account no later than the taxable year in which the taxpayer disposes of the residual interest giving rise to the adjustment.

The change in method of accounting must be made for the taxpayer's first taxable year beginning on or after January 1, 1995 (the "required year of

change"). If this year is a short taxable year ending on or before December 24, 1995, the taxpayer may instead treat its first taxable year ending after December 24, 1995, as the required year of change. For taxpayers that file the Form 3115 under this revenue ruling on or before March 25, 1996, the Commissioner hereby waives the requirement that the Form 3115 be filed within 180 days after the beginning of the required year of change.

In requesting a change in method of accounting for the required year of change, a taxpayer under examination, before an appeals office, or before a federal court may file the Form 3115 for that year without regard to the window periods described in section 6 of Rev. Proc. 92-20, without obtaining the consent of the district director under section 6.06 of Rev. Proc. 92-20, and without obtaining permission from an appeals officer or counsel for the Government under sections 4.02 and 4.03 of Rev. Proc. 92-20. In these cases, the taxpayer will receive the same terms and conditions in section 5 of Rev. Proc. 92-20 for taxpayers not under examination, provided the taxpayer furnishes a copy of the Form 3115 to the examining agent, appeals officer, or the counsel for the Government no later than the date the Form 3115 is filed with the National Office.

Any method of accounting not in compliance with this revenue ruling is designated as a Designated B method of accounting and will be treated as a Category A method of accounting for any taxable year beginning on or after January 1, 1996. As stated above, however, in no event will the taxable year of change be earlier than the first taxable year beginning on or after January 1, 1995.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The May 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, May 31, 1995.

Rev. Rul. 95-50

The following Department Store Inventory Price Indexes for May 1995

were issued by the Bureau of Labor Statistics on June 13, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail

inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, May 31, 1995.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups —

soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	May 1994	May 1995	Percent Change from May 1994 to May 1995 ¹
1. Piece Goods.....	456.9	507.4	11.1
2. Domestics and Draperies.....	643.7	643.5	0.0
3. Women's and Children's Shoes.....	661.1	635.2	-3.9
4. Men's Shoes.....	924.0	920.2	-0.4
5. Infants' Wear.....	598.2	599.2	0.2
6. Women's Underwear.....	516.4	529.4	2.5
7. Women's Hosiery.....	272.2	283.1	4.0
8. Women's and Girls' Accessories.....	567.5	539.4	-5.0
9. Women's Outerwear and Girls' Wear.....	444.7	437.0	-1.7
10. Men's Clothing.....	607.1	610.4	0.5
11. Men's Furnishings.....	556.0	575.7	3.5
12. Boys' Clothing and Furnishings.....	494.7	483.8	-2.2
13. Jewelry.....	1027.5	984.9	-4.1
14. Notions.....	727.0	750.3	3.2
15. Toilet Articles and Drugs.....	850.5	857.9	0.9
16. Furniture and Bedding.....	645.1	655.3	1.6
17. Floor Coverings.....	535.5	569.4	6.3
18. Housewares.....	779.7	775.1	-0.6
19. Major Appliances.....	249.8	247.3	-1.0
20. Radio and Television.....	85.2	84.8	-0.5
21. Recreation and Education ²	115.5	114.3	-1.0
22. Home Improvements ²	120.8	122.3	1.2
23. Auto Accessories ²	106.3	107.2	0.8
Groups 1-15: Soft Goods.....	599.5	597.1	-0.4
Groups 16-20: Durable Goods.....	465.3	465.4	0.0
Groups 21-23: Misc. Goods ²	114.5	114.2	-0.3
Store Total ³	553.0	552.4	-0.1

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472-1: Last-in, first-out inventories.

Rev. Rul. 95-61

LIFO; price indexes; department stores. The June 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, June 30, 1995.

The following Department Store Inventory Price Indexes for June 1995 were issued by the Bureau of Labor Statistics on July 14, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate

application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, June 30, 1995.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups—

soft goods, durable goods, and miscellaneous goods, and (c) a store total,

which covers all departments, including some not listed separately, except for

the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	June 1994	June 1995	Percent Change from June 1994 to June 1995 ¹
1. Piece Goods.....	469.1	522.9	11.5
2. Domestics and Draperies.....	639.5	646.7	1.1
3. Women's and Children's Shoes.....	653.6	624.2	-4.5
4. Men's Shoes.....	916.3	919.3	0.3
5. Infants' Wear.....	603.8	587.9	-2.6
6. Women's Underwear.....	512.0	515.1	0.6
7. Women's Hosiery.....	272.9	283.3	3.8
8. Women's and Girls' Accessories.....	569.9	549.5	-3.6
9. Women's Outerwear and Girls' Wear.....	428.7	416.3	-2.9
10. Men's Clothing.....	602.8	597.5	-0.9
11. Men's Furnishings.....	547.3	562.4	2.8
12. Boys' Clothing and Furnishings.....	489.3	477.8	-2.4
13. Jewelry.....	1022.2	1004.9	-1.7
14. Notions.....	736.1	758.7	3.1
15. Toilet Articles and Drugs.....	851.4	859.9	1.0
16. Furniture and Bedding.....	647.0	663.1	2.5
17. Floor Coverings.....	539.1	577.0	7.0
18. Housewares.....	782.8	771.8	-1.4
19. Major Appliances.....	250.3	247.2	-1.2
20. Radio and Television.....	85.0	82.1	-3.4
21. Recreation and Education ²	115.3	114.0	-1.1
22. Home Improvements ²	120.4	122.6	1.8
23. Auto Accessories ²	106.3	106.8	0.5
Groups 1—15: Soft Goods.....	591.7	587.8	-0.7
Groups 16—20: Durable Goods.....	466.4	462.8	-0.8
Groups 21—23: Misc. Goods ²	114.3	113.9	-0.3
Store Total ³	548.9	545.8	-0.6

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The July 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, July 31, 1995.

Rev. Rul. 95-65

The following Department Store In-

ventory Price Indexes for July 1995 were issued by the Bureau of Labor Statistics on August 11, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, July 31, 1995.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	July 1994	July 1995	Percent Change from July 1994 to July 1995 ¹
1. Piece Goods	471.5	515.5	9.3
2. Domestic and Draperies	644.3	656.6	1.9
3. Women's and Children's Shoes	639.0	617.5	-3.4
4. Men's Shoes	908.6	914.5	0.6
5. Infants' Wear	607.6	596.5	-1.8
6. Women's Underwear	519.2	526.0	1.3
7. Women's Hosiery	279.2	283.3	1.5
8. Women's and Girls' Accessories	567.7	546.7	-3.7
9. Women's Outerwear and Girls' Wear	404.3	398.1	-1.5
10. Men's Clothing	598.2	593.3	-0.8
11. Men's Furnishings	545.6	550.5	0.9
12. Boys' Clothing and Furnishings	483.6	474.7	-1.8
13. Jewelry	1018.7	999.0	-1.9
14. Notions	768.7	838.7	9.1
15. Toilet Articles and Drugs	851.1	861.1	1.2
16. Furniture and Bedding	646.7	657.8	1.7
17. Floor Coverings	555.6	563.7	1.5
18. Housewares	785.9	777.6	-1.1
19. Major Appliances	250.9	245.2	-2.3
20. Radio and Television	84.7	82.0	-3.2
21. Recreation and Education ²	115.4	113.9	-1.3
22. Home Improvements ²	119.6	122.4	2.3
23. Auto Accessories ²	106.0	106.7	0.7
Groups 1—15: Soft Goods	583.4	580.5	-0.5
Groups 16—20: Durable Goods	467.8	462.4	-1.2
Groups 21—23: Misc. Goods ²	114.2	113.8	-0.4
Store Total ³	544.7	541.2	-0.6

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The August 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, August 31, 1995.

Rev. Rul. 95-72

The following Department Store In-

ventory Price Indexes for August 1995 were issued by the Bureau of Labor Statistics on September 13, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, August 31, 1995.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups—soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Aug. 1994	Aug. 1995	Percent Change from Aug. 1994 to Aug. 1995 ¹
1. Piece Goods	467.8	534.7	14.3
2. Domestics and Draperies	649.2	663.1	2.1
3. Women's and Children's Shoes	636.4	622.3	-2.2
4. Men's Shoes	907.3	923.8	1.8
5. Infants' Wear	606.4	620.6	2.3
6. Women's Underwear	523.6	519.0	-0.9
7. Women's Hosiery	277.9	287.5	3.5
8. Women's and Girls' Accessories	557.5	550.4	-1.3
9. Women's Outerwear and Girls' Wear	407.1	404.5	-0.6
10. Men's Clothing	600.1	604.6	0.7
11. Men's Furnishings	552.3	542.4	-1.8
12. Boys' Clothing and Furnishings	477.1	477.3	0.0
13. Jewelry	1027.4	1011.2	-1.6
14. Notions	768.7	868.8	13.0
15. Toilet Articles and Drugs	852.5	861.5	1.1
16. Furniture and Bedding	646.9	659.2	1.9
17. Floor Coverings	554.2	572.4	3.3
18. Housewares	778.5	783.4	0.6
19. Major Appliances	249.5	247.7	0.7
20. Radio and Television	84.6	82.1	-3.0
21. Recreation and Education ²	115.4	114.2	-1.0
22. Home Improvements ²	120.1	122.2	1.7
23. Auto Accessories ²	106.0	107.1	1.0
Groups 1—15: Soft Goods	585.7	585.2	-0.1
Groups 16—20: Durable Goods	465.4	465.3	0.0
Groups 21—23: Misc. Goods ²	114.2	114.1	-0.1
Store Total ³	545.3	544.9	-0.1

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The September 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, September 30, 1995.

Rev. Rul. 95-76

The following Department Store In-

ventory Price Indexes for September 1995 were issued by the Bureau of Labor Statistics on October 13, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, September 30, 1995.

The Department Store Inventory Price Indexes are prepared on a na-

tional basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups—soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Sept. 1994	Sept. 1995	Percent Change from Sept. 1994 to Sept. 1995 ¹
1. Piece Goods.....	469.6	538.3	14.6
2. Domestic and Draperies.....	652.3	663.4	1.7
3. Women's and Children's Shoes.....	639.0	646.4	1.2
4. Men's Shoes.....	907.4	926.9	2.1
5. Infants' Wear.....	611.5	627.1	2.6
6. Women's Underwear.....	529.0	517.1	-2.2
7. Women's Hosiery.....	272.1	285.7	5.0
8. Women's and Girls' Accessories.....	567.3	555.5	-2.1
9. Women's Outerwear and Girls' Wear.....	432.2	418.9	-3.1
10. Men's Clothing.....	612.9	619.5	1.1
11. Men's Furnishings.....	566.8	558.7	-1.4
12. Boys' Clothing and Furnishings.....	488.2	482.8	-1.1
13. Jewelry.....	1026.2	1031.4	0.5
14. Notions.....	768.5	803.3	4.5
15. Toilet Articles and Drugs.....	851.0	863.0	1.4
16. Furniture and Bedding.....	640.6	665.6	3.9
17. Floor Coverings.....	558.3	563.1	0.9
18. Housewares.....	777.4	798.9	2.8
19. Major Appliances.....	248.5	249.7	0.5
20. Radio and Television.....	84.7	81.7	-3.5
21. Recreation and Education ²	115.0	114.3	-0.6
22. Home Improvements ²	120.7	121.7	0.8
23. Auto Accessories ²	105.8	106.9	1.0
Groups 1—15: Soft Goods.....	597.8	596.7	-0.2
Groups 16—20: Durable Goods.....	464.3	470.1	1.2
Groups 21—23: Misc. Goods ²	114.0	114.0	0.0
Store Total ³	551.4	553.2	0.3

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The October 1995 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, October 31, 1995.

Rev. Rul. 95-82

The following Department Store In-

ventory Price Indexes for October 1995 were issued by the Bureau of Labor Statistics on November 15, 1995. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, October 31, 1995.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major

groups of departments, (b) three special combinations of the major groups—soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Oct. 1994	Oct. 1995	Percent Change from Oct. 1994 to Oct. 1995 ¹
1. Piece Goods	486.5	508.6	4.5
2. Domestics and Draperies	647.7	664.7	2.6
3. Women's and Children's Shoes	641.3	647.5	1.0
4. Men's Shoes	909.3	930.1	2.3
5. Infants' Wear	616.2	633.8	2.9
6. Women's Underwear	537.0	522.6	-2.7
7. Women's Hosiery	276.2	290.7	5.2
8. Women's and Girls' Accessories	568.6	558.3	-1.8
9. Women's Outerwear and Girls' Wear	441.6	430.5	-2.5
10. Men's Clothing	614.9	621.1	1.0
11. Men's Furnishings	574.9	572.1	-0.5
12. Boys' Clothing and Furnishings	484.6	501.9	3.6
13. Jewelry	1014.6	1014.3	0.0
14. Notions	747.2	782.3	4.7
15. Toilet Articles and Drugs	850.6	868.7	2.1
16. Furniture and Bedding	641.3	666.4	3.9
17. Floor Coverings	559.3	567.4	1.4
18. Housewares	778.8	801.2	2.9
19. Major Appliances	247.0	248.9	0.8
20. Radio and Television	84.4	80.6	-4.5
21. Recreation and Education ²	115.5	114.0	-1.3
22. Home Improvements ²	119.2	122.1	2.4
23. Auto Accessories ²	105.6	107.0	1.3
Groups 1—15: Soft Goods	601.6	603.0	0.2
Groups 16—20: Durable Goods	464.0	469.3	1.1
Groups 21—23: Misc. Goods ²	114.1	113.9	-0.2
Store Total ³	553.5	556.9	0.6

¹Absence of a minus sign before percentage change in this column signifies price increase.

²Indexes on a January 1986=100 base.

³The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

Part III.—Adjustments

Section 481.—Adjustments Required by Changes in Method of Accounting

Final regulations relating to the requirements for changes in method of accounting. See T.D. 8608, page 67.

26 CFR 1.481-1: Adjustments in general.

How may certain "small resellers," "formerly small resellers," or "reseller-producers" change their method of accounting for costs subject to § 263A of the Code? See Rev. Proc. 95-33, page 380.

26 CFR 1.481-1: Adjustments in general.

Guidance is provided concerning the use of an optional method of accounting that treats certain

rent-to-own contracts as leases for federal income tax purposes. See Rev. Proc. 95-38, page 397.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Subchapter F.—Exempt Organizations
Part I.—General Rule

Section 501.—Exemption From Tax on Corporations, Certain Trusts, etc.

Guidance is provided to organizations exempt from taxation under § 501(a) of the Code on the

application of amendments made to §§ 162(e) and 6033(e) by § 13222 of the Omnibus Budget Reconciliation Act of 1993. The procedure identifies certain tax-exempt organizations that will be treated as satisfying the requirements of § 6033(e)(3). Those organizations will not be subject to the reporting and notice requirements of § 6033(e)(1) or the tax imposed by § 6033(e)(2). Procedures for other exempt organizations to establish that they satisfy the requirements of § 6033(e)(3) are also provided. See Rev. Proc. 95-35, page 391.

This procedure exercises the Commissioner's discretionary authority under section 6033(a)(2)(B) of the Code, by specifying that two additional classes of organizations, governmental units and affiliates of governmental units, which are exempt from federal income tax under section 501(a), are not required to file annual information returns on Form 990, *Return of Organization Exempt From Income Tax*. See Rev. Proc. 95-48, page 418.

Part III.—Taxation of Business Income of Certain Exempt Organizations

Section 513.—Unrelated Trade or Business

The Service is providing inflation adjustments to the maximum amount of a "low cost article" for calendar year 1996. This safe harbor ensures that funds raised through a charity's distribution of articles will not be treated as unrelated business income to the charity. See Rev. Proc. 95-53, page 445.

Section 514.—Unrelated Debt-Financed Income Plans, Etc.

26 CFR 1.514(a)-1: Unrelated debt-financed income and deductions.

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 514 of the Code to certain payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Subchapter J.—Estates, Trusts, Beneficiaries, and Decedents

Part I.—Estates, Trusts, and Beneficiaries

Subpart E.—Grantors and Others Treated as Substantial Owners

Section 672.—Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

If a grantor makes a transfer to a trust and reserves an unqualified power to remove a

trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the grantor (within the meaning of § 672(c) of the Code), is the reservation of the power tantamount to a reservation by the grantor of the trustee's discretionary powers of distribution? See Rev. Rul. 95-58, page 191.

Subchapter K.—Partners and Partnerships
Part I.—Determination of Tax Liability

Section 708.—Partnership Termination

If a New York general partnership registers as a New York registered limited liability partnership does it terminate under §708(b)(1)(B) of the Code? See Rev. Rul. 95-55, page 313.

Subchapter L.—Insurance Companies
Part I.—Life Insurance Companies
Subpart C.—Life Insurance Deductions

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

If an insurance company issues accident and health insurance contracts that otherwise qualify as guaranteed renewable contracts and maintains, in addition to the reserve for unearned premiums, a reserve computed on a full preliminary term

basis (additional reserve), are the contracts guaranteed renewable when the additional reserve is zero? See Rev. Rul. 95-80, page 79.

Section 809.—Reduction in Certain Deductions of Mutual Life Insurance Companies

26 CFR 1.809-9: Computation of the differential earnings rate and the recomputed differential earnings rate.

Mutual life insurance companies; differential earnings rate. The differential earnings rate for 1994 and the recomputed differential earnings rate for 1993 are set forth for use by mutual life insurance companies to compute their income tax liabilities for 1994.

Rev. Rul. 95-60

This revenue ruling contains the differential earnings rate for 1994 and the recomputed differential earnings rate for 1993. Under § 809 of the Internal Revenue Code, mutual life insurance companies use these rates in computing their Federal income tax liability for taxable years beginning in 1994. This revenue ruling also contains the figures on which the determinations of these rates are based. Notice 95-10, 1995-1 C.B. 293, contained tentative determinations of these rates.

Section 809(a) provides that, in the case of any mutual life insurance company, the amount of the deduction allowable under § 808 for policyholder dividends is reduced (but not below zero) by the "differential earnings amount." Any excess of the differential earnings amount over the amount of the deduction allowable under § 808 is taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of § 807. The "differential earnings amount" for any taxable year is the amount equal to the product of (a) the life insurance company's average equity base for the taxable year multiplied by (b) the

“differential earnings rate” for that taxable year. The “differential earnings rate” for the taxable year is the excess of (a) the “imputed earnings rate” for the taxable year over (b) the “average mutual earnings rate” for the second calendar year preceding the calendar year in which the taxable year begins. The “imputed earnings rate” for any taxable year is the amount that bears the same ratio to 16.5 percent as the “current stock earnings rate” for the taxable year bears to the “base period stock earnings rate.”

Section 809(f) provides that, in the case of any mutual life insurance company, if the “recomputed differential earnings amount” for any taxable year exceeds the differential earnings amount for that taxable year, the excess is included in life insurance gross income for the succeeding taxable year. If the differential earnings amount for any taxable year exceeds the recomputed differential earnings amount for that taxable year, the excess is allowed as a life insurance deduction for the succeeding taxable year. The “recom-

puted differential earnings amount” for any taxable year is an amount calculated in the same manner as the differential earnings amount for that taxable year, except that the average mutual earnings rate for the calendar year in which the taxable year begins is substituted for the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

The stock earnings rates and mutual earnings rates taken into account under § 809 generally are determined by dividing statement gain from operations by the average equity base. For this purpose, the term “statement gain from operations” means “the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes, and ... properly adjusted for realized capital gains and losses” See § 809(g)(1). The term “equity base” is defined as an amount determined in the manner prescribed by regulations equal to surplus and capital increased by the amount of nonadmit-

ted financial assets, the excess of statutory reserves over the amount of tax reserves, the sum of certain other reserves, and 50 percent of any policyholder dividends (or other similar liability) payable in the following taxable year. See § 809(b)(2), (3), (4), (5) and (6). Section 1.809-10 of the Income Tax Regulations provides that the equity base includes both the asset valuation reserve and the interest maintenance reserve for taxable years ending after December 31, 1991.

Section 1.809-9(a) of the regulations provides that neither the differential earnings rate under § 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under § 809(f)(3) may be less than zero.

For purposes of § 809, the differential earnings rate for 1994 and the rate used to calculate the recomputed differential earnings amount for 1993 (the recomputed differential earnings rate for 1993), and the figures on which these two rates are based are set forth in Table 1.

Rev. Rul. 95-60 Table 1

Determination of Rates To Be Used For Taxable Years

Beginning in 1994

Differential earnings rate for 1994.....	0
Recomputed differential earnings rate for 1993.....	0
Imputed earnings rate for 1993.....	12.611
Imputed earnings rate for 1994.....	15.109
Base period stock earnings rate.....	18.221
Current stock earnings rate for 1994.....	16.685
Stock earnings rate for 1991.....	19.667
Stock earnings rate for 1992.....	7.004
Stock earnings rate for 1993.....	23.385
Average mutual earnings rate for 1992.....	18.577
Average mutual earnings rate for 1993.....	18.406

Subpart E.—Definitions and Special Rules

Section 816.—Life Insurance Company Defined

26 CFR 1.801-3: Definitions.
(Also §§ 807, 848; 1.848-1.)

Accident and health insurance contracts. Under sections 807(d) and 816(e) of the Code, as added by section

211(a) of the Tax Reform Act of 1984, effective for taxable years beginning after December 31, 1983, the amount of the life insurance reserve for a guaranteed renewable accident and health contract is determined under a 2-year full preliminary term method. Rev. Rul. 71-367 obsolete.

Rev. Rul. 95-80

Periodically, the Internal Revenue

Service identifies certain revenue rulings that, although not specifically revoked or superseded, are obsolete because (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or subsequent published position; or (3) the facts set forth no longer exist or are not sufficiently described to permit clear application of the current statute and regulations.

Rev. Rul. 71-367, 1971-2 C.B. 258, concludes that an otherwise guaranteed renewable accident and health insurance contract is to be treated as a cancelable contract during the preliminary term because the amount of the reserve in addition to the reserve for unearned premiums (additional reserve) is zero during the preliminary term.

Section 211(a) of the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 1, 235, added § 807(d) to the Internal Revenue Code, effective for taxable years beginning after December 31, 1983. Section 807(d) provides that the amount of the life insurance reserve for a noncancellable accident and health insurance contract is determined by using a 2-year full preliminary term method. Under this method the amount of the additional reserve during the preliminary term is zero. Section 807(d) also applies to guaranteed renewable accident and health insurance contracts. See § 816(e). The addition of § 807(d) to the Code made Rev. Rul. 71-367 obsolete for taxable years beginning after December 31, 1983.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 71-367 is obsolete.

Part II.—Other Insurance Companies

Section 832.—Insurance Company Taxable Income

26 CFR 1.832-4: Gross income.

The salvage discount factors are set forth for the 1995 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 95-41, page 409.

Part III.—Provisions of General Application

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

26 CFR 1.846-1: Application of discount factors.

The loss payment patterns and discount factors are set forth for the 1995 accident year. These factors will be used for computing discounted unpaid losses under section 846 of the Code. See Rev. Proc. 95-40, page 402.

26 CFR 1.846-1: Application of discount factors.

The salvage discount factors are set forth for the 1995 accident year. These factors will be used for computing estimated salvage recoverable for purposes of section 832 of the Code. See Rev. Proc. 95-41, page 409.

Section 848.—Capitalization of Certain Policy Acquisition Expenses

26 CFR 1.848-1: Definitions and special provisions.

If an insurance company issues accident and health insurance contracts that otherwise qualify as guaranteed renewable contracts and maintains, in addition to the reserve for unearned premiums, a reserve computed on a full preliminary term basis (additional reserve), are the contracts guaranteed renewable when the additional reserve is zero? See Rev. Rul. 95-80, page 79.

Subchapter M.—Regulated Investment Companies and Real Estate Investment Trusts

Part IV.—Real Estate Mortgage Investment Conduits

Section 860C.—Taxation of Residual Interests

26 CFR 1.860C-1: Taxation of holders of residual interests.

A taxpayer may not use an inventory method under section 471 of the Code to account for REMIC residual interests. See Rev. Rul. 95-81, page 70.

Section 860E.—Treatment of Income in Excess of Daily Accruals on Residual Interests

26 CFR 1.860E-1: Treatment of taxable income of a residual interest holder in excess of daily accruals.

A taxpayer may not use an inventory method under section 471 of the Code to account for REMIC residual interests. See Rev. Rul. 95-81, page 70.

Section 860G.—Other Definitions and Special Rules

26 CFR 1.860A-0: Outline of REMIC provisions.

T.D. 8614

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Real Estate Mortgage Investment Conduits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to variable rate interest payments and specified portion interest payments on regular interests in real estate mortgage investment conduits (or REMICs). This action is necessary because of changes to the applicable tax law made by the Tax Reform Act of 1986 and by the Technical and Miscellaneous Revenue Act of 1988. These regulations provide guidance to REMIC sponsors and investors.

DATES: These regulations are effective August 17, 1995.

For dates of applicability of these regulations, see §1.860A-1.

SUPPLEMENTARY INFORMATION:

Background

On April 20, 1994, temporary regulations (TD 8534 [1994-1 C.B. 200]) relating to variable rate interest payments on REMIC regular interests were published in the Federal Register (59 FR 18746). A notice of proposed rule-

making (FI-10-94 [1994-1 C.B. 790]), published in the Federal Register for the same day (59 FR 18772), cross-references the temporary regulations. That notice also proposes guidance on whether interest payments on a regular interest in a REMIC consist of a specified portion of the interest payments on the qualified mortgages held by the REMIC.

No public hearing was requested or held, but written comments responding to the notice were received. After consideration of the comments, the regulations proposed by FI-10-94 are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed.

Explanation of Provisions

Sections 860A through 860G of the Internal Revenue Code set forth rules for the treatment of REMICs and for the treatment of persons who hold interests in REMICs. For an entity to qualify as a REMIC, every interest in the entity must be either a residual interest or a regular interest.

A. Variable Rates

Section 860G(a)(1)(B)(i) requires that any interest payments on a regular interest be payable based on a fixed rate, or on a variable rate to the extent provided in regulations. Regulations providing guidance under section 860G(a)(1)(B)(i) are included in a comprehensive set of final regulations relating to REMICs (the *1992 REMIC regulations*), which was published in the Federal Register for December 24, 1992 (57 FR 61293).

The 1992 REMIC regulations use a building-block approach to describe the permitted variable rates under section 860G(a)(1)(B)(i). A taxpayer must start with one permitted variable rate as a base and, if desired, may subject the rate to additions, subtractions, multiplications, caps, and floors. Under §1.860G-1(a)(3)(i) of the 1992 REMIC regulations, a permitted variable rate includes a rate that is a qualifying variable rate for purposes of sections 1271 through 1275 and the related regulations.

Notice 93-11, 1993-1 C.B. 298, addresses the application of the term *qualifying variable rate*. The notice provides that a *qualified floating rate* set at a *current value* (as defined in

proposed regulations under section 1275 (FI-189-84)) is a qualifying variable rate for purposes of §1.860G-1(a)(3)(i) of the 1992 REMIC regulations. Notice 93-11 also states that the 1992 REMIC regulations will be amended to conform to the language of the final section 1275 regulations when those regulations become effective. After the section 1275 regulations were revised and published in final form in the Federal Register for February 2, 1994 (59 FR 4799, 4827), the temporary regulations (TD 8534) and the proposed regulations (FI-10-94 [1994-1 C.B. 790]) were issued to conform §1.860G-1(a)(3)(i) of the 1992 REMIC regulations to the final section 1275 regulations.

The final section 1275 regulations define two types of variable rates. Section 1.1275-5(b) defines a *qualified floating rate*, and §1.1275-5(c) defines an *objective rate*. Under proposed §1.860G-1(a)(3)(i) and §1.860G-1T(a), permitted variable rates for regular interests in REMICs include a qualified floating rate. Objective rates, however, are not permitted.

One commentator proposes that the final version of §1.860G-1(a)(3)(i) be expanded to include as a permitted variable rate any objective rate that relates to one or more debt instruments (excluding any debt instrument that provides for payments measured in substantial part by reference to the value of property other than debt instruments). This would allow, for example, a rate equal to the total rate of return on a bond, or group of bonds.

Many objective rates reflect the returns on equities and commodities. The IRS and Treasury believe that proposed §1.860G-1(a)(3)(i) draws a sensible and necessary line between rates tied to interest rates (that is, qualified floating rates), and rates tied to commodities and equities. Moreover, the building-block approach adopted by the 1992 REMIC regulations affords taxpayers considerable flexibility to devise permitted variable rates, and the building-block approach would continue to apply after adoption of the proposed regulations. The rule in the temporary and proposed regulations, therefore, is retained in the final regulations under §1.860G-1(a)(3)(i).

Retaining §1.860G-1(a)(3)(i) as proposed affects a cross reference contained in §1.860G-1(a)(3)(ii)(A). Commentators suggest revising §1.860G-1(a)(3)(ii)(A) to modify the

restrictions imposed by the cross reference in that section to §1.860G-1(a)(3), which reference incorporates proposed §1.860G-1(a)(3)(i). Section 1.860G-1(a)(3)(ii)(A) permits a REMIC regular interest to have an interest rate based on a weighted average of the interest rates on some or all of the mortgages held by the REMIC (a *passthrough rate*). A mortgage taken into account in determining a passthrough rate (an *underlying mortgage*) must itself have a fixed rate or a permitted variable rate. Accordingly, a mortgage based on a qualified floating rate may be used to determine a passthrough rate but the underlying mortgage must conform to proposed §1.860G-1(a)(3)(i). This means the qualified floating rate must be set at a current value. A qualified floating rate is not set at a current value if it is set more than 3 months before the start of the related accrual period on the underlying mortgage. The commentators suggest loan servicers may need more than 3 months to compute revised interest and payment amounts and to tell borrowers of those revised amounts. Thus, according to the commentators, the 3-month period should be extended.

As noted above, the IRS and Treasury believe proposed §1.860G-1(a)(3)(i) sensibly distinguishes interest rate returns from other types of returns. For regular interests having a passthrough rate to reflect this distinction, any underlying mortgage based on a qualified floating rate that is used to determine the passthrough rate must also reflect this distinction. Thus, any underlying mortgage bearing interest at a qualified floating rate must have the rate set at a current value. Otherwise, proposed §1.860G-1(a)(3)(i) could be circumvented merely by creating a passthrough rate based on underlying mortgages bearing qualified floating rates not set at current values. Moreover, the ability of servicers to take more time to calculate revised rates and to notify borrowers of those rates appears to be limited by the Truth in Lending Act and Regulation Z (12 CFR Ch. 11 §226.20(c) (1995)), which require notice, within prescribed time periods, to a consumer of changes in a rate. Thus, this comment is not adopted here.

B. Specified Portions

Under section 860G(a)(1)(B)(ii), interest payments on a regular interest in

a REMIC may also consist of a specified portion of the interest payments on the qualified mortgages held by the REMIC, provided the specified portion does not vary while the regular interest is outstanding. A specified portion regular interest is sometimes called an *Interest Only* regular interest or *IO*. The 1992 REMIC regulations identify the specified portions permitted under section 860G(a)(1)(B)(ii).

Requests for further guidance prompted the publication of the proposed regulations addressing specified portions. Taxpayers requested the IRS clarify that a REMIC may issue an IO that is expressed as a percentage of the interest payable on an IO acquired from another REMIC (a collateral IO). In response, the notice of proposed rulemaking (FI-10-94) would add §1.860G-1(a)(2)(i)(D), under which the cash flows from a collateral IO issued by one REMIC can be proportionately divided through another REMIC. The proposed provision would negate the need for any other arrangement such as a grantor trust and would apply whether the collateral IO is acquired on formation by a related upper-tier REMIC or after formation by an unrelated REMIC (a re-REMIC transaction).

According to one commentator, the addition of §1.860G-1(a)(2)(i)(D) implies that more complex re-REMIC transactions are not allowed. According to another commentator, the language of the proposed rule implies that all qualified mortgages held by the REMIC must be IO regular interests. To remove both of those implications, the proposed rule is adopted in revised form, which appears as §1.860G-1(a)(2)(v).

C. Other Comments

Commentators also addressed other REMIC regulations not affected by this Treasury decision. Those comments may be considered in future guidance projects.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not

apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for “Section 1.860G-1T” to read in part as follows:

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

Par. 2. Section 1.860A-0 is amended by:

1. Adding entries for §1.860A-1(b)(4).
2. Revising the entry for §1.860G-1(a)(2)(v).
3. Adding an entry for §1.860G-1(a)(2)(vi).
4. Revising the entry for §1.860G-1(a)(3)(i).

The additions and revisions read as follows:

§1.860A-0 Outline of REMIC provisions.

* * * * *

§1.860A-1 Effective dates and transition rules.

* * * * *

- (b) * * *
- (4) Rate based on current interest rate.
 - (i) In general.
 - (ii) Rate based on index.
 - (iii) Transition obligations.

* * * * *

§1.860G-1 Definition of regular and residual interests.

- (a) * * *
- (2) * * *
- (v) Specified portion includes portion of interest payable on regular interest.

- (vi) Examples.
- (3) * * *
- (i) Rate based on current interest rate.

* * * * *

Par. 3. In §1.860A-, paragraph (b)(4) is added to read as follows:

§1.860A- Effective dates and transition rules.

* * * * *

- (b) * * *
- (4) Rate based on current interest rate—(i) *In general.* Section 1.860G-1(a)(3)(i) applies to obligations (other than transition obligations described in paragraph (b)(4)(iii) of this section) intended to qualify as regular interests that are issued on or after April 4, 1994.

(ii) *Rate based on index.* Section 1.860G-1(a)(3)(i) (as contained in 26 CFR part 1 revised as of April 1, 1994) applies to obligations intended to qualify as regular interests that—

(A) Are issued by a qualified entity (as defined in §1.860D-1(c)(3)) whose startup date (as defined in section 860G(a)(9) and §1.860G-2(k)) is on or after November 12, 1991; and

- (B) Are either—
 - (1) Issued before April 4, 1994; or
 - (2) Transition obligations described in paragraph (b)(4)(iii) of this section.

(iii) *Transition obligations.* Obligations are described in this paragraph (b)(4)(iii) if—

(A) The terms of the obligations and the prices at which the obligations are offered are fixed before April 4, 1994; and

(B) On or before June 1, 1994, a substantial portion of the obligations are transferred, with the terms and at the prices that are fixed before April 4, 1994, to investors who are unrelated to the REMIC’s sponsor at the time of the transfer.

Par. 4. Section 1.860G-1 is amended by:

1. Redesignating paragraph (a)(2)(v) as paragraph (a)(2)(vi).
2. Adding a new paragraph (a)(2)(v).
3. Revising paragraph (a)(3)(i).

The addition and revisions read as follows:

§1.860G-1 Definition of regular and residual interests.

- (a) * * *
- (2) * * *

(v) *Specified portion includes portion of interest payable on regular interest.* (A) The specified portions that meet the requirements of paragraph (a)(2)(i) of this section include a specified portion that can be expressed as a fixed percentage of the interest that is payable on some or all of the qualified mortgages where—

(1) Each of those qualified mortgages is a regular interest issued by another REMIC; and

(2) With respect to that REMIC in which it is a regular interest, each of those regular interests bears interest that can be expressed as a specified portion as described in paragraph (a)(2)(i)(A), (B), or (C) of this section.

(B) See §1.860A-1(a) for the effective date of this paragraph (a)(2)(v).

* * * * *

- (3) * * *

(i) *Rate based on current interest rate.* A qualified floating rate as defined in §1.1275-5(b)(1) (but without the application of paragraph (b)(2) or (3) of that section) set at a current value, as defined in §1.1275-5(a)(4), is a variable rate. In addition, a rate equal to the highest, lowest, or average of two or more qualified floating rates is a variable rate. For example, a rate based on the average cost of funds of one or more financial institutions is a variable rate.

* * * * *

§1.860G-1T [Removed]

Par. 5. Section 1.860G-1T is removed.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved July 31, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 16, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 17, 1995, 60 F.R. 42785)

26 CFR 1.860G-1: Definition of regular and residual interests.

A taxpayer may not use an inventory method under section 471 of the Code to account for REMIC residual interests. See Rev. Rul. 95-81, page 70.

Subchapter N.—Tax Based on Income from Sources Within or Without the United States
Part I.—Determination of Sources of Income

Section 863.—Special Rules for Determining Source

26 CFR 1.863-1: Allocation of gross income under section 863(a).

T.D. 8615

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Special Rules for Determining Sources of Scholarships and Fellowship Grants

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains a final Income Tax Regulation that provides guidance for determining the source of scholarships, fellowship grants, prizes and awards. The final regulation will affect both individuals and withholding agents. It will provide guidance concerning whether scholarships, fellowships, other grants, prizes and awards are U.S. source income subject to tax and withholding.

DATES: This regulation is effective August 25, 1995.

For dates of applicability of these regulations, see *Effective dates* in §1.863-1(d)(4).

SUPPLEMENTARY INFORMATION:

Background

This document contains a final Income Tax Regulation (26 CFR part 1) under section 863 of the Internal Revenue Code. On June 15, 1993, a notice of proposed rulemaking (INTL 0041-92) was published in the Federal

Register (58 FR 33060) (1993-2 C.B. 634). No public hearing was requested or held.

Written comments responding to the notice were received. After consideration of all of the comments, the regulation proposed under INTL-0041-92 is adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

Section 863(a) authorizes the Secretary to provide regulations regarding the source of items of gross income other than those items specified in sections 861(a) and 862(a). Rules for determining the source of scholarships, fellowship grants, grants, prizes and awards are not provided by sections 861(a) and 862(a).

The notice of proposed rulemaking proposed in §1.863-1(d)(1) that scholarships and fellowship grants be sourced by reference to the status of the grantor. However, it also provided a special rule in §1.863-1(d)(2) for nonresident aliens who receive scholarships or fellowship grants, as defined in the regulations under section 117, from U.S. grantors with respect to study or research activities to be conducted outside the United States. Under these circumstances, the scholarship or fellowship grant would be treated as income from sources outside the United States.

The final regulation adopts the proposed regulation with certain changes. Paragraph (d)(1) clarifies that these rules do not apply to salaries or other compensation for services.

The final regulation provides rules for sourcing scholarships and fellowship grants in paragraphs (d)(2)(i) and (ii) by reference to the status of the grantor. The special rule of paragraph (d)(2)(iii) provides that scholarships or fellowship grants received by a person other than a U.S. person for activities conducted outside the United States are treated as income from sources without the United States.

Commentators asked that the regulation be expanded to encompass grants that fall outside the scope of section 117. In addition, commentators also suggested that the special rule be expanded to include prizes and awards given to nonresident aliens for their past artistic, scientific, or charitable achievements. These suggestions are included in this final regulation.

The source of grants, prizes and awards is determined by reference to the status of the grantor under the general rules set forth in paragraph (d)(2)(i) and (ii). The term *grants* is defined in paragraph (d)(3)(iv) as amounts described in subparagraph (3) of section 4945(g) of the Code and the regulations thereunder and that are not otherwise scholarships, fellowship grants, prizes or awards as defined in §1.863-1(d)(3). For purposes of paragraph (d)(3)(iv), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in advance.

The term *prizes and awards* is defined in paragraph (d)(3)(iii) of this final regulation as having the same meaning as that set forth in section 74 and the regulations thereunder.

Under paragraph (d)(2)(iii), certain *targeted grants* and *achievement awards* received by a person other than a U.S. person for activities conducted outside the United States are treated as foreign source income. The term *targeted grants* does not appear elsewhere in the Code or the regulations. Targeted grants are a subset of the more inclusive term *grants*. Targeted grants may be received only from an organization described in section 501(c)(3), the United States, the States, or the District of Columbia and must be undertaken in the public interest without private financial benefit. The term *achievement award* does not appear elsewhere in the Code or regulations. An achievement award is an award issued by an organization described in section 501(c)(3), the United States, a State, or the District of Columbia for a past activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

Commentators requested that the final regulation provide express guidance for the issuance of scholarships or fellowship grants by agents on behalf of foreign grantors. No change is made in the final regulation because an actual payment made by a genuine agent of the payor does not alter the source. The final regulation looks to the status (*i.e.*, whether the person is a U.S. person or a foreign person) of the payor rather than the agent.

The term *international agency* in paragraph (d)(1) of the proposed reg-

ulation has been replaced in the final regulation with the term *international organization* as defined in section 7701(a)(18). This clarification uses the Code definition for such organizations.

Comments were received regarding the proposed regulation suggesting that the scope of the regulation be expanded to cover scholarships and fellowship grants awarded by charitable trusts. The final regulation changes the proposed language of "U.S. citizen or resident, a domestic corporation, ..." in paragraph (d)(2)(i) to include a domestic partnership, or an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)). The special rule of paragraph (d)(2)(iii) has been clarified to apply to scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person as defined in section 7701(a)(30).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has 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 this regulation, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.863-1 also issued under 26 U.S.C. 863(a). * * *

Par. 2. In §1.863-1, paragraph (d) is added to read as follows:

§1.863-1 Allocation of gross income under section 863(a).

* * * * *

(d) *Scholarships, fellowship grants, grants, prizes and awards*—(1) *In general.* This paragraph (d) applies to scholarships, fellowship grants, grants, prizes and awards. The provisions of this paragraph (d) do not apply to amounts paid as salary or other compensation for services.

(2) *Source of income.* The source of income from scholarships, fellowship grants, grants, prizes and awards is determined as follows:

(i) *United States source income.* Except as provided in paragraph (d)(2)(iii) of this section, scholarships, fellowship grants, grants, prizes and awards made by a U.S. citizen or resident, a domestic partnership, a domestic corporation, an estate or trust (other than a foreign estate or trust within the meaning of section 7701(a)(31)), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia shall be treated as income from sources within the United States.

(ii) *Foreign source income.* Scholarships, fellowship grants, grants, prizes and awards made by a foreign government (or an instrumentality, agency, or any political subdivision thereof), an international organization (as defined in section 7701(a)(18)), or a person other than a U.S. person (as defined in section 7701(a)(30)) shall be treated as income from sources without the United States.

(iii) *Certain activities conducted outside the United States.* Scholarships, fellowship grants, targeted grants, and achievement awards received by a person other than a U.S. person (as defined in section 7701(a)(30)) with respect to activities previously conducted (in the case of achievement awards) or to be conducted (in the case of scholarships, fellowships grants, and targeted grants) outside the United States shall be treated as income from sources without the United States.

(3) *Definitions.* The following definitions apply for purposes of this paragraph (d):

(i) *Scholarships* are defined in section 117 and the regulations thereunder.

(ii) *Fellowship grants* are defined in section 117 and the regulations thereunder.

(iii) *Prizes and awards* are defined in section 74 and the regulations thereunder.

(iv) *Grants* are amounts described in subparagraph (3) of section 4945(g) and the regulations thereunder, and are not amounts otherwise described in paragraphs (d)(3)(i), (ii), or (iii) of this section. For purposes of this paragraph (d), the reference to section 4945(g)(3) is applied without regard to the identity of the payor or recipient and without the application of the objective and nondiscriminatory basis test and the requirement of a procedure approved in advance.

(v) *Targeted grants* are grants—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or any political subdivision thereof), or the District of Columbia; and

(B) For an activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(vi) *Achievement awards* are awards—

(A) Issued by an organization described in section 501(c)(3), the United States (or an instrumentality or agency thereof), a State (or political subdivision thereof), or the District of Columbia; and

(B) For a past activity undertaken in the public interest and not primarily for the private financial benefit of a specific person or persons or organization.

(4) *Effective dates.* The following are the effective dates concerning this paragraph (d):

(i) *Scholarships and fellowship grants.* This paragraph (d) is effective for scholarship and fellowship grant payments made after December 31, 1986. However, for scholarship and fellowship grant payments made after May 14, 1989, and before June 16, 1993, the residence of the payor rule of paragraph (d)(2)(i) and (ii) of this section may be applied without applying paragraph (d)(2)(iii) of this section.

(ii) *Grants, prizes and awards.* This paragraph (d) is effective for payments made for grants, prizes and awards, targeted grants, and achievement awards after September 25, 1995. However, the taxpayer may elect to apply the provisions of this paragraph (d) to payments made for grants, prizes and awards, targeted grants, and achievement awards after December 31, 1986, and before September 26, 1995.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved August 3, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 24, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 25, 1995, 60 F.R. 44274)

Part II.—Nonresident Aliens and Foreign Corporations
Subpart A.—Nonresident Alien Individuals

Section 871.—Tax on Nonresident Alien Individuals

Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 85-163, 1985-2 C.B. 349; and Rev. Rul. 87-89, Situations (1) and (2), 1987-2 C.B. 195, are rendered obsolete for payments made after September 10, 1995, that are subject to the final regulations under section 7701(1). See Rev. Rul. 95-56, page 322.

Subpart B.—Foreign Corporations

Section 881.—Tax on Income of Foreign Corporations Not Connected with United States Business

Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 85-163, 1985-2 C.B. 349; and Rev. Rul. 87-89, Situations (1) and (2), 1987-2 C.B. 195, are rendered obsolete for payments made after September 10, 1995, that are subject to the final regulations under section 7701(1). See Rev. Rul. 95-56, page 322.

Part III.—Income From Sources Without the United States

Subpart A.—Foreign Tax Credit

Section 901—Taxes of Foreign Countries and of Possessions of United States

(Also Sections 902, 952, 960.)

Update of Rev. Rul. 92-63. Rev. Rul. 92-63, 1992-2 C.B. 195 (as corrected by Rev. Rul. 92-63A, 1992-2 C.B. 197), is modified and superseded with respect to countries listed under section 901(j)(2)(A) of the Code.

Rev. Rul. 95-63

This ruling modifies and supersedes Rev. Rul. 92-63, 1992-2 C.B. 195 (as

corrected by Rev. Rul. 92-63A, 1992-2 C.B. 197), which lists countries subject to certain special tax rules under sections 901(j) and 952(a)(5) of the Internal Revenue Code.

LAW AND ANALYSIS

Sections 901, 902, and 960 of the Code generally allow U.S. taxpayers to claim a foreign tax credit for income, war profits, and excess profits taxes paid or accrued (or deemed paid or accrued) to any foreign country or to any possession of the United States. Section 901(j)(1)(A) denies the credit for taxes paid or accrued (or deemed paid or accrued under sections 902 or 960) to any country described in section 901(j)(2)(A) if the taxes are with respect to income attributable to a period during which section 901(j) applies. Section 901(j)(1)(B) requires taxpayers to apply subsections (a), (b), and (c) of section 904 and sections 902 and 960 separately with respect to income attributable to such a period from sources within such country. In addition, section 952(a)(5) provides that subpart F income includes income derived by a controlled foreign corporation from any foreign country during any period during which section 901(j) applies to that foreign country.

Based on certifications by the Secretary of State, this revenue ruling states the dates on which Angola, Afghanistan, Cambodia and Vietnam ceased to be described in section 901(j)(2)(A). In addition, this revenue ruling reflects the addition of Sudan to the list of countries described in section 901(j)(2)(A). For any country that is first described in section 901(j)(2)(A) on a date after January 1, 1987, section 901(j) applies to taxes paid or accrued (or deemed paid or accrued under sections 902 and 960) to that country with respect to income attributable to any period beginning six months after that date. Sudan was first described in section 901(j)(2)(A) on August 12, 1993. Accordingly, sections 901(j) and 952(a)(2) apply to Sudan beginning on February 12, 1994. All other countries and periods listed below are restated from Rev. Rul. 92-63, *supra*.

HOLDING AND EFFECTIVE DATES

Section 901(j)(2)(A) of the Code describes the following countries for the following periods:

<i>Country</i>	<i>starting date</i>	<i>ending date</i>
Afghanistan	January 1, 1987	August 4, 1994
Albania	January 1, 1987	March 15, 1991
Angola	January 1, 1987	June 18, 1993
Cambodia	January 1, 1987	August 4, 1994
Cuba	January 1, 1987	still in effect
Iran	January 1, 1987	still in effect
Iraq	February 1, 1991	still in effect
Libya	January 1, 1987	still in effect
North Korea	January 1, 1987	still in effect
South Africa	January 1, 1988	July 10, 1991
Sudan	February 12, 1994	still in effect
Syria	January 1, 1987	still in effect
Vietnam	January 1, 1987	July 21, 1995
People's Democratic Republic of Yemen	January 1, 1987	May 22, 1990

For guidance on issues arising in a taxable year when section 901(j) ceases to apply to a country, *see* Rev. Rul. 92-62, 1992-2 C.B. 193.

EFFECT ON OTHER REVENUE RULINGS

This ruling modifies and supersedes Rev. Rul. 92-63, 1992-2 C.B. 195, with respect to countries listed under section 901(j)(2)(A).

Section 902.—Deemed Paid Credit Where Domestic Corporation Owns 10 Percent or More of Voting Stock of Foreign Corporation

Rev. Rul. 92-63, 1992-2 C.B. 195, (as corrected by Rev. Rul. 92-63A, 1992-2 C.B. 197) is modified and superseded with respect to countries listed under section 901(j)(2)(A) of the Code. *See* Rev. Rul. 95-63, page 85.

Section 904.—Limitation on Credit

26 CFR 1.904(i)-1: Limitation on use of deconsolidation to avoid foreign tax credit limitations.

T.D. 8627

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Limitation on Use of Deconsolidation to Avoid Foreign Tax Credit Limitations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to certain limitations on the amount of the foreign tax credit under section 904(i). The final regulations will affect the sourcing and foreign tax credit separate limitation character of income for purposes of the calculation of the foreign tax credit by certain related domestic corporations. The final regulations are necessary to prevent avoidance of the foreign tax credit limitations.

DATES: These regulations are effective January 1, 1994.

For dates of applicability, *see* §1.904(i)-1(e) of these regulations.

SUPPLEMENTARY INFORMATION:

Background

This document contains final Income Tax Regulations (26 CFR part 1) under section 904 of the Internal Revenue Code.

On May 17, 1994, a notice of proposed rulemaking (INTL-0006-90) relating to the foreign tax credit limitation imposed under section 904(i) was published in the Federal Register (59 FR 25584) (1994-1 C.B. 816).

Written comments responding to this notice were received. A public hearing was requested and held on October 17, 1994. After consideration of all the comments, the proposed regulations under section 904(i) are adopted as revised by this Treasury decision. The final regulations are substantially as proposed. The preamble to the proposed regulations contains a discussion of the provisions.

Explanation of Revisions and Summary of Comments Common Parent of an Extended Affiliated Group

Section 1.904(i)-1(b)(1)(i)(B)(1) of the proposed regulations defined affiliates to include certain domestic corporations ultimately owned 80 percent or more by entities that are not includible corporations. The final regulations are modified to require that the domestic corporations be ultimately owned by a common parent that is a corporation.

Commentators suggested that Congress did not intend to apply the rules of this section to domestic subsidiaries of a common foreign parent. However, section 904(i)(1) states that domestic corporations are affiliates under section 904(i) if those corporations would be affiliates under section 1504(a) without the exclusions contained in section 1504(b). Without the exclusion of foreign corporations under section 1504(b)(3), multiple chains of domestic corporations owned 80% or more by a foreign common parent would be affiliates under section 1504(a). Thus, it is clear that Congress intended broad application of this provision to structures such as those with foreign common parents. The examples in the legislative history using domestic common parents are merely illustrative. Therefore, no change to §1.904(i)-1(b)(1)(i)(B)(1) was made in the final regulations in response to this comment.

Commentators suggested that the final regulations should be effective only for taxable years beginning after May 17, 1994, the publication date of the proposed regulations, for structures with a foreign common parent. Commentators also suggested that final

regulations should not be applied to foreign common parent structures in existence prior to the enactment of section 904(i). The statute provides authority to address all structures, including foreign common parent structures. Therefore, no change in the effective date was made and no grandfather clause added with respect to such foreign common parent structures.

Determination of Taxable Income

Commentators requested clarification whether provisions such as §§1.861-11T and 1.861-14T, as well as the consolidated return provisions, apply to determine the taxable income of an affiliate in a separate category.

Section 1.904(i)-1(a)(1)(i) of the final regulations provides that each affiliate must determine its net taxable income or loss in each separate category, as defined in §1.904-5(a)(1) and treating U.S. source income or loss as a separate category. In general, an affiliate may not use the consolidated return regulations in computing net taxable income or loss in each separate category. However, a consolidated group is treated as one affiliate, and such affiliate must use the consolidated return regulations (without regard to sections 904(f) and 907(c)(4)) in computing the affiliate's net taxable income or loss in each separate category. To the extent applicable in the absence of section 904(i) and these regulations, other provisions of the Code and regulations will be used in the determination of an affiliate's net taxable income or loss in a separate category under §1.904(i)-1(a)(1)(i).

Section 1.904(i)-1(a)(1)(ii) of the final regulations states that each affiliate's net income in a separate category will be combined with net income of all other affiliates in the same separate category. However, net losses in a separate category are combined with other affiliates' income or loss in the same category, under §1.904(i)-1(a)(1)(ii), only to the extent that the affiliate's net loss in the separate category offsets taxable income, whether U.S. or foreign source, of the affiliate with the net loss. The consolidated return provisions dealing with sections 904(f) and 907(c)(4) are then applied to the combined amounts in each separate category as if all affiliates were members of a single consolidated group.

Allocation Methods

The proposed regulations required that allocation be accomplished under "any consistently applied reasonable method." Several commentators raised questions about the appropriateness of certain allocation methods. The final regulations adopt the proposed standard but have been clarified to provide that the determination of the reasonableness of a method is based on all of the facts and circumstances.

Section 1.904(i)-1(a) of the proposed regulations required consistent application of the allocation method chosen. Commentators requested clarification as to whether this consistency rule requires the same allocation method to be used by each affiliate or whether, instead, the rule requires consistency in the choice of an allocation method from year to year. The final regulations clarify that a method is consistently applied only if used by all affiliates from year to year. Once chosen, an allocation method may be changed only with the consent of the Commissioner.

Deemed Distributions

One comment noted that if a domestic corporation, affiliated by virtue of section 904(i) with another domestic corporation, makes a payment to that other domestic corporation in order to compensate the other corporation for an increase in its U.S. income tax as a result of the application of section 904(i), the payment may be a constructive dividend to a foreign parent, followed by a contribution to capital to the other domestic corporation. It was suggested that the rules of §1.1502-33(d) be applied by the section 904(i) regulations to allow affiliates that have altered tax liabilities due to the effect of section 904(i) to allocate that liability among the expanded affiliated group without triggering a constructive dividend. The final regulations clarify that the consolidated return regulations, including §1.1502-33(d), generally are not applicable to the extended affiliated group.

Consistency in Choice of Taxable Year

One commentator questioned whether year-to-year consistency in the choice of the base taxable year for the extended affiliated group is required

under §1.904(i)-1(c) of the proposed regulations, and whether the taxpayer must secure the permission of the Service to alter that choice. Failure to require consistency would permit the matching of affiliates' taxable years in the most advantageous manner each year and allow an expanded group to delay the affiliation of each newly acquired corporation, under §1.904(i)-1(b)(1)(iii), for the maximum period of time. The final regulations clarify that the taxable year chosen must be used consistently from year to year, and may be changed only with the Commissioner's consent.

Consolidated Group Considered a Single Affiliate

The final regulations, in §1.904(i)-1(b)(1)(ii), clarify that a consolidated group, the members of which are affiliates under this section, will be treated as a single affiliate for purposes of this section. Thus, for example, the computations under §1.904(i)-1(a)(1)(i) by a consolidated group of affiliates will produce one set of calculations with respect to each separate category of foreign source taxable income or loss for the consolidated group.

Exception for Newly Acquired Affiliates

Section 1.904(i)-1(b)(1)(ii) of the proposed regulations stated that "[a]n includible corporation will not be considered an affiliate of another includible corporation during its taxable year beginning before the date on which the first includible corporation first becomes an affiliate with respect to that other includible corporation." [emphasis added]. A commentator questioned the identity of the corporation referenced by the emphasized "its". The final regulations, in renumbered §1.904(i)-1(b)(1)(iii)(A), clarify that the reference is to the new affiliate.

Because of this ambiguity in §1.904(i)-1(b)(1)(ii) of the proposed regulations, taxpayers may have lacked sufficient notice of the Service's interpretation of that provision. For this reason, includible corporations acquired from unrelated third parties prior to the thirty-first day after the publication of the regulations will be considered an affiliate on a date that is consistent with any reasonable interpretation of §1.904(i)-1(b)(1)(ii) of the proposed regulations. Therefore, §1.904(i)-1(b)-

(1)(iii)(A) will only apply to acquisitions of affiliates after December 7, 1995. With respect to acquisitions on or before December 7, 1995, §1.904(i)-1(b)(1)(iii)(B) will apply.

It has also been clarified that the exception only applies to acquisitions from unrelated third parties and does not apply where the acquisition of the new affiliate is used to avoid the application of section 904(i). Both of these clarifications apply to any acquisition of an includible corporation after December 31, 1993.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. These regulations affect related domestic corporations not electing to file a consolidated return, or ineligible to file a consolidated return for all of the domestic corporations because of the existence of nonincludible entities. It is assumed that a substantial number of small entities do not operate in such structures. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small businesses.

Need for Final Regulations

This regulation, when adopted, would apply to taxable years of affiliates beginning after December 31, 1993. The final regulations will clarify the law in this area and will provide taxpayers with needed immediate guidance. The effective date is also necessary to prevent avoidance of tax. This regulation is not being issued subject to the effective date limitation of section 553(d) of 5 U.S.C..

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *
Section 1.904(i)-1 also issued under 26 U.S.C. 904(i). * * *

Par. 2. Section 1.904-0 is amended by:

1. Revising the introductory text.
2. Adding an entry for §1.904(i)-1.

The revision and addition read as follows:

§1.904-0 Outline of regulation provisions for section 904.

This section lists the regulations under section 904 of the Internal Revenue Code of 1986.

* * * * *

§1.904(i)-1 Limitation on use of deconsolidation to avoid foreign tax credit limitations.

- (a) General rule.
 - (1) Determination of taxable income.
 - (2) Allocation.
- (b) Definitions and special rules.
 - (1) Affiliate.
 - (i) Generally.
 - (ii) Rules for consolidated groups.
 - (iii) Exception for newly acquired affiliates.
- (2) Includible corporation.
- (c) Taxable years.
- (d) Consistent treatment of foreign taxes paid.
- (e) Effective date.

Par. 3. Section 1.904(i)-1 is added to read as follows:

§1.904(i)-1 Limitation on use of deconsolidation to avoid foreign tax credit limitations.

(a) *General rule.* If two or more includible corporations are affiliates, within the meaning of paragraph (b)(1) of this section, at any time during their taxable years, then, solely for purposes of applying the foreign tax credit provisions of section 59(a), sections 901 through 908, and section 960, the rules of this section will apply.

(1) *Determination of taxable income*—(i) Each affiliate must compute its net taxable income or loss in each separate category (as defined in

§1.904-5(a)(1), and treating U.S. source income or loss as a separate category) without regard to sections 904(f) and 907(c)(4). Only affiliates that are members of the same consolidated group use the consolidated return regulations (other than those under sections 904(f) and 907(c)(4)) in computing such net taxable income or loss. To the extent otherwise applicable, other provisions of the Internal Revenue Code and regulations must be used in the determination of an affiliate's net taxable income or loss in a separate category.

(ii) The net taxable income amounts in each separate category determined under paragraph (a)(1)(i) of this section are combined for all affiliates to determine one amount for the group of affiliates in each separate category. However, a net loss of an affiliate (first affiliate) in a separate category determined under paragraph (a)(1)(i) of this section will be combined under this paragraph (a) with net income or loss amounts of other affiliates in the same category only if, and to the extent that, the net loss offsets taxable income, whether U.S. or foreign source, of the first affiliate. The consolidated return regulations that apply the principles of sections 904(f) and 907(c)(4) to consolidated groups will then be applied to the combined amounts in each separate category as if all affiliates were members of a single consolidated group.

(2) *Allocation.* Any net taxable income in a separate category calculated under paragraph (a)(1)(ii) of this section for purposes of the foreign tax credit provisions must then be allocated among the affiliates under any consistently applied reasonable method, taking into account all of the facts and circumstances. A method is consistently applied if used by all affiliates from year to year. Once chosen, an allocation method may be changed only with the consent of the Commissioner. This allocation will only affect the source and foreign tax credit separate limitation character of the income for purposes of the foreign tax credit separate limitation of each affiliate, and will not otherwise affect an affiliate's total net income or loss. This section applies whether the federal income tax consequences of its application favor, or are adverse to, the taxpayer.

(b) *Definitions and special rules*—For purposes of this section only, the following terms will have the meanings specified.

(1) *Affiliate*—(i) *Generally*. Affiliates are includible corporations—

(A) That are members of the same affiliated group, as defined in section 1504(a); or

(B) That would be members of the same affiliated group, as defined in section 1504(a) if—

(1) Any non-includible corporation meeting the ownership test of section 1504(a)(2) with respect to any such includible corporation was itself an includible corporation; or

(2) The constructive ownership rules of section 1563(e) were applied for purposes of section 1504(a).

(ii) *Rules for consolidated groups*. Affiliates that are members of the same consolidated group are treated as a single affiliate for purposes of this section. The provisions of paragraph (a) of this section shall not apply if the only affiliates under this definition are already members of the same consolidated group without operation of this section.

(iii) *Exception for newly acquired affiliates*—(A) With respect to acquisitions after December 7, 1995, an includible corporation acquired from unrelated third parties (First Corporation) will not be considered an affiliate of another includible corporation (Second Corporation) during the taxable year of the First Corporation beginning before the date on which the First Corporation originally becomes an affiliate with respect to the Second Corporation.

(B) With respect to acquisitions on or before December 7, 1995, an includible corporation acquired from unrelated third parties will not be considered an affiliate of another includible corporation during its taxable year beginning before the date on which the first includible corporation first becomes an affiliate with respect to that other includible corporation.

(C) This exception does not apply where the acquisition of an includible corporation is used to avoid the application of this section.

(2) *Includible corporation*. The term *includible corporation* has the same meaning it has in section 1504(b).

(c) *Taxable years*. If all of the affiliates use the same U.S. taxable year, then that taxable year must be used for purposes of applying this section. If, however, the affiliates use more than one U.S. taxable year, then an appropriate taxable year must be

used for applying this section. The determination whether a taxable year is appropriate must take into account all of the relevant facts and circumstances, including the U.S. taxable years used by the affiliates for general U.S. income tax purposes. The taxable year chosen by the affiliates for purposes of applying this section must be used consistently from year to year. The taxable year may be changed only with the prior consent of the Commissioner. Those affiliates that do not use the year determined under this paragraph (c) as their U.S. taxable year for general U.S. income tax purposes must, for purposes of this section, use their U.S. taxable year or years ending within the taxable year determined under this paragraph (c). If, however, the stock of an affiliate is disposed of so that it ceases to be an affiliate, then the taxable year of that affiliate will be considered to end on the disposition date for purposes of this section.

(d) *Consistent treatment of foreign taxes paid*. All affiliates must consistently either elect under section 901(a) to claim a credit for foreign income taxes paid or accrued, or deemed paid or accrued, or deduct foreign taxes paid or accrued under section 164. See also §1.1502-4(a); §1.905-1(a).

(e) *Effective date*. Except as provided in paragraph (b)(1)(iii) of this section (relating to newly acquired affiliates), this section is effective for taxable years of affiliates beginning after December 31, 1993.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved September 27, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on November 6, 1995, 8:45 a.m., and published in the issue of the Federal Register for November 7, 1995, 60 F.R. 56117)

Subpart B.—Earned Income of Citizens or Residents of United States

Section 911.—Citizens or Residents of the United States Living Abroad

26 CFR 1.911-1: Partial exclusion for earned income from sources within a foreign country and foreign housing costs.

Guidance is provided to individuals who fail to

meet the eligibility requirements of section 911(d)(1) of the Code because adverse conditions in a foreign country preclude the individual from meeting those requirements. A current list of countries and the dates those countries are subject to the section 911(d)(4) waiver is provided. See Rev. Proc. 95-45, page 412.

Subpart D.—Possessions of the United States

Section 936.—Puerto Rico and Possession Tax Credit

26 CFR 1.936-7: Manner of making election under section 936(h)(5); special election for export sales; revocation of election under section 936(a).

What procedures apply, in post-1993 tax years, for electing the § 936(a)(4)(B) percentage limitation, electing to compute the § 936(a)(4)(A) economic activity limitation on a consolidated basis, revoking a § 936(a) election, or changing a § 936(h) intangible property income allocation method. See Rev. Proc. 95-37, page 393.

Subpart F.—Controlled Foreign Corporations

Section 952.—Subpart F Income Defined

Rev. Rul. 92-63, 1992-2 C.B. 195, (as corrected by Rev. Rul. 92-63A, 1992-2 C.B. 197) is modified and superseded with respect to countries listed under section 901(j)(2)(A) of the Code. See Rev. Rul. 95-63, page 85.

Section 954.—Foreign Base Company Income

26 CFR 1.954-0: Introduction.

T.D. 8618

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 4 and 602

Definition of a Controlled Foreign Corporation, Foreign Base Company Income and Foreign Personal Holding Company Income of a Controlled Foreign Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations governing the definition of a controlled

foreign corporation and the definitions of foreign base company income and foreign personal holding company income of a controlled foreign corporation. These regulations are necessary because of changes made to the prior law by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1989, and the Omnibus Budget Reconciliation Act of 1993. Certain conforming changes in the regulations were necessary because of changes made by the Deficit Reduction Act of 1984. The regulations will provide the public with the guidance to comply with those acts and will affect United States shareholders of controlled foreign corporations.

DATES: These regulations are effective September 7, 1995.

For dates of applicability, see §1.954-0(a).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1068. The estimated average burden per respondent associated with the collection of information in this regulation is one hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document contains final regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 954(b), 954(c) and 957(a) of the Internal Revenue Code (Code). Sections 954 and 957 were amended by sections 1201, 1221, 1222 and 1223 of the Tax Reform Act of 1986 (Pub. L. 99-514), by section 1012 of the Tech-

nical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647), by section 7811 of the Revenue Reconciliation Act of 1989 (Pub. L. 101-239) and by section 13233 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66). These regulations are also issued under authority contained in section 7805 of the Code.

Temporary regulations (TD 8216 [1988-2 C.B. 257]) and a cross-referenced notice of proposed rulemaking (INTL-362-88 [1988-2 C.B. 829]) under sections 954 and 957 of the Code were published in the Federal Register on July 21, 1988 (53 FR 27489 and 53 FR 27532, respectively). Numerous written comments on the proposed and temporary regulations were received from the public. As explained below, the comments were considered in the drafting of the final regulations.

Discussion of Major Comments and Changes to the Regulations

§1.954-1: Foreign base company income.

Section 1.954-1T(a)(3) and (5) (temporary regulations) apply the *de minimis* and full inclusion tests of section 954(b)(3) before the high tax exception of section 954(b)(4). Commenters have expressed concern that, in certain cases, the only amounts required to be included in the gross income of the United States shareholders of a controlled foreign corporation may be full inclusion income. This result may occur when subpart F income, other than full inclusion foreign base company income, qualifies for the high tax exception. In response to these comments, §1.954-1(d)(6) provides that an amount that otherwise would be included as full inclusion foreign base company income, pursuant to the operation of the full inclusion test of section 954(b)(3)(B), will be excluded from full inclusion foreign base company income if more than 90 percent of the adjusted gross foreign base company and adjusted gross insurance income qualifies for the high tax exception described in section 954(b)(4) and the high tax election is actually made.

Section 1.954-1T(a)(4) provides that in computing net foreign base company income, foreign personal holding company income is reduced by related person interest expense before allocat-

ing and apportioning other expenses in accordance with §1.904(d)-5(c)(2). Commenters understood this rule to be at variance with §1.904(d)-5(c)(2), which requires related person interest expense to be allocated to passive foreign personal holding company income after the allocation of directly related expenses. In response to this comment, the rule regarding allocation of related person interest expense was removed from §1.954-1T(a)(4) and (c) was amended to clarify that foreign base company income is reduced by directly related expenses before passive foreign personal holding company income is reduced by related person interest expense.

Section 1.954-1T(a)(7) treats amounts recharacterized as foreign base company income or insurance income under section 952(c) as adjusted net foreign base company income or adjusted net insurance income. Thus, these amounts are not included in net foreign base company income or net insurance income for purposes of applying the high tax exception. Commenters argued that the rules of paragraph (a)(7) should be amended to provide that amounts that are recharacterized under section 952(c)(2) should not be treated as adjusted net foreign base company income or adjusted net insurance income if the amounts would have qualified for the high tax exception. This comment was rejected because section 952(c)(2) does not incorporate the exclusions and special rules of section 954(b)(4). Additional rules regarding the coordination of sections 952(c) and 954 are being proposed under section 952 in a separate document published elsewhere in *** [INTL-75-92, page 480, this Bulletin].

Several comments were made concerning the anti-abuse rules of §1.954-1T(b)(4), which require aggregation of gross income of related controlled foreign corporations for purposes of the *de minimis* and full inclusion tests. One comment suggested that the aggregation rules of paragraph (b)(4) should be applied only if a purpose of first importance (as opposed to a principal purpose) is to avoid the application of the *de minimis* or full inclusion tests described in section 954(b)(3). This comment was rejected because the standard suggested is significantly more subjective than that of the regulations and is therefore unadministrable. However, it was determined that it was unnecessary to make the aggregation

rules of paragraph (b)(4) applicable to the full inclusion test, for which there is not the same opportunity for tax avoidance.

One commenter suggested that the anti-abuse rules of §1.954-1T(b)(4) should be amended to provide that the gross income of separate controlled foreign corporations is aggregated only if a substantial portion of the activities of the separate corporations would comprise a single branch, and that the presumptions described in paragraph (b)(4)(ii) should be eliminated. The commenter also suggested that the definition of related person for purposes of these rules should refer to the provisions of section 954(d)(3), rather than the broader provisions of section 267. These comments were rejected because the suggested amendments would unduly restrict the application of the anti-abuse rules. The presumptions described in paragraph (b)(4)(ii) may be rebutted, for example, by establishing reliance on the requirements of foreign law. The anti-abuse rules are necessary to prevent the misuse of the *de minimis* rule of section 954(b)(3), and do not impose a significant limitation or burden on the activities of controlled foreign corporations.

Section 1.954-1T(c) provides that in computing net foreign base company income, the gross amount in each category of foreign base company income may not be reduced below zero. Section 1.954-2T(e) provides that the excess of losses over gains from the sale or exchange of certain property may not be allocated to any other category of foreign personal holding company income. Section 1.954-2T(f) and (g) contain similar provisions with regard to excess losses from commodities and foreign currency transactions, respectively. Because the categories of foreign base company income described in section 954(a) and the categories of foreign personal holding company income described in section 954(c)(1)(B), (C) and (D) are defined in terms of net income, the temporary regulations interpreted the statutory scheme as generally precluding the allocation of excess losses from categories of foreign personal holding company income described in paragraph (e), (f), or (g) against other foreign personal holding company income categories. Commenters contended that by preventing any category of subpart F income from being reduced below zero, paragraph (c) caused inappropriate tax

credit results and failed to harmonize the subpart F provisions with section 904(f)(5). Commenters stated that paragraphs (e), (f) and (g) should be amended to allow excess losses described in those paragraphs to be allocated to other categories of foreign personal holding company income.

Paragraph (c) has been amended to clarify that, in determining net income, if the amount in any category of foreign base company income (including any category of foreign personal holding company income) is less than zero, the loss may not reduce any other categories of foreign base company income (or foreign personal holding company income) except by operation of the earnings and profits limitation. Proposed regulations published elsewhere in *** [INTL-75-92, page 480, this Bulletin] will provide rules concerning the application of the earnings and profits limitation.

Section 1.954-1T(d) provides that the effective rate of foreign income tax on an item of income is determined in a manner consistent with the existing foreign tax credit regime under sections 904 and 960. In some cases, the amount of an item of income for foreign law purposes with respect to which foreign income tax is paid will be different from the amount for United States tax purposes. As a result, the effective rate of tax with respect to the item of income may be affected. In addition, because pursuant to section 960 the foreign income taxes of a controlled foreign corporation more than three tiers below a United States shareholder are not considered, the high tax exception will never apply to items of income of such corporations.

Commenters suggested that certain foreign law accounting practices should be considered in determining the effective rate of tax on an item of income, for purposes of applying the high tax exception of section 954(b)(4) and paragraph (d) of the regulations. Commenters also contended that it is inappropriate to use section 960 to determine the effective rate of foreign tax and thus prevent consideration of taxes paid by controlled foreign corporations more than three tiers below the United States shareholder.

The comment that the high tax exception should not be limited to creditable taxes under section 960 was rejected. The high tax exception is not intended to apply to the extent that an item of income would be subject to

residual United States tax if such item were included in the gross income of the United States shareholder. The taxes paid with respect to such item of income should be considered for purposes of the high tax exception only to the extent they are otherwise considered for United States taxing purposes. See Joint Committee on Taxation Staff, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 970-71 (1986).

The comment that foreign law accounting practices should be considered in determining the effective rate of tax on an item of income, for purposes of applying the high tax exception, was also rejected. Such a rule would impose a significant burden on the IRS. It would require the IRS to monitor and apply foreign tax and accounting principles, and to reconcile their application with United States tax and accounting principles, both in the current tax year and in later tax years to prevent an item of income, deduction, credit, gain or loss from being duplicated or omitted. Further, the IRS would have to consider and identify the particular foreign tax and accounting principles that could be taken into account for purposes of these rules.

Section 1.954-1T(d)(4) defines the term *item of income* for purposes of the high tax exception by reference to the foreign tax credit and subpart F income categories to which the income relates. Thus, it is possible that amounts attributable to separate transactions may be included in the same item of income. If the income from the separate transactions were subject to foreign income tax at different rates, the effective rate of tax for the income item would reflect an average of the two (or more) rates of tax. One commenter has suggested that additional categories of income be created within the existing foreign tax credit and subpart F income groups to limit the effect of this tax rate blending.

The regulations rely on existing guidance under the foreign tax credit and subpart F provisions generally to define *item of income* for purposes of section 954(b)(4). To identify items of income on a transaction-by-transaction basis is inconsistent with the separate limitation categories of income described in section 904, and adds complexity by requiring different computations for purposes of these rules and the rules under the foreign tax credit provisions of the Code. More-

over, there is no bias in the existing rules toward a particular result.

Commenters suggested that the consistency rule of §1.954-1T(d)(4)(ii)(B) be eliminated, to allow taxpayers to apply the high tax exception on an item-by-item basis. The consistency rule prohibits a taxpayer from selectively applying the high tax exception with respect to foreign personal holding company income that is passive income under section 904(d). Elimination of the consistency rule would provide a result that is incompatible with the foreign tax credit provisions of the Code, and thus the comment was rejected.

The final regulations clarify how the rules of paragraph (d) coordinate with the earnings and profits limitation of section 952(c)(1). Under §1.954-1(d)(4)(ii), if the amount of income included in subpart F income for the taxable year is reduced by the earnings and profits limitation, the amount of income that is an item of income, for purposes of paragraph (d), is determined after the application of the rules of section 952(c)(1). An example was added to illustrate this rule.

Section 1.954-1T(d)(5) provides that the election to apply the high tax exception must be made by the controlling United States shareholders and is binding on all United States shareholders of the controlled foreign corporation. Commenters argued that the Secretary does not have the authority to bind all United States shareholders to a single election. This comment was rejected because it was determined that section 954(b)(4) provides the authority. Further, allowing each United States shareholder to separately elect the high tax exception would add undue complexity to the operation of the foreign tax credit rules.

Section 1.954-1(f) provides guidance on the definition of related person under section 954(d)(3).

§1.954-2: Foreign Personal Holding Company Income.

Section 1.954-2T(a)(2)(i) provides that amounts that fall within the definition of income equivalent to interest, under paragraph (h), will be so treated though such amounts may also fall within the definition of gain from certain property transactions under paragraph (e), gain from a commodities transaction under paragraph (f) or

foreign currency gain under paragraph (g). Paragraph (a)(2)(i) provides that amounts will be treated as income equivalent to interest even if these amounts are excluded from the computation of foreign personal holding company income under paragraphs (e), (f), or (g) because they are derived from certain qualifying business transactions. A commenter suggested that paragraph (a)(2)(i) should not treat income from qualifying business transactions excluded under paragraphs (e), (f), or (g) as income equivalent to interest. This comment was rejected. The rules regarding qualifying business transactions in paragraphs (e), (f) and (g) do not operate to exclude interest income from characterization as foreign personal holding company income. Income equivalent to interest within the meaning of section 954(c)(1)(E) and paragraph (h) generally should be treated like interest for purposes of subpart F.

Several commenters suggested that the test described in §1.954-2T(a)(3) to determine the use for which property is held (for purposes of determining the character of the income, gain or loss realized from a disposition of such property) should not focus solely on the use of the property immediately prior to its disposition, but instead should consider the predominant use for which the property was held. This comment was accepted. Section 1.954-2(a)(3) provides that the use for which property is held is the use for which it was held for more than one-half of the period during which the controlled foreign corporation held the property. If there has been a change in use, however, and a principal purpose for such change in use was to avoid characterizing income or gain attributable to the property as foreign personal holding company income, then the change in use will be disregarded.

Section 1.954-2T(a)(3)(ii), *Examples 2 and 3* illustrate the rules regarding change in use for which property is held. The final regulations delete these examples because *Example 1* sufficiently illustrated the rules of this paragraph. *Examples 4 and 5* of paragraph (a)(3)(ii) illustrate the change in use rules with respect to hedging transactions. The final regulations delete these examples because the rules governing hedging transactions are now generally contained in paragraph (a)(4)(ii).

Section 1.954-2T(a)(4)(i) lists some of the types of income that are in-

cluded in the term *interest*. To clarify that this list was not meant to be exclusive, paragraph (a)(4)(i) has been amended to provide that the term *interest* includes all amounts that are treated as interest (including tax-exempt interest) under the Code and regulations or any other provision of law. A new sentence illustrates the types of income that would be treated as interest.

Section 1.954-2T(a)(4)(ii) provides that certain hedging transactions that reduce the risk of price changes in the cost of inventory and similar property are included within the definition of *inventory and similar property* if certain requirements are met and if they are so identified by the fifth day after which they are entered into. Paragraphs (f)(4) and (g)(4) of the temporary regulations contain definitions of the term *qualified hedging transaction* that have similar five-day identification requirements. These several definitions of a hedging transaction have been consolidated in §1.954-2(a)(4)(ii) which contains a definition of *bona fide hedging transaction* and new identification requirements for bona fide hedging transactions that apply for purposes of computing foreign personal holding company income under §1.954-2.

Section 1.954-2(a)(4)(ii)(A) generally defines a bona fide hedging transaction as a transaction that meets the requirements of §1.1221-2(a) through (c) with two exceptions. First, the risk being hedged may be with respect to ordinary property, section 1231 property or a section 988 transaction. Second, a transaction that hedges the liabilities, inventory or other assets of a related person, or that is entered into to assume or reduce risks of a related person, will not be treated as a bona fide hedging transaction. Several commenters had sought to expand the definition of qualified hedging transactions to include hedging transactions conducted by a controlled foreign corporation that is a currency coordination center, *i.e.*, a controlled foreign corporation that aggregates the currency exposures of related controlled foreign corporations and hedges such exposures. The statute provides, however, that a transaction must satisfy the business needs of the particular controlled foreign corporation. See also Joint Committee on Taxation Staff, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 976 (1986).

Section 1.954-2(a)(4)(ii)(B) provides identification requirements for a bona fide hedging transaction. The same-day identification and the recordkeeping requirements of §1.1221-2 apply for transactions entered into on or after March 7, 1996. For bona fide hedging transactions entered into prior to this date and after July 22, 1988, the transaction must be identified by the close of the fifth day after the day on which it is entered into. For bona fide hedging transactions entered into prior to July 22, 1988, the transaction must be identified reasonably contemporaneously with the date it is entered into but no later than within the normal period prescribed under the method of accounting of the controlled foreign corporation used for financial reporting purposes.

Section 1.954-2(a)(4)(ii)(C) describes the treatment of transactions that are misidentified as hedging transactions, and hedging transactions that the taxpayer fails to identify as such. Paragraph (a)(4)(ii)(C) also provides relief for taxpayers that have identified, or failed to identify, a hedging transaction due to inadvertent error. These misidentification rules are substantially similar to the rules in §1.1221-2(f), modified for purposes of the subpart F regime.

Section 1.954-2T(a)(4)(iii) defines regular dealer, and states that, "purchasing and selling property through a regulated exchange or off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant" for purposes of these rules. This provision was intended to mean that such purchasing and selling activity alone, in the absence of other activities, will not qualify a controlled foreign corporation as a regular dealer within the meaning of paragraph (a)(4)(iii). Because commenters indicated that this reference to purchasing and selling through a regular exchange or off-exchange market was confusing, this provision was removed. Further, the definition of regular dealer was amended. Section 1.954-2(a)(4)(iv) provides that a controlled foreign corporation will be a regular dealer if it regularly and actively offers to, and in fact does, engage in certain specified activities with customers who are not related persons (as defined in section 954(d)(3)) with respect to the CFC. Examples were added to clarify that a controlled foreign corporation that

qualifies as a dealer under §1.954-2(a)(4)(iv) will not be disqualified from being treated as a regular dealer because it also engages in transactions with related persons.

The temporary regulations define *dealer property* as property held by a controlled foreign corporation that is a regular dealer in property of such kind in its capacity as a dealer. The temporary regulations also state that property held for investment or speculation is not dealer property. A commenter suggested that property should be considered dealer property within the meaning of §1.954-2T(a)(4)(iv) if the controlled foreign corporation holding the property is a regular dealer in such property. This comment was rejected because it proposes an unduly expansive definition of dealer property. Paragraph (a)(4), therefore, generally continues to define dealer property in the same manner as the temporary regulations.

The final regulations do clarify, however, that if a controlled foreign corporation qualifies as a regular dealer, all of the property held in a dealer capacity by that corporation is treated as dealer property. Thus, dealer property includes property arising from a transaction entered into with a related person, as long as the controlled foreign corporation is a regular dealer and holds the property in its capacity as a dealer, and not for investment or speculation. The examples of §1.954-2(a)(4)(vi) illustrate this rule. A rule has been added for licensed securities dealers under which only securities identified as held for investment under section 475(b) or 1236 will be treated as held for investment or speculation. Also, to conform to amendments to section 954(c)(1)(B) made by the Technical and Miscellaneous Revenue Act of 1988, §1.954-2(a)(4)(v)(C) provides that a bona fide hedging transaction with respect to dealer property is treated as a transaction in dealer property.

Section 954(c)(2)(B) and §1.954-2T(b)(2) exclude from foreign personal holding company income export financing interest that is derived in the active conduct of a banking business. A commenter suggested that paragraph (b)(2) should treat a controlled foreign corporation as engaged in the conduct of a banking business even if it transfers the servicing of loans to related or unrelated parties. This comment was rejected because servicing of

loans is a fundamental element of banking activity that gives rise to export financing interest for which an exception from foreign personal holding company income is intended.

Section 1.954-2T(b)(2) references the definition of export financing interest contained in section 904(d)(2)(G). Under section 904(d)(2)(G), the property that is financed must be manufactured, produced, grown or extracted in the United States by the taxpayer or a related person. Section 1.954-2(b)(2) clarifies that §1.927(a)-1T(c)(1) applies for purposes of determining whether property is manufactured, produced, grown or extracted in the United States.

Section 1.954-2T(b)(2) also provides that the term *export financing interest* does not include income from related party factoring that is treated as interest under section 864(d)(1) or (6). The final regulations contain examples that clarify that if amounts are not treated as interest under section 864(d)(1) or (6) because the exception under section 864(d)(7) applies, these amounts may be export financing interest under paragraph (b)(2).

Section 954(c)(3)(A) and §1.954-2T(b)(3) and (4) provide that certain dividend, interest, rent or royalty income received from related corporate payors is not included in foreign personal holding company income. To reflect amendments to section 954(c)(3)(A) by the Revenue Reconciliation Act of 1989, the final regulations provide that if a partnership with one or more corporate partners makes a payment of interest, rent or royalties, the interest, rent or royalty payment will be treated as paid by a corporate partner to the extent the payment gives rise to a partnership item of deduction that is allocable to the corporate partner or to the extent that a partnership item reasonably related to the payment would be allocated to the corporate partner under an existing allocation under the partnership agreement. To the extent the payment is treated as made by the corporate partner, it will be excluded from the foreign personal holding company income of the recipient if the corporate partner otherwise satisfies the conditions of section 954(c)(3)(A).

Under §1.954-2T(b)(3)(ii), interest may not be excluded from foreign personal holding company income of the recipient to the extent the deduction for interest is allocated to the payor's

subpart F income. To clarify how this rule is to be applied when a controlled foreign corporation is both the recipient and payor of interest, §1.954-2(b)(4)-(ii)(B)(2) was added, which parallels the rule contained in §1.904-5(k)(2).

Section 1.954-2T(b)(3) provides that, to exclude dividends and interest received from related corporate payors from foreign personal holding company income, a substantial part of the payor's assets must be used in a trade or business in the payor's country of incorporation. Section 1.954-2T(b)(3)(iv) provides that a substantial part of the payor's assets will be considered to be used in a trade or business in the payor's country of incorporation if, for each quarter of the taxable year, the average value of its assets which are so used is over 50 percent of the average value of all of its assets (determined as of the beginning and end of the quarter). To simplify the application of this rule, §1.954-2(b)(4)(iv) provides that the average value of assets is to be determined on a yearly rather than a quarterly basis by averaging the values of assets as of the close of each quarter.

Section 1.954-2T(b)(3)(vi)(A) provides that for purposes of the substantial assets test, tangible property (other than inventory) is generally considered located where it is physically located. Paragraph (b)(3)(vi)(B) contains an exception for property temporarily located elsewhere for inspection or repair. A commenter suggested that, in addition to this exception, the regulations should restore the exception contained in prior regulations that treated purchased property located abroad and intended for prompt shipment to the country of incorporation as property located in the country of incorporation. This comment was rejected because this provision would have been inconsistent with the rule that property purchased for use in a trade or business is not considered used in a trade or business until it is placed in service.

Section 1.954-2T(b)(3)(vii)(A) provides that for purposes of the substantial assets test, the location of intangible property is determined based on the site of the activities conducted by the payor during the taxable year in connection with the use or exploitation of the property. The country in which services are performed is determined under the principles of section 954(e) and §1.954-4(c). This rule was amended to provide more comprehensive

guidance to determine the situs of activities in connection with the use or exploitation of intangible property. Section 1.954-2(b)(4)(vii)(B) provides that the country in which the activities connected to the use or exploitation of property are conducted is the country in which the expenses associated with these activities are incurred by the payor or its agent or an independent contractor.

Section 1.954-2T(b)(3)(vii)(A) provides that the intangible property is considered located in the payor's country of incorporation during each quarter of the taxable year if the activities connected with its use or exploitation are conducted in its country of incorporation during the entire taxable year. A commenter argued that this test is inconsistent with the quarterly determination required by the substantial assets test of §1.954-2T(b)(3)(iv). Changes were made to the location of property rules (§1.954-2(b)(4)(vi) through (ix)) so that relevant determinations are made for each quarter separately.

The final regulations continue to reserve on the provision of special rules regarding the location of assets of banks and insurance companies for purposes of the same-country exception. Comments are invited regarding the need for special guidance on this issue.

Several comments questioned the application of the rules of §1.954-2T(b)(6), pursuant to which interest income of a controlled foreign corporation that is described in section 103 is included in foreign personal holding company income but is characterized as tax-exempt interest when included in the gross income of the United States shareholders. The purpose of this rule was to prevent a person from avoiding the consequences of the alternative minimum tax provisions by investing in tax-exempt obligations described in section 103 through a controlled foreign corporation.

The final regulations reserve on the treatment of tax-exempt interest. The administrative complexity of applying the rule described in the temporary regulations, and the potential for double taxation that it creates, argue against its continued application. Proposed regulations, published elsewhere in *** [INTL-75-92, page 39, this Bulletin], will provide rules regarding the treatment of tax-exempt interest. In the interim, the rules of the temporary regulations continue to apply.

Section 1.954-2T(b)(5) provides that the determination whether rents and royalties are derived from the active conduct of a trade or business is made under the facts and circumstances of each case, and refers to paragraphs (c) and (d) for the application of its provisions. Commenters have asked whether only the facts and circumstances described in paragraphs (c) and (d) may be considered. The final regulations are clarified to reflect that whether rents or royalties are derived in the active conduct of a trade or business is determined solely under the provisions of paragraphs (c) and (d).

Section 1.954-2T(c)(2)(iii) defines *active leasing expenses* for purposes of determining whether rental income is derived in the active conduct of a trade or business. A commenter suggested that paragraph (c)(2)(iii) be amended to state that if a corporation sells property of the same type as the property that is leased, the corporation's expenses that are of the type described in that paragraph may be pro-rated on any reasonable basis between the leasing and the sales function. It was determined that the change requested by this commenter was unnecessary because paragraph (c)(2)(iii) already defines active leasing expenses as deductions properly allocable to rental income.

A commenter suggested that an example be added to §1.954-2T(c) to illustrate that expenses such as payments to third parties for insurance, utilities and repairs are considered active leasing expenses and not amounts paid to agents or independent contractors. The regulations were amended in response to this comment. Section 1.954-2(c)(2)(iii)(D) provides that the term *active leasing expenses* does not include payments to agents or independent contractors other than payments for insurance, utilities and other expenses for like services or capitalized property. A similar change was made to the definition of the term *adjusted leasing profit*.

Section 954(c)(1)(B) and §1.954-2T(e) include in foreign personal holding company income the excess of gains over losses from certain property transactions. Section 1.954-2T(e)(1)(i) provides that gain or loss that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss but rather gain or loss from a property transaction under paragraph (e). A commenter contended that gain or loss from transactions described

in section 988(a)(1)(B) should be characterized as gain or loss described in section 954(c)(1)(C) and §1.954-2T(f) rather than in section 954(c)(1)(B) and paragraph (e). This comment was rejected, because the capital transactions described in section 988(a)(1)(B) are more appropriately subject to the provisions of section 954(c)(1)(B) and paragraph (e). This provision is now contained in §1.954-2(g)(5).

A commenter asked that gain from a disposition of stock of a subsidiary be excluded from foreign personal holding company income to the extent that gain from the subsidiary's disposition of its assets would be so excluded. There is no statutory authority for the position recommended by the commenter, however. In addition, the look-through treatment proposed by the commenter is inconsistent with the treatment prescribed for dispositions of interests in a partnership or trust under section 954(c)(1)(B)(ii). For these reasons, the comment was rejected.

Pursuant to §1.954-2T(e)(3)(vi), gain from a disposition of non-depreciable intangible property or goodwill is characterized as foreign personal holding company income unless the intangible property is disposed of in connection with a disposition of the entire trade or business of the controlled foreign corporation. Commenters have argued that the gain should be excluded from foreign personal holding company income if such property is used in the trade or business of the controlled foreign corporation, without regard to whether an entire trade or business of the controlled foreign corporation is sold.

The regulations were modified in response to this comment. Section 1.954-2(e)(3)(iv) excludes from foreign personal holding company income any gain or loss of a controlled foreign corporation from a disposition of intangible property, goodwill or going concern value to the extent used or held for use in the trade or business of the controlled foreign corporation.

Section 1.954-2T(e)(4) provides that gain or loss from the sale, exchange or retirement of a debt instrument is included in the computation of foreign personal holding company income under paragraph (e) with certain exceptions. However, a loss on a debt instrument taken in consideration for the sale or exchange of property is excluded from foreign personal holding

company income if the gain or loss from that underlying sale or exchange is not includible in foreign base company income. This rule was eliminated from the final regulations because it was inconsistent to prevent a controlled foreign corporation from using these losses to offset subpart F income when gain from such debt instruments was not excepted from the general inclusion rule.

Section 1.954-2T(e)(5) provides that rights to acquire property, other than certain property that is dealer property or inventory property, are characterized as property that does not give rise to income for purposes of section 954(c)(1)(B). One commenter has suggested that such rights should not be characterized as property that does not give rise to income. This comment was rejected because any gain that may arise upon a disposition of an option, warrant, or other right to acquire property, other than gain from a disposition of inventory or dealer property, is income of the type intended to be characterized as foreign personal holding company income for purposes of section 954(c)(1)(B). The provisions of §1.954-2T(e)(5) are now incorporated into the definition of property that does not give rise to income under §1.954-2(e)(3). However, the final regulations clarify that notional principal contracts are excluded from the definition of property that does not give rise to income. (But see §1.954-2(f), (g) and (h).)

Section 954(c)(1)(C) and §1.954-2T(f) provide rules for including the excess of gains over losses from commodities transactions in foreign personal holding company income. Several commenters argued that §1.954-2T(f)(2)(i) defines *commodity* too broadly, and that, like sections 553 and 864, the regulations should apply only to commodities that are actively traded on a regulated exchange. This comment was rejected because the statute and its legislative history make clear that section 954(c)(1)(C) is intended to apply broadly to any commodity of a kind that is actively traded. Thus, there is no reason to distinguish income from a disposition of a commodity actively traded on a regulated exchange from income from a disposition of a commodity of a kind that is otherwise actively traded.

Although §1.954-2(f)(2)(i) no longer explicitly provides that nonfunctional currency is a commodity, nonfunctional

currency continues to fall within the general definition of *commodity*. Consequently, foreign currency is still treated as a commodity if the currency is actively traded or if contractual interests in the currency are actively traded. Under the ordering rules of paragraph (a)(2), however, paragraph (g) (foreign currency transactions) continues to apply before paragraph (f). Thus, unless an election is made under section 988(c)(1)(D)(ii), a currency futures contract is treated as a commodities transaction, while a currency forward contract is generally treated as a foreign currency transaction.

Section 1.954-2T(f)(1) excludes gains and losses from qualified active sales and qualified hedging transactions from the computation of foreign personal holding company income under paragraph (f). In defining *qualified active sale*, paragraph (f)(3) requires substantially all of the controlled foreign corporation's business to be as an active producer, processor, merchant or handler of commodities of like kind. Commenters argued that by using the phrase "of like kind," §1.954-2T(f)(3) defines *qualified active sales* too narrowly. The "of like kind" language was not intended to require that all of the commodities be of one kind, but rather that the controlled foreign corporation must be an active producer, etc. with respect to each kind of commodity. To avoid confusion, the "of like kind" language has been eliminated from the definition of the term *qualified active sale*.

Section 1.954-2T(f)(3)(ii) defines the term *sale of commodities*. Commenters questioned the requirement, incorporated in the definition of this term, that the corporation hold the commodity in physical form. This comment was accepted. The final regulations no longer require the controlled foreign corporation to hold the commodity in physical form. Section 1.954-2(f)(2)-(iii)(B) requires only that the controlled foreign corporation hold the commodity directly and not through an independent contractor. The retention of this requirement is consistent with the legislative history of section 954(c)(1)(C), which makes clear that the exclusion from foreign personal holding company income was intended to apply only with respect to commodities for which controlled foreign corporations are active producers, processors, handlers or merchants. Section 1.954-2(f)(2)(iii)(D) provides that activities of employees of

entities related to the controlled foreign corporation may be treated as activities directly engaged in by the controlled foreign corporation if the employees are paid and supervised by the controlled foreign corporation.

Section 1.954-2(f)(2)(iii)(B) also amends the definition of the term *active conduct of a commodities business* by clarifying that the requirements specified in that paragraph must be satisfied with respect to each commodity and that property may be held either as dealer property or as inventory or similar property.

Section 954(c)(1)(C)(ii) and §1.954-2T(f)(1) and (3) exclude income attributable to commodities transactions from foreign personal holding company income if substantially all of the business of a controlled foreign corporation is as an active producer, processor, merchant or handler of commodities. Section 1.954-2T(f)(3)(iv) provides that the controlled foreign corporation will satisfy the substantially all requirement if 85 percent of its taxable income for the taxable year is attributable to qualified active sales and qualified hedging transactions. Several commenters argued that this test could fail to reflect the nature of the controlled foreign corporation's business accurately in some years because of the volatility of certain commodities markets.

To accommodate this concern, §1.954-2(f)(2)(iii)(C) modifies the definition of the term *substantially all* by applying the 85 percent test to gross receipts rather than taxable income. To prevent manipulation of this modified test, a provision was added under which the District Director may disregard any sale or hedging transaction that has as a principal purposes manipulation of the 85 percent test.

Section 1.954-2T(f)(4) defines the term *qualified hedging transaction* as a bona fide hedging transaction that is entered into primarily to reduce the risk of price change with respect to commodities sold or to be sold in qualified active sales. A commenter argued that a bona fide hedging transaction should not be required to relate to a qualified active sale to be treated as a qualified hedging transaction. This comment was rejected because this provision is based on the statutory requirement that qualified hedging transactions must arise out of the business of the controlled foreign corporation as an active producer, processor, merchant or

handler of commodities. Thus, the rule of the temporary regulations is retained.

Section 954(c)(1)(D) and §1.954-2T(g) include in foreign personal holding company income the net foreign currency gains attributable to section 988 transactions. The rules in §1.954-2T(g)(2)(i) governing the treatment of gain or loss attributable to foreign currency transactions in hyperinflationary currencies have been removed. Section 1.954-2(g)(5)(iii) provides that the applicable rules of section 985 will apply to such transactions.

Section 1.954-2T(g)(2)(ii) excludes from foreign personal holding company income gain or loss from qualified business transactions that are separately identified, and gain or loss from qualified hedging transactions that are identified with, or traced to, a qualified business transaction. Many commenters argued that these rules are too cumbersome to apply. They contended that a controlled foreign corporation that has a large number of qualified business transactions may not hedge such transactions individually, and that it is difficult or impossible in such cases to relate a hedge to one or even several qualified business transactions. The commenters also argued that the alternative election to treat all currency gain (or loss) as foreign personal holding company income (or loss allocable to foreign personal holding company income) does not provide adequate relief for controlled foreign corporations whose hedging activities relate to qualified business transactions on a net basis but give rise to foreign currency gain that is treated as foreign personal holding company income.

The regulations are modified in response to those comments. Section 1.954-2(g)(2)(ii) excludes from foreign personal holding company income foreign currency gain or loss directly related to the business needs of the controlled foreign corporation. Foreign currency gain or loss is directly related to the business needs of the corporation, first, if it can be clearly determined that it arises from a transaction entered into or property used in the normal course of the corporation's trade or business and the transaction or property does not itself give rise to subpart F income (other than foreign currency gain or loss), or, second, if it arises from a bona fide hedging transaction with respect to such a transaction or property. To exclude gain or

loss from a hedging transaction from foreign personal holding company income under this rule, corporations need not trace a hedging transaction to a specific transaction or property if all (or all but a de minimis amount) of the aggregate risks being hedged are within the business needs exception and the hedging transaction otherwise satisfies the requirements of section 1221, as modified for this purpose.

Section 1.954-2(g)(2)(ii)(C) provides a specific dealer exception under which transactions described in section 988(c)(1)(B)(iii) and (C) that are entered into by a regular dealer, in its capacity as a dealer, are treated as directly related to its business needs for purposes of the exclusion under §1.954-2(g)(2)(ii). Because a corporation's borrowings support all of its activities, paragraph (g)(2)(iii) provides that foreign currency gain or loss attributable to an interest-bearing liability that is not covered by paragraph (g)(5)(iv) is characterized as subpart F income and non-subpart F income on the same basis as interest expense is allocated and apportioned. Thus, for example, exchange gain or loss from an unhedged interest-bearing liability may fall under this rule.

Section 1.954-2T(g)(3) provides that a transaction will not be treated as a qualified business transaction if the foreign currency gain or loss from the transaction is attributable to property or an activity of a kind that gives rise to subpart F income. Commenters have argued that this requirement is too restrictive because it may cause the gain or loss from the underlying transaction, and the foreign currency gain or loss attributable to the transaction, to be in different separate categories for foreign tax credit purposes.

In response to this comment, a new election was added to paragraph (g). Under §1.954-2(g)(3), the controlling United States shareholders may elect to have the controlled foreign corporation include foreign currency gain or loss that would otherwise be included in foreign personal holding company income under paragraph (g) in the category of subpart F income to which such gain or loss relates. This election works in conjunction with the general rules of paragraph (g)(2). Thus, for example, this election may apply to currency gain or loss that would otherwise be treated as foreign personal holding company income under paragraph (g) even if other currency gain or

loss is excluded under the business needs exception of paragraph (g)(2)(ii).

As described above, the temporary regulations permit taxpayers to elect to treat all foreign currency gain or loss as foreign personal holding company income. The final regulations retain this election, with modifications. Under §1.954-2(g)(4), the controlling United States shareholders of the controlled foreign corporation may elect to include in the computation of foreign personal holding company income net foreign currency gains or losses attributable to any section 988 transaction and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D). Shareholders are not permitted to make separate elections for section 1256 contracts and section 988 transactions. An election under paragraph (g)(4) supersedes an election under paragraph (g)(3).

Section 1.954-2(g)(5)(iv) reserves on the treatment of gain or loss allocated under §1.861-9. It is anticipated that when §1.861-9 is finalized, a provision will be added to this paragraph to indicate that gain or loss that is allocated or apportioned under section 861 in the same manner as interest expense is not foreign currency gain or loss under paragraph (g).

Section 954(c)(1)(E) and §1.954-2T(h) include income equivalent to interest in foreign personal holding company income. A commenter argued that the term *income equivalent to interest* might be read to include income from a wide range of interest rate sensitive transactions entered into by a securities dealer or commodities producer, processor, merchant or handler in the ordinary course of its business. The commenter suggested that the regulations should be modified to confirm that such income is not income equivalent to interest.

The final regulations do not contain a general dealer exception that applies to all income equivalent to interest because income equivalent to interest is generally treated like interest, for which no general dealer exception is provided. However, consistent with Notice 89-90 (1989-2 C.B. 407), §1.954-2(h)(3)(ii) provides a specific dealer exception for income from notional principal contracts.

Section 1.954-2T(h)(1) provides that income equivalent to interest does not include income attributable to notional principal contracts except to the extent

that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Notice 89-90 stated, however, that final regulations would provide that income equivalent to interest would include income from notional principal contracts regardless of whether the notional principal contract is integrated with an investment, because notional principal contracts generally affect the all-in cost of interest-bearing liabilities or the return on interest-bearing assets. Accordingly, §1.954-2(h)(3) provides that income from notional principal contracts based solely on interest rates or interest rate indices is income equivalent to interest, and paragraph (h)(1)(ii) provides that income from a notional principal contract covered by §1.861-9T is not income equivalent to interest. Paragraph (f) continues to apply to notional principal contracts based on commodities (or a commodities index), and paragraph (g) continues to apply to notional principal contracts covered by section 988.

Section 1.954-2T(h)(3) treats factoring income as income equivalent to interest, with certain exceptions. Commenters have argued that income realized by a credit card company from factoring its receivables (which is attributable to the discount at which it acquires the receivables from the business establishments honoring its credit card) does not represent an interest equivalent amount, but instead represents other types of income, such as compensation for services.

This comment was rejected. It is true that the income attributable to the discount at which a controlled foreign corporation acquires a receivable reflects not only the time value of money, but also certain other elements (for example, collection risk and cost). However, the factoring income derived by the controlled foreign corporation is analogous to interest income derived from a loan made by a bank, which reflects not only the time value of money, but also the other elements of the discount income received in the factoring transaction described above. The Tax Reform Act of 1986 repealed the exclusion from foreign personal holding company income of such interest income derived by a bank. The repeal of this provision indicates that interest income is not intended to be excluded from foreign personal holding company income merely because it may reflect more than the time value of

money. Income equivalent to interest should not be treated differently.

Some of the rules described in the final regulations are inconsistent with provisions of §§1.954-3 through 1.954-8, as well as the regulations under other provisions of subpart F. In such cases, these final regulations are intended to apply instead of the regulations under other provisions of section 954 and of subpart F generally. Section 1.952-3 is removed because the rules of that section are replaced by §1.954-1. Other conforming changes are being considered in a separate regulations project.

Many nonsubstantive structural and editorial changes were made to these final regulations for clarity.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 4 and 602 are amended to read as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by removing the authority citation for “Section 1.954-0T, 1.954-1T, 1.954-2T and 1.957-1T” and adding the following citations in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *
Section 1.954-0 also issued under 26 U.S.C. 954(b) and (c).
Section 1.954-1 also issued under 26 U.S.C. 954(b) and (c).
Section 1.954-2 also issued under 26 U.S.C. 954(b) and (c).
Section 1.957-1 also issued under 26 U.S.C. 957. * * *

§1.952-3 [Removed]

Par. 2. Section 1.952-3 is removed.

Par. 3. Sections 1.954-0, 1.954-1 and 1.954-2 are added to read as follows:

§1.954-0 Introduction.

(a) *Effective dates*—(1) *Final regulations*—(i) *In general.* Except as otherwise specifically provided, the provisions of §§1.954-1 and 1.954-2 apply to taxable years of a controlled foreign corporation beginning after November 6, 1995. If any of the rules

described in §§1.954-1 and 1.954-2 are inconsistent with provisions of other regulations under subpart F, these final regulations are intended to apply instead of such other regulations.

(ii) *Election to apply final regulations retroactively*—(A) *Scope of election*. An election may be made to apply the final regulations retroactively with respect to any taxable year of the controlled foreign corporation beginning on or after January 1, 1987. If such an election is made, these final regulations must be applied in their entirety for such taxable year and all subsequent taxable years. All references to section 11 in the final regulations shall be deemed to include section 15, where applicable.

(B) *Manner of making election*. An election under this paragraph (a)(1)(ii) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(1) By the controlling United States shareholders, as defined in §1.964-1(c)(5), by attaching a statement to such effect with their original or amended income tax returns for the taxable year of such United States shareholders in which or with which the taxable year of the CFC ends, and including any additional information required by applicable administrative pronouncements, or

(2) In such other manner as may be prescribed in applicable administrative pronouncements.

(C) *Time for making election*. An election may be made under this paragraph (a)(1)(ii) with respect to a taxable year of the controlled foreign corporation beginning on or after January 1, 1987 only if the time for filing a return or claim for refund has not expired for the taxable year of any United States shareholder of the controlled foreign corporation in which or with which such taxable year of the controlled foreign corporation ends.

(D) *Revocation of election*. An election made under this paragraph (a)(1)(ii) may not be revoked.

(2) *Temporary regulations*. The provisions of §§4.954-1 and 4.954-2 of this chapter apply to taxable years of a controlled foreign corporation beginning after December 31, 1986 and on or before November 6, 1995. However, the provisions of §4.954-2(b)(6) of this chapter continue to apply. For transactions entered into on or before October 9, 1995, taxpayers may rely on Notice

89-90, 1989-2 C.B. 407, in applying the temporary regulations.

(3) §§1.954A-1 and 1.954A-2. The provisions of §§1.954A-1 and 1.954A-2 (as contained in 26 CFR part 1 edition revised April 1, 1995) apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) of the Internal Revenue Code*.

§1.954-0 Introduction.

- (a) Effective dates.
 - (1) Final regulations.
 - (i) In general.
 - (ii) Election to apply final regulations retroactively.
 - (A) Scope of election.
 - (B) Manner of making election.
 - (C) Time for making election.
 - (D) Revocation of election.
 - (2) Temporary regulations.
 - (3) §§1.954A-1 and 1.954A-2.
 - (b) Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) of the Internal Revenue Code.

§1.954-1 Foreign base company income.

- (a) In general.
 - (1) Purpose and scope.
 - (2) Gross foreign base company income.
 - (3) Adjusted gross foreign base company income.
 - (4) Net foreign base company income.
 - (5) Adjusted net foreign base company income.
 - (6) Insurance income.
 - (7) Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).
- (b) Computation of adjusted gross foreign base company income and adjusted gross insurance income.
 - (1) *De minimis* and full inclusion tests.
 - (i) *De minimis* test.
 - (A) In general.
 - (B) Currency translation.
 - (C) Coordination with sections 864(d) and 881(c).

- (ii) Seventy percent full inclusion test.
- (2) Character of gross income included in adjusted gross foreign base company income.
- (3) Coordination with section 952(c).
- (4) Anti-abuse rule.
 - (i) In general.
 - (ii) Presumption.
 - (iii) Related persons.
 - (iv) Example.
- (c) Computation of net foreign base company income.
 - (1) General rule.
 - (i) Deductions against gross foreign base company income.
 - (ii) Losses reduce subpart F income by operation of earnings and profits limitation.
 - (iii) Items of income.
 - (A) Income other than passive foreign personal holding company income.
 - (B) Passive foreign personal holding company income.
 - (2) Computation of net foreign base company income derived from same country insurance income.
 - (d) Computation of adjusted net foreign base company income or adjusted net insurance income.
 - (1) Application of high tax exception.
 - (2) Effective rate at which taxes are imposed.
 - (3) Taxes paid or accrued with respect to an item of income.
 - (i) Income other than passive foreign personal holding company income.
 - (ii) Passive foreign personal holding company income.
 - (4) Special rules.
 - (i) Consistency rule.
 - (ii) Coordination with earnings and profits limitation.
 - (iii) Example.
 - (5) Procedure.
 - (6) Coordination of full inclusion and high tax exception rules.
 - (7) Examples.
 - (e) Character of income.
 - (1) Substance of the transaction.
 - (2) Separable character.
 - (3) Predominant character.
 - (4) Coordination of categories of gross foreign base company income or gross insurance income.
 - (i) In general.
 - (ii) Income excluded from other categories of gross foreign base company income.
 - (f) Definition of related person.

- (1) Persons related to controlled foreign corporation.
 - (i) Individuals.
 - (ii) Other persons.
 - (2) Control.
 - (i) Corporations.
 - (ii) Partnerships.
 - (iii) Trusts and estates.
 - (iv) Direct or indirect ownership.
- §1.954-2 Foreign personal holding company income.*
- (a) Computation of foreign personal holding company income.
 - (1) Categories of foreign personal holding company income.
 - (2) Coordination of overlapping categories under foreign personal holding company provisions.
 - (i) In general.
 - (ii) Priority of categories.
 - (3) Changes in the use or purpose for which property is held.
 - (i) In general.
 - (ii) Special rules.
 - (A) Anti-abuse rule.
 - (B) Hedging transactions.
 - (iii) Example.
 - (4) Definitions and special rules.
 - (i) Interest.
 - (ii) Bona fide hedging transaction.
 - (A) Definition.
 - (B) Identification.
 - (C) Effect of identification and non-identification.
 - (1) Transactions identified.
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 - (5) Anti-abuse rule.
 - (iii) Inventory and similar property.
 - (A) Definition.
 - (B) Hedging transactions.
 - (iv) Regular dealer.
 - (v) Dealer property.
 - (A) Definition.
 - (B) Securities dealers.
 - (C) Hedging transactions.
 - (vi) Examples.
 - (vii) Debt instrument.
 - (b) Dividends, interest, rents, royalties and annuities.
 - (1) In general.
 - (2) Exclusion of certain export financing interest.
 - (i) In general.
 - (ii) Exceptions.
 - (iii) Conduct of a banking business.
 - (iv) Examples.
 - (3) Treatment of tax-exempt interest. [RESERVED].
 - (4) Exclusion of dividends or interest from related persons.
- (i) In general.
 - (A) Corporate payor.
 - (B) Payment by a partnership.
- (ii) Exceptions.
 - (A) Dividends.
 - (B) Interest paid out of adjusted foreign base company income or insurance income.
 - (1) In general.
 - (2) Rule for corporations that are both recipients and payors of interest.
 - (C) Coordination with sections 864(d) and 881(c).
 - (iii) Trade or business requirement.
 - (iv) Substantial assets test.
 - (v) Valuation of assets.
 - (vi) Location of tangible property.
 - (A) In general.
 - (B) Exception.
 - (vii) Location of intangible property.
 - (A) In general.
 - (B) Exception for property located in part in the payor's country of incorporation.
 - (viii) Location of inventory and dealer property.
 - (A) In general.
 - (B) Inventory and dealer property located in part in the payor's country of incorporation.
 - (ix) Location of debt instruments.
 - (x) Treatment of certain stock interests.
 - (xi) Treatment of banks and insurance companies. [Reserved]
- (5) Exclusion of rents and royalties derived from related persons.
 - (i) In general.
 - (A) Corporate payor.
 - (B) Payment by a partnership.
 - (ii) Exceptions.
 - (A) Rents or royalties paid out of adjusted foreign base company income or insurance income.
 - (B) Property used in part in the controlled foreign corporation's country of incorporation.
- (6) Exclusion of rents and royalties derived in the active conduct of a trade or business.
 - (c) Excluded rents.
 - (1) Active conduct of a trade or business.
 - (2) Special rules.
 - (i) Adding substantial value.
 - (ii) Substantiality of foreign organization.
 - (iii) Active leasing expenses.
 - (iv) Adjusted leasing profit.
 - (3) Examples.
 - (d) Excluded royalties.
 - (1) Active conduct of a trade or business.
- (2) Special rules.
 - (i) Adding substantial value.
 - (ii) Substantiality of foreign organization.
 - (iii) Active licensing expenses.
 - (iv) Adjusted licensing profit.
 - (3) Examples.
 - (e) Certain property transactions.
 - (1) In general.
 - (i) Inclusions.
 - (ii) Exceptions.
 - (iii) Treatment of losses.
 - (iv) Dual character property.
 - (2) Property that gives rise to certain income.
 - (i) In general.
 - (ii) Gain or loss from the disposition of a debt instrument.
 - (3) Property that does not give rise to income.
 - (f) Commodities transactions.
 - (1) In general.
 - (i) Inclusion in foreign personal holding company income.
 - (ii) Exception.
 - (iii) Treatment of losses.
 - (2) Definitions.
 - (i) Commodity.
 - (ii) Commodities transaction.
 - (iii) Qualified active sale.
 - (A) In general.
 - (B) Active conduct of a commodities business.
 - (C) Substantially all.
 - (D) Activities of employees of a related entity.
 - (E) Financial activities.
 - (iv) Qualified hedging transaction.
 - (A) In general.
 - (B) Exception.
 - (g) Foreign currency gain or loss.
 - (1) Scope and purpose.
 - (2) In general.
 - (i) Inclusion.
 - (ii) Exclusion for business needs.
 - (A) General rule.
 - (B) Business needs.
 - (C) Regular dealers.
 - (D) Example.
 - (iii) Special rule for foreign currency gain or loss from an interest-bearing liability.
 - (3) Election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category.
 - (i) In general.
 - (ii) Time and manner of election.
 - (iii) Revocation of election.
 - (iv) Example.
 - (4) Election to treat all foreign currency gains or losses as foreign personal holding company income.

- (i) In general.
- (ii) Time and manner of election.
- (iii) Revocation of election.
- (5) Gains and losses not subject to this paragraph.
 - (i) Capital gains and losses.
 - (ii) Income not subject to section 988.
 - (iii) Qualified business units using the dollar approximate separate transactions method.
 - (iv) Gain or loss allocated under §1.861-9. [Reserved]
 - (h) Income equivalent to interest.
 - (1) In general.
 - (i) Inclusion in foreign personal holding company income.
 - (ii) Exceptions.
 - (A) Liability hedging transactions.
 - (B) Interest.
 - (2) Definition of income equivalent to interest.
 - (i) In general.
 - (ii) Income from the sale of property.
 - (3) Notional principal contracts.
 - (i) In general.
 - (ii) Regular dealers.
 - (4) Income equivalent to interest from factoring.
 - (i) General rule.
 - (ii) Exceptions.
 - (iii) Factored receivable.
 - (iv) Examples.
 - (5) Receivables arising from performance of services.
 - (6) Examples.

§1.954-1 Foreign base company income.

In general—(1) *Purpose and scope.* Section 954 and §§1.954-1 and 1.954-2 provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and thus is subject to current taxation under section 1, 11 or 55 of the Internal Revenue Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957.

- (2) *Gross foreign base company in-*

come. The gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income (determined after the application of section 952(b))—

- (i) Foreign personal holding company income, as defined in section 954(c);
- (ii) Foreign base company sales income, as defined in section 954(d);
- (iii) Foreign base company services income, as defined in section 954(e);
- (iv) Foreign base company shipping income, as defined in section 954(f); and
- (v) Foreign base company oil related income, as defined in section 954(g).

(3) *Adjusted gross foreign base company income.* The term *adjusted gross foreign base company income* means the gross foreign base company income of a controlled foreign corporation as adjusted by the *de minimis* and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term *net foreign base company income* means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions (including taxes) properly allocable or apportionable to such income under the rules of section 954(b)(5) and paragraph (c) of this section.

(5) *Adjusted net foreign base company income.* The term *adjusted net foreign base company income* means the net foreign base company income of a controlled foreign corporation reduced, first, by any items of net foreign base company income excluded from subpart F income pursuant to section 952(c) and, second, by any items excluded from subpart F income pursuant to the high tax exception of section 954(b). See paragraph (d)(4)(ii) of this section. The term *foreign base company income* as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income, unless otherwise provided.

(6) *Insurance income.* The term *gross insurance income* includes all gross income taken into account in determining insurance income under section 953. The term *adjusted gross insurance income* means gross insurance income as adjusted by the *de minimis* and full inclusion rules of paragraph (b) of this section. The term *net insurance income* means adjusted

gross insurance income reduced under section 953 so as to take into account deductions (including taxes) properly allocable or apportionable to such income. The term *adjusted net insurance income* means net insurance income reduced by any items of net insurance income that are excluded from subpart F income pursuant to section 952(b) or pursuant to the high tax exception of section 954(b). The term *insurance income* as used in subpart F of the Internal Revenue Code and in the regulations under that subpart means adjusted net insurance income, unless otherwise provided.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income, respectively. Amounts subject to recharacterization under section 952(c) are determined after adjusted net foreign base company income and adjusted net insurance income are otherwise determined under subpart F and are not again subject to any exceptions or special rules that would affect the amount of subpart F income. Thus, for example, items of gross foreign base company income or gross insurance income that are excluded from adjusted gross foreign base company income or adjusted gross insurance income because the *de minimis* test is met are subject to recharacterization under section 952(c). Further, the *de minimis* and full inclusion tests of paragraph (b) of this section, and the high tax exception of paragraph (d) of this section, for example, do not apply to such amounts.

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis and full inclusion tests*—(i) *De minimis test*—(A) *In general.* Except as provided in paragraph (b)(1)(i)(C) of this section, adjusted gross foreign base company income and adjusted gross insurance income are equal to zero if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

- (1) 5 percent of gross income; or
- (2) \$1,000,000.

(B) *Currency translation.* Controlled foreign corporations having a functional currency other than the United States dollar shall translate the \$1,000,000 threshold using the exchange rate provided under section 989(b)(3) for amounts included in income under section 951(a).

(C) *Coordination with sections 864(d) and 881(c).* Adjusted gross foreign base company income or adjusted gross insurance income of a controlled foreign corporation always includes income from trade or service receivables described in section 864(d)(1) or (6), and portfolio interest described in section 881(c), even if the *de minimis* test of this paragraph (b)(1)(i) is otherwise satisfied.

(ii) *Seventy percent full inclusion test.* Except as provided in section 953, adjusted gross foreign base company income consists of all gross income of the controlled foreign corporation other than gross insurance income and amounts described in section 952(b), and adjusted gross insurance income consists of all gross insurance income other than amounts described in section 952(b), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income. See paragraph (d)(6) of this section, under which certain items of full inclusion foreign base company income may nevertheless be excluded from subpart F income.

(2) *Character of gross income included in adjusted gross foreign base company income.* The gross income included in the adjusted gross foreign base company income of a controlled foreign corporation generally retains its character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. However, gross income included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(ii) of this section is met is termed *full inclusion foreign base company income*, and constitutes a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Income that is included in subpart F income because the full

inclusion test of paragraph (b)(1)(ii) of this section is met does not reduce amounts that, under section 952(c), are subject to recharacterization.

(4) *Anti-abuse rule—(i) In general.* For purposes of applying the *de minimis* test of paragraph (b)(1)(i) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if a principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to prevent income from being treated as foreign base company income or insurance income under the *de minimis* test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign base company income or insurance income under the *de minimis* test of paragraph (b)(1)(i) of this section if the corporations are related persons, as defined in paragraph (b)(4)(iii) of this section, and the corporations are described in paragraph (b)(4)(ii)(A), (B), or (C) of this section. This presumption may be rebutted by proof to the contrary.

(A) The activities carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were previously carried on, or assets that were previously held, by a single controlled foreign corporation. Further, the United States shareholders of the controlled foreign corporations or related persons (as determined under paragraph (b)(4)(iii) of this section) are substantially the same as the United States shareholders of the one controlled foreign corporation in a prior taxable year. A presumption made in connection with the requirements of this paragraph (b)(4)(ii)(A) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of §1.367(a)-6T(g)(2) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and §301.7701-3 of this chapter) that is a related person (as defined in paragraph

(b)(4)(iii) of this section) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under §1.367(a)-6T(g)(2) if carried on directly by a United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Example.* The following example illustrates the application of this paragraph (b)(4).

Example. (i)(1) *USP* is the sole United States shareholder of three controlled foreign corporations: *CFC1*, *CFC2* and *CFC3*. The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP*, a foreign entity classified as a partnership under section 7701(a)(2) and § 301.7701-3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP*, and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP*. Based on the facts in the table below, the foreign base company income derived by each controlled foreign corporation for its current taxable year, including income derived from *FP*, is less than five percent of the gross income of each controlled foreign corporation and is less than \$1,000,000:

| | <i>CFC1</i> | <i>CFC2</i> | <i>CFC3</i> |
|--------------------------------------|-------------|-------------|--------------|
| Gross income | \$4,000,000 | \$8,000,000 | \$12,000,000 |
| Five percent of gross income | 200,000 | 400,000 | 600,000 |
| Foreign base company income | 199,000 | 398,000 | 597,000 |

(2) Thus, without the application of the anti-abuse rule of this paragraph (b)(4), each controlled foreign corporation would be treated

as having no foreign base company income after the application of the *de minimis* test of section 954(b)(3)(A) and paragraph (b)(1)(i) of this section.

(i) However, under these facts, the requirements of paragraph (b)(4)(i) of this section are met unless the presumption of paragraph (b)(4)(ii) of this section is successfully rebutted. The sum of the foreign base company income of the controlled foreign corporations is \$1,194,000. Thus, the amount of gross foreign base company income of each controlled foreign corporation will not be reduced by reason of the *de minimis* rule of section 954(b)(3)(A) and this paragraph (b).

(c) *Computation of net foreign base company income*—(1) *General rule.* The net foreign base company income of a controlled foreign corporation (as defined in paragraph (a)(4) of this section) is computed under the rules of this paragraph (c)(1). The principles of §1.904–5(k) shall apply where payments are made between controlled foreign corporations that are related persons (within the meaning of section 954(d)(3)). Consistent with these principles, only payments described in §1.954–2(b)(4)(ii)(B)(2) may be offset as provided in §1.904–5(k)(2).

(i) *Deductions against gross foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed first by taking into account deductions in the following manner:

(A) First, the gross amount of each item of income described in paragraph (c)(1)(iii) of this section is determined.

(B) Second, any expenses definitely related to less than all gross income as a class shall be allocated and apportioned under the principles of sections 861, 864 and 904(d) to the gross income described in paragraph (c)(1)(i)(A) of this section.

(C) Third, foreign personal holding company income that is passive within the meaning of section 904 (determined before the application of the high-taxed income rule of §1.904–4(c)) is reduced by related person interest expense allocable to passive income under §1.904–5(c)(2); such interest must be further allocated and apportioned to items described in paragraph (c)(1)(iii)(B) of this section.

(D) Fourth, the amount of each item of income described in paragraph (c)(1)(iii) of this section is reduced by other expenses allocable and apportionable to such income under the principles of sections 861, 864 and 904(d).

(ii) *Losses reduce subpart F income by operation of earnings and profits*

limitation. Except as otherwise provided in §1.954–2(g)(4), if after applying the rules of paragraph (c)(1)(i) of this section, the amount remaining in any category of foreign base company income or foreign personal holding company income is less than zero, the loss in that category may not reduce any other category of foreign base company income or foreign personal holding company income except by operation of the earnings and profits limitation of section 952(c)(1).

(iii) *Items of income*—(A) *Income other than passive foreign personal holding company income.* A single item of income (other than foreign personal holding company income that is passive) is the aggregate amount from all transactions that falls within a single separate category (as defined in §1.904–5(a)(1)), and either—

(1) Falls within a single category of foreign personal holding company income as—

(i) Dividends, interest, rents, royalties and annuities;

(ii) Gain from certain property transactions;

(iii) Gain from commodities transactions;

(iv) Foreign currency gain; or

(v) Income equivalent to interest; or

(2) Falls within a single category of foreign base company income, other than foreign personal holding company income, as—

(i) Foreign base company sales income;

(ii) Foreign base company services income;

(iii) Foreign base company shipping income;

(iv) Foreign base company oil related income; or

(v) Full inclusion foreign base company income.

(B) *Passive foreign personal holding company income.* A single item of foreign personal holding company income that is passive is an amount of income that falls within a single group of passive income under the grouping rules of §1.904–4(c)(3), (4) and (5) and a single category of foreign personal holding company income described in paragraphs (c)(1)(iii)(A)(1)(i) through (v).

(2) *Computation of net foreign base company income derived from same country insurance income.* Deductions relating to foreign base company in-

come attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks located in the country under the laws of which the controlled foreign corporation is created or organized shall be allocated and apportioned in accordance with the rules set forth in section 953.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income*—(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any net item of such income that qualifies for the high tax exception provided by section 954(b)(4) and this paragraph (d). Any item of income that is foreign base company oil related income, as defined in section 954(g), or portfolio interest, as described in section 881(c), does not qualify for the high tax exception. See paragraph (c)(1)(iii) of this section for the definition of the term *item of income*. For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see §1.904–4(c). A net item of income qualifies for the high tax exception only if—

(i) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income; and

(ii) It is established that the net item of income was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(2) *Effective rate at which taxes are imposed.* The effective rate with respect to a net item of income shall be determined separately for each controlled foreign corporation in a chain of corporations through which a distribution is made. The effective rate at which taxes are imposed on a net item of income is—

(i) The United States dollar amount of foreign income taxes paid or accrued (or deemed paid or accrued) with respect to the net item of income, determined under paragraph (d)(3) of this section; divided by

(ii) The United States dollar amount of the net item of foreign base

company income or insurance income, described in paragraph (c)(1)(iii) of this section, increased by the amount of foreign income taxes referred to in paragraph (d)(2)(i) of this section.

(3) *Taxes paid or accrued with respect to an item of income—(i) Income other than passive foreign personal holding company income.* The amount of foreign income taxes paid or accrued with respect to a net item of income (other than an item of foreign personal holding company income that is passive) for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a United States shareholder under section 951(a)(1)(A) (determined, in the case of a United States shareholder that is an individual, as if an election under section 962 has been made, whether or not such election is actually made). For this purpose, in accordance with the regulations under section 960, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a). The amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), will not be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholders of all or part of such income.

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to a net item of foreign personal holding company income that is passive for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 and that would be taken into account for purposes applying the provisions of §1.904-4(c) with respect to that net item of income.

(4) *Special rules—(i) Consistency rule.* An election to exclude income from the computation of subpart F income for a taxable year must be made consistently with respect to all items of passive foreign personal holding company income eligible to be excluded for the taxable year. Thus, high-taxed passive foreign personal holding company income of a con-

trolled foreign corporation must either be excluded in its entirety, or remain subject to subpart F in its entirety.

(ii) *Coordination with earnings and profits limitation.* If the amount of income included in subpart F income for the taxable year is reduced by the earnings and profits limitation of section 952(c)(1), the amount of income that is a net item of income, within the meaning of paragraph (c)(1)(iii) of this section, is determined after the application of the rules of section 952(c)(1).

(iii) *Example.* The following example illustrates the provisions of paragraph (d)(4)(ii) of this section. All of the taxes referred to in the following example are foreign income taxes. For simplicity, this example assumes that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, this example does not separately illustrate the deduction for taxes and gross-up.

Example. During its 1995 taxable year, *CFC*, a controlled foreign corporation, earns \$100 of royalty income that is foreign personal holding company income. *CFC* has no expenses associated with this royalty income. *CFC* pays \$20 of foreign income taxes with respect to the royalty income. For 1995, *CFC* has current earnings and profits of \$50. *CFC*'s subpart F income, as determined prior to the application of this paragraph (d), exceeds its current earnings and profits. Thus, under paragraph (d)(4)(ii) of this section, the amount of *CFC*'s only net item of income, the royalty income, will be limited to \$50. The remaining \$50 will be subject to recharacterization in a subsequent taxable year under section 952(c)(2). Because the amount of foreign income taxes paid with respect to this net item of income is \$20, the effective rate of tax on the item, for purposes of this paragraph (d), is 40 percent. Accordingly, an election under paragraph (d)(5) of this section may be made to exclude the item of income from the computation of subpart F income.

(5) *Procedure.* An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(i) By the controlling United States shareholders, as defined in §1.964-1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by applicable administrative pronouncements; or

(ii) In such other manner as may be prescribed in applicable administrative pronouncements.

(6) *Coordination of full inclusion and high tax exception rules.* Notwithstanding paragraph (b)(1)(ii) of this section, full inclusion foreign base company income will be excluded from subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance company income of a controlled foreign corporation (determined without regard to the full inclusion test of paragraph (b)(1) of this section) is attributable to net amounts excluded from subpart F income pursuant to an election to have the high tax exception described in section 954(b)(4) and this paragraph (d) apply.

(7) *Examples.* (i) The following examples illustrate the rules of this paragraph (d). All of the taxes referred to in the following examples are foreign income taxes. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up. Except as otherwise stated, these examples assume there are no earnings, deficits, or foreign income taxes in the post-1986 pools of earnings and profits or foreign income taxes.

Example 1. (i) *Items of income.* During its 1995 taxable year, controlled foreign corporation *CFC* earns from outside its country of operation portfolio dividend income of \$100 and interest income, net of taxes, of \$100 (consisting of a gross payment of \$150 reduced by a third-country withholding tax of \$50). For purposes of illustration, assume that *CFC* incurs no expenses. None of the income is taxed in *CFC*'s country of operation. The dividend income was not subject to third-country withholding taxes. Pursuant to the operation of section 904, the interest income is high withholding tax interest and the dividend income is passive income. Accordingly, pursuant to paragraph (c)(1)(iii) of this section, *CFC* has two net items of income—

(1) \$100 of foreign personal holding company (FPHC)/passive income (the dividends); and

(2) \$100 of FPHC/high withholding tax income (the interest).

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(1) of this *Example 1*. Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F income under the rules of this paragraph (d). Foreign tax of \$50 would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(2) of this *Example 1*. Therefore, the effective rate of foreign tax is 33 percent (\$50 of creditable taxes paid, divided by \$150,

consisting of the net item of foreign base company income (\$100) plus creditable taxes paid thereon (\$50)). The highest rate of tax specified in section 11 for the 1995 taxable year is 35 percent. Accordingly, the net item of income described in paragraph (i)(2) of this *Example 1* may be excluded from subpart F income if an election under paragraph (d)(5) of this section is made, since it is subject to foreign tax at an effective rate that is greater than 31.5 percent (90 percent of 35 percent). However, for purposes of section 904(d), it remains high withholding tax interest.

Example 2. (i) The facts are the same as in *Example 1*, except that *CFC's* country of operation imposes a tax of \$50 with respect to *CFC's* dividend income (and thus *CFC* earns portfolio dividend income, net of taxes, of only \$50). The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, *CFC* has two items of income for purposes of this paragraph (d)—

- (1) \$50 of FPHC/passive income (net of the \$50 foreign tax); and
- (2) \$100 of FPHC/high withholding tax interest income.

(ii) Each item is taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of this *Example 2*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 2*: foreign tax (\$50) divided by sum (\$150) of income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either or both of the net items of income described in paragraphs (i)(1) and (2) of this *Example 2* from subpart F income. If no election is made the items would be included in the subpart F income of *CFC*.

Example 3. (i) The facts are the same as in *Example 1*, except that the \$100 of portfolio dividend income is subject to a third-country withholding tax of \$50, and the \$150 of interest income is from sources within *CFC's* country of operation, is subject to a \$10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (c)(1)(iii)-(B) of this section they constitute separate items of income pursuant to the application of the grouping rules of §1.904-4(c). Accordingly, *CFC* has two net items of income for purposes of this paragraph (d)—

- (1) \$50 (net of \$50 tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and
- (2) \$140 (net of \$10 tax) of FPHC/country of operation income.

(ii) The item described in paragraph (i)(1) of this *Example 3* is taxed at an effective rate greater than 31.5 percent, but Item 2 is not. The net item of income described in paragraph (i)(1) of this *Example 3*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 3*: foreign tax (\$10) divided by sum (\$150) of net item of income (\$140) plus creditable tax thereon (\$10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude

the net item of income described in paragraph (i)(1) of this *Example 3* but not the net item of income described in paragraph (i)(2) of this *Example 3* from subpart F income.

Example 4. The facts are the same as in *Example 3*, except that the \$150 of interest income is subject to an income tax of \$50 in *CFC's* country of operation. Accordingly, *CFC's* items of income are the same as in *Example 3*, but both items are taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of *Example 3*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of *Example 3*: Foreign tax (\$50) divided by sum (\$150) of net item of income (\$100) plus creditable tax thereon (\$50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(i) of this section, an election made by *CFC's* controlling United States shareholders must exclude from subpart F income both items of FPHC income under the high tax exception of section 954(b)(4) and this paragraph (d). The election may not be made only with respect to one item.

Example 5. The facts are the same as in *Example 1*, except that *CFC* earns \$5 of portfolio dividend income and \$150 of interest income. In addition, *CFC* earns \$45 for performing consulting services within its country of operation for unrelated persons. *CFC's* gross foreign base company income for 1995 of \$155 (\$150 of gross interest income and \$5 of portfolio dividend income) is greater than 70 percent of its gross income of \$200. Therefore, under the full inclusion test of paragraph (b)(1)(ii) of this section, *CFC's* adjusted gross foreign base company income is \$200, and under paragraph (b)(2) of this section, the \$45 of consulting income is full inclusion foreign base company income. If *CFC* elects, under paragraph (d)(5) of this section, to exclude the interest income from subpart F income pursuant to the high tax exception, the \$45 of full inclusion foreign base company income will be excluded from subpart F income under paragraph (d)(6) of this section because the \$150 of gross interest income excluded under the high tax exception is more than 90 percent of *CFC's* adjusted gross foreign base company income of \$155.

(ii) The following examples generally illustrate the application of paragraph (c) of this section and this paragraph (d). *Example 1* illustrates the order of computations. *Example 2* illustrates the computations required by sections 952 and 954 and this §1.954-1 if the full inclusion test of paragraph (b)(1)(ii) of this section is met and the income is not excluded from subpart F income under section 952(b). Computations in these examples involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78

are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up.

Example 1. (i) *Gross income.* *CFC*, a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)-(1)(A) and §1.954-2(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 952(b) or section 954(c). Another \$50 is foreign base company sales income under section 954(d). The remaining \$850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f) or (g) or 953, and is foreign source general limitation income described in section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of \$500. This amount includes \$8 of interest paid to a related person that is allocable to foreign personal holding company income under section 904, and \$2 of other expense that is directly related to foreign personal holding company income. Another \$20 of expense is directly related to foreign base company sales. The remaining \$470 of expenses is allocable to general limitation income that is not foreign base company income or insurance income.

(iii) *Earnings and losses.* *CFC* has earnings and profits for the current taxable year of \$500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by \$600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of \$30 is considered imposed on the interest income under the rules of section 954(b)(4), this paragraph (d), and §1.904-6. Foreign income tax of \$14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4), paragraph (d) of this section, and §1.904-6. Foreign income tax of \$177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4), this paragraph (d), and §1.904-6. For the taxable year of *CFC*, the maximum United States rate of taxation under section 11 is 35 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have \$500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows:

Step 1—Determine gross income:

(1) Gross income \$1000

Step 2—Determine gross foreign base company income and gross insurance income:

(2) Interest income included in gross foreign personal holding company income under section 954(c) 100

| | | | | |
|--|-----|---|-------|--|
| (3) Gross foreign base company sales income under section 954(d) | 50 | (18) Ninety percent of the maximum United States corporate tax rate | 31.5% | 953, and is foreign source general limitation income for purposes of section 904(d)(1)(I). |
| (4) Total gross foreign base company income and gross insurance income as defined in sections 954(c), (d), (e), (f) and (g) and 953 (line (2) plus line (3)) | 150 | (19) Effective rate of foreign income tax imposed on net foreign personal holding company income (\$90 of interest) under section 954(b)(4) and this paragraph (d) (line (16) divided by line (12)) | 33% | (ii) <i>Expenses.</i> For the current taxable year, <i>CFC</i> has expenses of \$650. This amount includes \$350 of interest paid to related persons that is allocable to foreign personal holding company income under section 904, and \$50 of other expense that is directly related to foreign personal holding company income. The remaining \$250 of expenses is allocable to services income other than foreign base company income or insurance income. |
| <i>Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:</i> | | (20) Effective rate of foreign income tax imposed on \$30 of net foreign base company sales income under section 954(b)(4) and this paragraph (d) (line (17) divided by line (13)) | 47% | (iii) <i>Earnings and losses.</i> <i>CFC</i> has earnings and profits for the current taxable year of \$350. In the prior taxable year, <i>CFC</i> had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income of <i>CFC</i> (consisting entirely of foreign source general limitation income) by \$600 for the prior taxable year. |
| (5) Five percent of gross income (.05 × line (1)) | 50 | (21) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (12) if line (19) is greater than line (18)) | 90 | (iv) <i>Taxes.</i> Foreign income tax of \$120 is considered imposed on the \$720 of interest income under the rules of section 954(b)(4), paragraph (d) of this section, and §1.904-6. Foreign income tax of \$2 is considered imposed on the services income under the rules of section 954(b)(4), paragraph (d) of this section, and §1.904-6. For the taxable year of <i>CFC</i> , the maximum United States rate of taxation under section 11 is 35 percent. |
| (6) Seventy percent of gross income (.70 × line (1)) | 700 | (22) Net foreign base company sales income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (13) if line (20) is greater than line (18)) | 30 | (v) <i>Conclusion.</i> Based on these facts, if <i>CFC</i> elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have \$350 of subpart F income as defined in section 952(a), determined as follows. |
| (7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the <i>de minimis</i> test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or \$1,000,000) (if the amount on this line 7 is zero, proceed to <i>Step 8</i>) | 150 | (23) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (14), reduced by the sum of line (21) and line (22)) | 0 | |
| (8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6)) | 150 | <i>Step 7—Compute adjusted net insurance income:</i> | | |
| <i>Step 4—Compute net foreign base company income:</i> | | (24) Adjusted net insurance income | 0 | |
| (9) Expenses directly related to adjusted gross foreign base company sales income | 20 | <i>Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):</i> | | |
| (10) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income | 2 | (25) Earnings and profits for the current year | 500 | <i>Step 1—Determine gross income:</i> |
| (11) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904 | 8 | (26) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (25) over the sum of lines (23) and (24)); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year | 500 | (1) Gross income |
| (12) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by lines (10) and (11)) | 90 | (27) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) | 600 | \$1000 |
| (13) Net foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (3) reduced by line (9)) | 30 | (28) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (23), line (24), and the lesser of line (26) or line (27)) | 500 | <i>Step 2—Determine gross foreign base company income and gross insurance income:</i> |
| (14) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (12) plus line (13)) | 120 | (29) Amount of prior year's deficit to be recharacterized as subpart F income in later years under section 952(c) (excess of line (27) over line (26)) | 100 | (2) Gross foreign base company income and gross insurance income as defined in sections 954(c), (d), (e), (f) and (g) and 953 (interest income) |
| <i>Step 5—Compute net insurance income:</i> | | <i>Example 2.</i> (i) <i>Gross income.</i> <i>CFC</i> , a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)-(1)(A) and §1.954-2(b)(1)(ii), is not income from trade or service receivables described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 954(c) and §1.954-2 or section 952(b). The remaining \$280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), or (g) or | | |
| (15) Net insurance income under section 953 | 0 | 1000 | | |
| <i>Step 6—Compute adjusted net foreign base company income:</i> | | <i>Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:</i> | | |
| (16) Foreign income tax imposed on net foreign personal holding company income (as determined under section 954(b)(4) and this paragraph (d)) | 30 | (3) Seventy percent of gross income (.70 × line (1)) | 700 | (3) Gross foreign base company income and gross insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)) |
| (17) Foreign income tax imposed on net foreign base company sales income (as determined under section 954(b)(4) and this paragraph (d)) | 14 | (4) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion rule of this paragraph (b)(1)(ii) (line (4) minus line (2)) | 280 | 1000 |
| | | <i>Step 4—Compute net foreign base company income:</i> | | |
| | | (6) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income | 50 | |
| | | (7) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904 | 350 | |

| | |
|---|-----|
| (8) Deductions allocable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) of this section..... | 250 |
| (9) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by line (6) and line (7)).... | 320 |
| (10) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (5) reduced by line (8))..... | 30 |
| (11) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (9) plus line (10))..... | 350 |

Step 5—Compute net insurance income:

| | |
|--|---|
| (12) Net insurance income under section 953..... | 0 |
|--|---|

Step 6—Compute adjusted net foreign base company income:

| | |
|--|-------|
| (13) Foreign income tax imposed on net foreign personal holding company income (interest)..... | 120 |
| (14) Foreign income tax imposed on net full inclusion foreign base company income..... | 2 |
| (15) Ninety percent of the maximum United States corporate tax rate..... | 31.5% |

| | |
|--|-----|
| (16) Effective rate of foreign income tax imposed on \$320 of net foreign personal holding company income under section 954(b)(4) and this paragraph (d) (line (13) divided by line (9))..... | 38% |
| (17) Effective rate of foreign income tax imposed on \$30 of net full inclusion foreign base company income under section 954(b)(4) and this paragraph (d) (line (14) divided by line (10))..... | 7% |

| | |
|--|-----|
| (18) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (9) if line (16) is greater than line (15)).... | 320 |
| (19) Net full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (10) if line (17) is greater than line (15)).... | 0 |

| | |
|--|----|
| (20) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (11) reduced by the sum of line (18) and line (19))..... | 30 |
|--|----|

Step 7—Compute adjusted net insurance income:

| | |
|---|---|
| (21) Adjusted net insurance income..... | 0 |
|---|---|

Step 8—Reduction of adjusted net foreign base company income or adjusted net insurance income by reason of paragraph (d)(6) of this section:

| | |
|--|-----|
| (22) Adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1) of this section) (line (4) reduced by line (5))..... | 720 |
|--|-----|

| | |
|--|-----|
| (23) Ninety percent of adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1)(ii) of this section) (90% of the amount on line (22))..... | 648 |
|--|-----|

| | |
|---|-----|
| (24) Net foreign base company income and net insurance income excluded from subpart F income under section 954(b)(4), increased by the amount of expenses that reduced this income under section 954(b)(5) and paragraph (c) of this section (line (18) increased by the sum of line (6) and line (7))..... | 720 |
|---|-----|

| | |
|--|----|
| (25) Adjusted net full inclusion foreign base company income excluded from subpart F income under paragraph (d)(6) of this section (zero, or line (10) reduced by line (19) if line (24) is greater than line (23))..... | 30 |
|--|----|

| | |
|---|---|
| (26) Adjusted net foreign base company income after application of paragraph (d)(6) of this section (line (20) reduced by line (25))..... | 0 |
|---|---|

Step 9—Additions to or reduction of subpart F income by reason of section 952(c):

| | |
|---|-----|
| (27) Earnings and profits for the current year..... | 350 |
|---|-----|

| | |
|---|-----|
| (28) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (27) over the sum of line (21) and line (26)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year..... | 350 |
|---|-----|

| | |
|--|-----|
| (29) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1)..... | 600 |
|--|-----|

| | |
|--|-----|
| (30) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (21) and line (26) plus the lesser of line (28) or line (29)).... | 350 |
|--|-----|

| | |
|---|-----|
| (31) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (29) over line (28))..... | 250 |
|---|-----|

(e) *Character of income*—(1) *Substance of the transaction.* For purposes of section 954, income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount that is designated as rent by the taxpayer but actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as rent but shall be characterized as income from the sale of property, royalties or income from services, as the case may be. Local law shall not be controlling in characterizing income.

(2) *Separable character.* To the extent the definitional provisions of section 953 or 954 describe the income or

gain derived from a transaction, or any portion or portions thereof, that income or gain, or portion or portions thereof, is so characterized for purposes of subpart F. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing personal property and selling it to related persons outside its country of incorporation, also performs services outside its country of incorporation with respect to the property it sells, the sales income will be treated as foreign base company sales income and the services income will be treated as foreign base company services income for purposes of these rules.

(3) *Predominant character.* The portion of income or gain derived from a transaction that is included in the computation of foreign personal holding company income is always separately determinable and thus must always be segregated from other income and separately classified under paragraph (e)(2) of this section. However, the portion of income or gain derived from a transaction that would meet a particular definitional provision under section 954 or 953 (other than the definition of foreign personal holding company income) in unusual circumstances may not be separately determinable. If such portion is not separately determinable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise not separately determinable, then the classification of income from the transaction shall be made in accordance with the predominant character of the arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income*—(i) *In general.* The computations of gross foreign base company income and gross insurance income are limited by the following rules:

(A) If income is foreign base company shipping income, pursuant to section 954(f), it shall not be considered insurance income or income in any other category of foreign base company income.

(B) If income is foreign base company oil related income, pursuant to section 954(g), it shall not be considered insurance income or income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(A) of this section.

(C) If income is insurance income, pursuant to section 953, it shall not be considered income in any category of foreign base company income except as provided in paragraph (e)(4)(i)(A) or (B) of this section.

(D) If income is foreign personal holding company income, pursuant to section 954(c), it shall not be considered income in any other category of foreign base company income, other than as provided in paragraph (e)(4)(i)(A), (B) or (C) of this section.

(ii) *Income excluded from other categories of gross foreign base company income.* Income shall not be excluded from a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in another category of gross foreign base company income or gross insurance income, if the income is excluded from that other category by a more specific provision of section 953 or 954. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under §1.954-2(f) as income from a qualified active sale may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See §1.954-2(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

(f) *Definition of related person*—(1) *Persons related to controlled foreign corporation.* Unless otherwise provided, for purposes of section 954 and §§1.954-1 through 1.954-8 inclusive, the following persons are considered under section 954(d)(3) to be related persons with respect to a controlled foreign corporation:

(i) *Individuals.* An individual, whether or not a citizen or resident of the United States, who controls the controlled foreign corporation.

(ii) *Other persons.* A foreign or domestic corporation, partnership, trust or estate that controls or is controlled by the controlled foreign corporation, or is controlled by the same person or persons that control the controlled foreign corporation.

(2) *Control*—(i) *Corporations.* With respect to a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation.

(ii) *Partnerships.* With respect to a partnership, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the capital or profits interest in the partnership.

(iii) *Trusts and estates.* With respect to a trust or estate, control means the ownership, directly, or indirectly, of more than 50 percent (by value) of the beneficial interest in the trust or estate.

(iv) *Direct or indirect ownership.* For purposes of this paragraph (f), to determine direct or indirect ownership, the principles of section 958 shall be applied without regard to whether a corporation, partnership, trust or estate is foreign or domestic or whether or not an individual is a citizen or resident of the United States.

§1.954-2 Foreign personal holding company income.

(a) *Computation of foreign personal holding company income*—(1) *Categories of foreign personal holding company income.* For purposes of subpart F and the regulations under that subpart, foreign personal holding company income consists of the following categories of income—

(i) Dividends, interest, rents, royalties, and annuities as described in paragraph (b) of this section;

(ii) Gain from certain property transactions as described in paragraph (e) of this section;

(iii) Gain from commodities transactions as described in paragraph (f) of this section;

(iv) Foreign currency gain as described in paragraph (g) of this section; and

(v) Income equivalent to interest as described in paragraph (h) of this section.

(2) *Coordination of overlapping categories under foreign personal holding company provisions*—(i) *In general.* If any portion of income, gain or loss from a transaction is described in more than one category of foreign personal holding company income (as described in paragraph (a)(2)(ii) of this section),

that portion of income, gain or loss is treated solely as income, gain or loss from the category of foreign personal holding company income with the highest priority.

(ii) *Priority of categories.* The categories of foreign personal holding company income, listed from highest priority (paragraph (a)(2)(ii)(A) of this section) to lowest priority (paragraph (a)(2)(ii)(E) of this section), are—

(A) Dividends, interest, rents, royalties, and annuities, as described in paragraph (b) of this section;

(B) Income equivalent to interest, as described in paragraph (h) of this section without regard to the exceptions in paragraph (h)(1)(ii)(A) of this section;

(C) Foreign currency gain or loss, as described in paragraph (g) of this section without regard to the exclusion in paragraph (g)(2)(ii) of this section;

(D) Gain or loss from commodities transactions, as described in paragraph (f) of this section without regard to the exclusion in paragraph (f)(1)(ii) of this section; and

(E) Gain or loss from certain property transactions, as described in paragraph (e) of this section without regard to the exceptions in paragraph (e)(1)(ii) of this section.

(3) *Changes in the use or purpose for which property is held*—(i) *In general.* Under paragraphs (e), (f), (g) and (h) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. The use or purpose for which property is held is that use or purpose for which it was held for more than one-half of the period during which the controlled foreign corporation held the property prior to the disposition.

(ii) *Special rules*—(A) *Anti-abuse rule.* If a principal purpose of a change in use or purpose of property was to avoid including gain or loss in the computation of foreign personal holding company income, all the gain or loss from the disposition of the property is treated as foreign personal holding company income. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Hedging transactions.* The provisions of paragraph (a)(3)(i) of this

section shall not apply to bona fide hedging transactions, as defined in paragraph (a)(4)(ii) of this section. A transaction will be treated as a bona fide hedging transaction only so long as it satisfies the requirements of paragraph (a)(4)(ii) of this section.

(iii) *Example.* The following example illustrates the application of this paragraph (a)(3).

Example. At the beginning of taxable year 1, *CFC*, a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from the building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. The building was not used in an active trade or business of *CFC* for more than one-half of the period during which it was held by *CFC*. Therefore, the building is considered to be property that gives rise to rents, as described in paragraph (e)(2) of this section, and gain from the sale is included in the computation of *CFC*'s foreign personal holding company income under paragraph (e) of this section.

(4) *Definitions and special rules.* The following definitions and special rules apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term *interest* includes all amounts that are treated as interest income (including interest on a tax-exempt obligation) by reason of the Internal Revenue Code or Income Tax Regulations or any other provision of law. For example, interest includes stated interest, acquisition discount, original issue discount, *de minimis* original issue discount, market discount, *de minimis* market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(ii) *Bona fide hedging transaction—*
(A) *Definition.* The term *bona fide hedging transaction* means a transaction that meets the requirements of §1.1221-2(a) through (c) and that is identified in accordance with the requirements of paragraph (a)(4)(ii)(B) of this section, except that in applying §1.1221-2(b)(1), the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction. A transaction that hedges the liabilities, inventory or other assets of a related person (as defined in section 954(d)(3)), that is entered into to assume or reduce risks of a related

person, or that is entered into by a person other than a person acting in its capacity as a regular dealer (as defined in paragraph (a)(4)(iv) of this section) to reduce risks assumed from a related person, will not be treated as a bona fide hedging transaction. For an illustration of how this rule applies with respect to foreign currency transactions, see paragraph (g)(2)(ii)(D) of this section.

(B) *Identification.* The identification requirements of this section shall be satisfied if the taxpayer meets the identification and recordkeeping requirements of §1.1221-2(e). However, for bona fide hedging transactions entered into prior to March 7, 1996, the identification and recordkeeping requirements of §1.1221-2 shall not apply. Rather, for bona fide hedging transactions entered into on or after July 22, 1988 and prior to March 7, 1996, the identification and recordkeeping requirements shall be satisfied if such transactions are identified by the close of the fifth day after the day on which they are entered into. For bona fide hedging transactions entered into prior to July 22, 1988, the identification and recordkeeping requirements shall be satisfied if such transactions are identified reasonably contemporaneously with the date they are entered into, but no later than within the normal period prescribed under the method of accounting of the controlled foreign corporation used for financial reporting purposes.

(C) *Effect of identification and non-identification—*
(1) *Transactions identified.* If a taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the identification is binding with respect to any loss arising from such transaction whether or not all of the requirements of paragraph (a)(4)(ii)(A) of this section are satisfied. Accordingly, such loss will be allocated against income that is not subpart F income (or, in the case of an election under paragraph (g)(3) of this section, against the category of subpart F income to which it relates) and apportioned among the categories of income described in section 904(d)(1). If the transaction is not in fact a bona fide hedging transaction described in paragraph (a)(4)(ii)(A) of this section, however, then any gain realized with respect to such transaction shall not be considered as gain from a bona fide hedging transaction. Accordingly, such gain shall be treated

as gain from the appropriate category of foreign personal holding company income. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself operate to exclude gain from the appropriate category of foreign personal holding company income.

(2) *Inadvertent identification.* Notwithstanding paragraph (a)(4)(ii)(C)(1) of this section, if the taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the characterization of the loss is determined as if the transaction had not been identified as a bona fide hedging transaction if—

(i) The transaction is not a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);

(ii) The identification of the transaction as a bona fide hedging transaction was due to inadvertent error; and

(iii) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(3) *Transactions not identified.* Except as provided in paragraphs (a)(4)(ii)(C)(4) and (5) of this section, the absence of an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section is binding and establishes that a transaction is not a bona fide hedging transaction. Thus, subject to the exceptions, the characterization of gain or loss is determined without reference to whether the transaction is a bona fide hedging transaction.

(4) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section, the taxpayer may treat gain or loss from the transaction as gain or loss from a bona fide hedging transaction if—

(i) The transaction is a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);

(ii) The failure to identify the transaction was due to inadvertent error; and

(iii) All of the taxpayer's bona fide hedging transactions in all open years are being treated on either original or, if necessary, amended returns as bona fide hedging transactions in accordance with the rules of this section.

(5) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (a)(4)(ii)(B) of this section but

the taxpayer has no reasonable grounds for treating the transaction as other than a bona fide hedging transaction, then loss from the transaction shall be treated as realized with respect to a bona fide hedging transaction. Thus, a taxpayer may not elect to exclude loss from its proper characterization as a bona fide hedging transaction. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (a)(4)-(ii)(A) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(iii) *Inventory and similar property*—(A) *Definition*. The term *inventory and similar property* (or *inventory or similar property*) means property that is stock in trade of the controlled foreign corporation or other property of a kind that would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year (if the controlled foreign corporation were a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business.

(B) *Hedging transactions*. A bona fide hedging transaction with respect to inventory or similar property (other than a transaction described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)) shall be treated as a transaction in inventory or similar property.

(iv) *Regular dealer*. The term *regular dealer* means a controlled foreign corporation that—

(A) Regularly and actively offers to, and in fact does, purchase property from and sell property to customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business; or

(B) Regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in property with customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business.

(v) *Dealer property*—(A) *Definition*. Property held by a controlled foreign corporation is *dealer property* if—

(1) The controlled foreign corporation is a regular dealer in property of such kind (determined under paragraph (a)(4)(iv) of this section); and

(2) The property is held by the controlled foreign corporation in its capacity as a dealer in property of such kind without regard to whether the property arises from a transaction with a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. The property is not held by the controlled foreign corporation in its capacity as a dealer if the property is held for investment or speculation on its own behalf or on behalf of a related person (as defined in section 954(d)(3)).

(B) *Securities dealers*. If a controlled foreign corporation is a licensed securities dealer, only the securities that it has identified as held for investment in accordance with the provisions of section 475(b) or section 1236 will be considered to be property held for investment or speculation under this section. A licensed securities dealer is a controlled foreign corporation that is both a securities dealer, as defined in section 475, and a regular dealer, as defined in paragraph (a)(4)(iv) of this section, and that is either—

(1) registered as a securities dealer under section 15(a) of the Securities Exchange Act of 1934 or as a Government securities dealer under section 15C(a) of such Act; or

(2) licensed or authorized in the country in which it is chartered, incorporated, or organized to purchase and sell securities from or to customers who are residents of that country. The conduct of such securities activities must be subject to bona fide regulation, including appropriate reporting, monitoring, and prudential (including capital adequacy) requirements, by a securities regulatory authority in that country that regularly enforces compliance with such requirements and prudential standards.

(C) *Hedging transactions*. A bona fide hedging transaction with respect to dealer property shall be treated as a transaction in dealer property.

(vi) *Examples*. The following examples illustrate the application of paragraphs (a)(4)(ii), (iv) and (v) of this section.

Example 1. (i) *CFC1* and *CFC2* are related controlled foreign corporations (within the mean-

ing of section 954(d)(3)) located in Countries F and G, respectively. *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons with respect to *CFC1* or *CFC2* (within the meaning of section 954(d)(3)) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments. *CFC1* uses securities that are traded in securities markets in Country G to hedge positions that it enters into with customers located in Country F. *CFC1* is not a member of a securities exchange in Country G, so it purchases such securities from *CFC2* and unrelated persons that are registered as securities dealers in Country G and that are members of Country G securities exchanges. Such hedging transactions qualify as bona fide hedging transactions under paragraph (a)(4)(ii) of this section.

(ii) Transactions that *CFC1* and *CFC2* enter into with each other do not affect the determination of whether they are regular dealers. Because *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons within the meaning of section 954(d)(3) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments, however, they qualify as regular dealers in such property within the meaning of paragraph (a)(4)(iv) of this section. Moreover, because *CFC1* purchases securities from *CFC2* as bona fide hedging transactions with respect to dealer property, the securities are dealer property under paragraph (a)(4)(v)(C) of this section. Similarly, because *CFC2* sells securities to *CFC1* in the ordinary course of its business as a dealer, the securities are dealer property under paragraph (a)(4)(v)(A) of this section.

Example 2. (i) *CFC* is a controlled foreign corporation located in Country B. *CFC* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. *CFC* regularly and actively holds itself out as being willing to, and in fact does, enter into either side of options, forward contracts, or other financial instruments with other members of the same controlled group. *CFC* hedges risks arising from such transactions by entering into transactions with persons who are not related persons (within the meaning of section 954(d)(3)) with respect to *CFC*. However, *CFC* does not regularly and actively hold itself out as being willing to, and does not, enter into either side of transactions with unrelated persons.

(ii) *CFC* is not a regular dealer in property under paragraph (a)(4)(iv) of this section and its options, forwards, and other financial instruments are not dealer property within the meaning of paragraph (a)(4)(v) of this section.

(vii) *Debt instrument*. The term *debt instrument* includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(b) *Dividends, interest, rents, royalties, and annuities*—(1) *In general*. Foreign personal holding company income includes—

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(4) of this section and distributions of previously taxed income under section 959(b);

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(4) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in paragraph (b)(5) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(6) of this section; and

(iv) Annuities.

(2) *Exclusion of certain export financing interest*—(i) *In general.* Foreign personal holding company income does not include interest that is export financing interest. The term *export financing interest* means interest that is derived in the conduct of a banking business and is export financing interest as defined in section 904(d)(2)(G). Solely for purposes of determining whether interest is export financing interest, property is treated as manufactured, produced, grown, or extracted in the United States if it is so treated under §1.927(a)-1T(c).

(ii) *Exceptions.* Export financing interest does not include income from related party factoring that is treated as interest under section 864(d)(1) or (6) after the application of section 864(d)(7).

(iii) *Conduct of a banking business.* For purposes of this section, export financing interest is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iv) *Examples.* The following examples illustrate the application of this paragraph (b)(2).

Example 1. (i) *DS*, a domestic corporation, manufactures property in the United States. In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory or equipment sold by *DS* is attributable to

products imported into the United States. *CFC*, a controlled foreign corporation with respect to which *DS* is a related person (within the meaning of section 954(d)(3)), provides loans described in section 864(d)(6) to unrelated persons for the purchase of property from *DS*. This property is purchased exclusively for use or consumption outside the United States and outside *CFC*'s country of incorporation.

(ii) If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS*, *CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of this paragraph (b)(2) and, thus, not included in foreign personal holding company income. However, interest from the loans made with respect to purchases from *DS* of property that is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the exception under section 864(d)(7) does not apply. Thus the interest from loans made with respect to this inventory is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

Example 2. (i) *DS*, a domestic corporation manufactures property in the United States. *DS* wholly owns two controlled foreign corporations organized in Country A, *CFC1* and *CFC2*. *CFC1* has a substantial part of its assets used in its trade or business in Country A. *CFC1* purchases the property that *DS* manufactures and sells it without further manufacture for use or consumption within Country A. This property is inventory property, as described in section 1221(1), in the hands of *CFC1*. Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory sold by *CFC1* is attributable to products imported into the United States. *CFC2* provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property from *CFC1*.

(ii) If, in issuing and servicing loans made with respect to purchases from *CFC1* of the inventory property, *CFC2* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of paragraph (b)(2) of this section. It is not treated as income from a trade or service receivable under section 864(d)(6) because the exception under section 864(d)(7) applies. Thus the interest is excluded from foreign personal holding company income.

Example 3. The facts are the same as in *Example 2* except that the property sold by *CFC1* is manufactured by *CFC1* in Country A from component parts that were manufactured by *DS* in the United States. The interest accrued from the loans by *CFC2* is not export financing interest as defined in section 904(d)(2)(G) because the property is not manufactured in the United States under §1.927(a)-1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

(3) *Treatment of tax-exempt interest.* [Reserved] For guidance, see §4.954-2(b)(6) of this chapter.

(4) *Exclusion of dividends or interest from related persons*—(i) *In general*—(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include dividends or interest if the payor—

(1) Is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3);

(2) Is created or organized under the laws of the same foreign country (the *country of incorporation*) as is the controlled foreign corporation; and

(3) Uses a substantial part of its assets in a trade or business in its country of incorporation, as determined under this paragraph (b)(4).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(4), if a partnership with one or more corporate partners makes a payment of interest, a corporate partner will be treated as the payor of the interest—

(1) If the interest payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that the item of deduction is allocable to the corporate partner under section 704(b); or

(2) If the interest payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions*—(A) *Dividends.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(4) only to the extent that they are paid out of earnings and profits that are earned or accumulated during a period in which—

(1) The stock on which dividends are paid with respect to which the exclusion is claimed was owned by the recipient controlled foreign corporation directly, or indirectly through a chain of one or more subsidiaries each of which meets the requirements of paragraph (b)(4)(i)(A) of this section; and

(2) Each of the requirements of paragraph (b)(4)(i)(A) of this section is satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962,

during a period in which the payor was a related corporation as to the controlled foreign corporation and the other requirements of paragraph (b)(4)(i)(A) of this section were substantially satisfied.

(3) This paragraph (b)(4)(ii)(A) is illustrated by the following example:

Example. A, a domestic corporation, owns all of the stock of B, a corporation created and organized under the laws of Country Y, and C, a corporation created and organized under the laws of Country X. The taxable year of each of the corporations is the calendar year. In Year 1, B earns \$100 of income from the sale of products in Country Y that it manufactured in Country Y. C had no earnings and profits in Year 1. On January 1 of Year 2, A contributes all of the stock of B and C to Newco, a Country Y corporation, in exchange for all of the stock of Newco. Neither B nor C earns any income in Year 2, but at the end of Year 2 B distributes the \$100 accumulated earnings and profits to Newco. Newco's income from the distribution, \$100, is foreign personal holding company income because the earnings and profits distributed by B were not earned or accumulated during a period in which the stock of B was owned by Newco and in which each of the requirements of paragraph (b)(4)(i)(A) of this section was satisfied.

(B) *Interest paid out of adjusted foreign base company income or insurance income*—(1) *In general.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that the deduction for the interest is allocated under §1.954-1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in §1.954-1(a)(3)), adjusted gross insurance income (as defined in §1.954-1(a)(6)), or any other category of income included in the computation of subpart F income under section 952(a).

(2) *Rule for corporations that are both recipients and payors of interest.* If a controlled foreign corporation is both a recipient and payor of interest, the interest that is received will be characterized before the interest that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by the controlled foreign corporation to a related person (as defined in section 954(d)(3)) shall be offset against and eliminate any interest received or accrued, directly or indirectly, by the controlled foreign corporation from that related person. In a case in which the controlled foreign corporation pays or accrues interest to a related person, as defined in section 954(d)(3), and also receives or accrues interest indirectly from the related person, the smallest

interest payment is eliminated and the amounts of all other interest payments are reduced by the amount of the smallest interest payment.

(C) *Coordination with sections 864(d) and 881(c).* Income of a controlled foreign corporation that is treated as interest under section 864(d)(1) or (6), or that is portfolio interest, as defined by section 881(c), is not excluded from foreign personal holding company income under section 954(c)(3)(A)(i) and this paragraph (b)(4).

(iii) *Trade or business requirement.* Except as otherwise provided under this paragraph (b)(4), the principles of section 367(a) apply for purposes of determining whether the payor has a trade or business in its country of incorporation and whether its assets are used in that trade or business. Property purchased or produced for use in a trade or business is not considered used in a trade or business before it is placed in service or after it is retired from service as determined in accordance with the principles of sections 167 and 168.

(iv) *Substantial assets test.* A substantial part of the assets of the payor will be considered to be used in a trade or business located in the payor's country of incorporation for a taxable year only if the average value of the payor's assets for such year that are used in the trade or business and are located in such country equals more than 50 percent of the average value of all the assets of the payor (including assets not used in a trade or business). The average value of assets for the taxable year is determined by averaging the values of assets at the close of each quarter of the taxable year. The value of assets is determined under paragraph (b)(4)(v) of this section, and the location of assets used in a trade or business of the payor is determined under paragraphs (b)(4)(vi) through (xi) of this section.

(v) *Valuation of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their fair market value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property*—(A) *In general.* Tangible property

(other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, and dealer property as defined in paragraph (a)(4)(v) of this section) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* An item of tangible personal property that is used in the trade or business of a payor in the payor's country of incorporation is considered located within the payor's country of incorporation while it is temporarily located elsewhere for inspection or repair if the property is not placed in service in a country other than the payor's country of incorporation and is not to be so placed in service following the inspection or repair.

(vii) *Location of intangible property*—(A) *In general.* Intangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, dealer property as defined in paragraph (a)(4)(v) of this section, and debt instruments) is considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the use or exploitation of the property in that country during that entire quarter. For this purpose, the country in which the activities connected to the use or exploitation of the property are conducted is the country in which the expenses associated with these activities are incurred. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(4) if they would be deductible under section 162 or includible in inventory costs or the cost of goods sold if the payor were a domestic corporation. If the payor conducts such activities through an agent or independent contractor, then the expenses incurred by the payor with respect to the agent or independent contractor shall be deemed to be incurred by the payor in the country in which the expenses of the agent or independent contractor were incurred by the agent or independent contractor.

(B) *Exception for property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the use or exploitation of an item of intangible property, including goodwill (other than inventory and similar property,

dealer property and debt instruments) during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the intangible considered located in the payor's country of incorporation during that quarter is a percentage of the value of the item as of the close of the quarter. That percentage equals the ratio that the expenses incurred by the payor (described in paragraph (b)(4)(vii)(A) of this section) during the entire quarter by reason of activities that are connected with the use or exploitation of the item of intangible property and are conducted in the payor's country of incorporation bear to all expenses incurred by the payor during the entire quarter by reason of all such activities worldwide.

(viii) *Location of inventory and dealer property*—(A) *In general.* Inventory and similar property, as defined in paragraph (a)(4)(iii) of this section, and dealer property, as defined in paragraph (a)(4)(v) of this section, are considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the production and sale, or purchase and resale, of such property in its country of incorporation during that entire quarter. If the payor conducts such activities through an agent or independent contractor, then the location of such activities is the place in which they are conducted by the agent or independent contractor.

(B) *Inventory and dealer property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the production and sale, or purchase and resale, of inventory or similar property or dealer property during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the inventory or similar property or dealer property considered located in the payor's country of incorporation during each quarter is a percentage of the value of the inventory or similar property or dealer property as of the close of the quarter. That percentage equals the ratio that the costs and expenses incurred by the payor during the entire quarter by reason of activities connected with the production and sale, or purchase and resale, of inventory or similar property or dealer property that are conducted in the payor's country of incorporation bear to all costs or expenses incurred

by the payor during the entire quarter by reason of all such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property or dealer property is included in this computation if it—

(1) Would be included in inventory costs or otherwise capitalized with respect to inventory or similar property or dealer property under section 61, 263A, 471, or 472 if the payor were a domestic corporation; or

(2) Would be deductible under section 162 if the payor were a domestic corporation and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of §1.861-8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(4), debt instruments, other than debt instruments that are inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or dealer property (as defined in paragraph (a)(4)(v) of this section) are considered to be used in a trade or business only if they arise from the sale of inventory or similar property or dealer property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, and only until such time as interest is required to be charged under section 482. Debt instruments that arise from the sale of inventory or similar property or dealer property during a quarter are treated as having the same location, proportionately, as the inventory or similar property or dealer property held during that quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* Stock in a controlled foreign corporation (lower-tier corporation) that is incorporated in the same country as the payor and that is more than 50-percent owned, directly or indirectly, by the payor within the meaning of section 958(a) shall be considered located in the payor's country of incorporation and, solely for purposes of section 954(c)(3), used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorpora-

tion. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(4).

(xi) *Treatment of banks and insurance companies.* [Reserved]

(5) *Exclusion of rents and royalties derived from related persons*—(i) *In general*—(A) *Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include rents or royalties if—

(1) The payor is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3); and

(2) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation receiving the payments is created or organized (the country of incorporation).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(5), if a partnership with one or more corporate partners makes a payment of rents or royalties, a corporate partner will be treated as the payor of the rents or royalties—

(1) If the rent or royalty payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent the item of deduction is allocable to the corporate partner under section 704(b); or

(2) If the rent or royalty payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions*—(A) *Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(5) to the extent that deductions for the payments are allocated under section 954(b)(5) and §1.954-1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in §1.954-1(a)(3)), adjusted gross insurance income (as defined in §1.954-1(a)(6)), or any other category of income included in the

computation of subpart F income under section 952(a).

(B) *Property used in part in the controlled foreign corporation's country of incorporation.* If the payor uses the property both in the controlled foreign corporation's country of incorporation and elsewhere, the part of the rent or royalty attributable (determined under the principles of section 482) to the use of, or the privilege of using, the property outside such country of incorporation is included in the computation of foreign personal holding company income under this paragraph (b).

(6) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties that are derived in the active conduct of a trade or business and received from a person that is not a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. For purposes of this section, rents or royalties are derived in the active conduct of a trade or business only if the provisions of paragraph (c) or (d) of this section are satisfied.

(c) *Excluded rents*—(1) *Active conduct of a trade or business.* Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—

(i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;

(iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or

(iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country,

maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (c)(1)(iv) of this section, whether an organization in a foreign country is substantial in relation to the amount of rents is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses.* The term *active leasing expenses* means the deductions incurred by an organization of the lessor in a foreign country that are properly allocable to rental income and that would be allowable under section 162 to the lessor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the lessor;

(B) Deductions for rents paid or accrued;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the lessor (if the lessor were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the leased property other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(iv) *Adjusted leasing profit.* The term *adjusted leasing profit* means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the lessor with respect to such rental income;

(B) The amounts that would be allowable to such lessor (if the lessor were a domestic corporation) as deductions under sections 167 or 168 with respect to such rental income; and

(C) The amounts paid by the lessor to agents or independent contractors with respect to such rental income other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(3) *Examples.* The application of this paragraph (c) is illustrated by the following examples.

Example 1. Controlled foreign corporation A is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of Corporation A from these leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 2. Controlled foreign corporation D purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation D owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation D also leases in country X on a long-term basis, generally for a term of one year, motor vehicles that it owns. Under the terms of the long-term leases, Corporation D is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation D maintains and operates an organization therein that is regularly engaged in the business of marketing and servicing the motor vehicles that are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation D receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation E owns a complex of apartment buildings that it has acquired by purchase. Corporation E engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to Corporation E. The rental income of Corporation E from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation F acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation F acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by

Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation *G* owns equipment that it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents Corporation *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Active conduct of a trade or business.* Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—

(i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (d)(1)(ii) of this section, whether an organization in a foreign country is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent

of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term *active licensing expenses* means the deductions incurred by an organization of the licensor in a foreign country that are properly allocable to royalty income and that would be allowable under section 162 to the licensor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the licensor;

(B) Deductions for royalties paid or incurred;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the licensor (if the controlled foreign corporation were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term *adjusted licensing profit* means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the licensor with respect to such royalty income;

(B) The amounts that would be allowable to such licensor as deductions under section 167 or 197 (if the licensor were a domestic corporation) with respect to such royalty income; and

(C) The amounts paid by the licensor to agents or independent contractors with respect to such royalty income.

(3) *Examples.* The application of this paragraph (d) is illustrated by the following examples.

Example 1. Controlled foreign corporation *A*, through its own staff of employees, owns and operates a research facility in foreign country *X*. At the research facility, employees of Corporation *A* who are scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, that ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *A* for the privilege of using patented rights that it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A), but only so long as the licensor is regularly engaged in the development, creation or produc-

tion of, or in the acquisition of and addition of substantial value to, property of such kind.

Example 2. Assume that Corporation *A* in *Example 1*, in addition to receiving royalties for the use of patents that it develops, receives royalties for the use of patents that it acquires by purchase and licenses to others without adding any value thereto. Corporation *A* generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation *A*, that Corporation *A* has acquired rights under a patent and is interested in licensing its rights. Corporation *A* does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation *A* for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation *B* receives royalties for the use of patents that it acquires by purchase. The primary business of Corporation *B*, operated on a regular basis, consists of licensing patents that it has purchased raw from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation *B*, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *B* from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation *C* receives royalties for the use of a patent that it developed through its own staff of employees at its facility in country *X*. Corporation *C* has developed no other patents. It does not regularly employ a staff of scientists, engineers or technicians to create new products to be patented. Further, it does not purchase and license patents developed by others to which it has added substantial value. The royalties received by Corporation *C* are not derived from the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation *D* finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation *D* also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice that is intended to promote the use of the patented property. Corporation *D* does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the patents. Royalties received by Corporation *D* for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusions.* Gain

from certain property transactions described in section 954(c)(1)(B) includes the excess of gains over losses from the sale or exchange of—

(A) Property that gives rise to dividends, interest, rents, royalties or annuities, as described in paragraph (e)(2) of this section;

(B) Property that is an interest in a partnership, trust or REMIC; and

(C) Property that does not give rise to income, as described in paragraph (e)(3) of this section.

(ii) *Exceptions.* Gain or loss from certain property transactions described in section 954(c)(1)(B) and paragraph (e)(1)(i) of this section does not include gain or loss from the sale or exchange of—

(A) Inventory or similar property, as defined in paragraph (a)(4)(iii) of this section;

(B) Dealer property, as defined in paragraph (a)(4)(v) of this section; or

(C) Property that gives rise to rents or royalties described in paragraph (b)(6) of this section that are derived in the active conduct of a trade or business from persons that are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation.

(iii) *Treatment of losses.* Section 1.954-1(c)(1)(ii) provides for the treatment of losses in excess of gains from the sale or exchange of property described in paragraph (e)(1)(i) of this section.

(iv) *Dual character property.* Property may, in part, constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or, in part, constitute property that does not give rise to any income as described in paragraph (e)(3) of this section. However, property that is described in paragraph (e)(1)(i)(B) of this section cannot be dual character property. Dual character property must be treated as two separate properties for purposes of paragraph (e)(2) or (3) of this section. Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under paragraph (e)(2) or (3) of this section, and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated under this paragraph (e)(1)(iv) pursuant to the method that most

reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its trade or business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain that is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(iv) addresses the contemporaneous use of property for dual purposes. For rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income—(i) In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (b) of this section, including—

(A) Property that gives rise to export financing interest described in paragraph (b)(2) of this section; and

(B) Property that gives rise to income from related persons described in paragraph (b)(4) or (5) of this section.

(ii) *Gain or loss from the disposition of a debt instrument.* Gain or loss from the sale, exchange or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) In the case of gain—

(1) It is interest (as defined in paragraph (a)(4)(i) of this section); or

(2) It is income equivalent to interest

(as described in paragraph (h) of this section); and

(B) In the case of loss—

(1) It is directly allocated to, or treated as an adjustment to, interest income (as described in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Internal Revenue Code or Income Tax Regulations; or

(2) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Internal Revenue Code or Income Tax Regulations.

(3) *Property that does not give rise to income.* Except as otherwise provided in this paragraph (e)(3), for purposes of this section, the term *property that does not give rise to income* includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options. Property that does not give rise to income shall not include—

(i) Property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (e)(2) of this section;

(ii) Tangible property (other than real property) used or held for use in the controlled foreign corporation's trade or business that is of a character that would be subject to the allowance for depreciation under section 167 or 168 and the regulations under those sections (including tangible property described in §1.167(a)-2);

(iii) Real property that does not give rise to rental or similar income, to the extent used or held for use in the controlled foreign corporation's trade or business;

(iv) Intangible property (as defined in section 936(h)(3)(B)), goodwill or going concern value, to the extent used or held for use in the controlled foreign corporation's trade or business;

(v) Notional principal contracts (but see paragraphs (f)(2), (g)(2) and (h)(3) of this section for rules that include income from certain notional principal contracts in gains from commodities transactions, foreign currency gains and income equivalent to interest, respectively); or

(vi) Other property that is excepted from the general rule of this paragraph (e)(3) by the Commissioner in published guidance. See §601.601(d)(2) of this chapter.

(f) *Commodities transactions—(1) In general—(i) Inclusion in foreign personal holding company income.* Foreign personal holding company income includes the excess of gains over losses from commodities transactions.

(ii) *Exception.* Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f).

(iii) *Treatment of losses.* Section 1.954-1(c)(1)(ii) provides for the treatment of losses in excess of gains from commodities transactions.

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term *commodity* includes tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

(ii) *Commodities transaction.* The term *commodities transaction* means the purchase or sale of a commodity for immediate (spot) delivery or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, or an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to—

(A) A futures or forward contract in a commodity;

(B) A leverage contract in a commodity purchased from a leverage transaction merchant;

(C) An exchange of futures for physical transaction;

(D) A transaction, including a notional principal contract, in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities;

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities; and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(iii) *Qualified active sale*—(A) *In general.* The term *qualified active sale* means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of com-

modities is not a qualified active sale. For example, the sale by a controlled foreign corporation of commodities that were held for investment or speculation would not be a qualified active sale.

(B) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities only with respect to commodities for which each of the following conditions is satisfied—

(1) It holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or as dealer property (as defined in paragraph (a)(4)(v) of this section); and

(2) With respect to such commodities, it incurs substantial expenses in the ordinary course of a commodities business from engaging in one or more of the following activities directly, and not through an independent contractor—

(i) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(ii) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aerating or milling of commodities; or

(iii) Significant activities as described in paragraph (f)(2)(iii)(B)(3) of this section.

(3) For purposes of paragraph (f)(2)-(iii)(B)(2)(iii) of this section, the significant activities must relate to—

(i) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging freight, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(ii) Owning and operating facilities for storage or warehousing; or

(iii) Owning or chartering vessels or vehicles for the transportation of the commodities.

(C) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of com-

modities if the sum of its gross receipts from all of its qualified active sales (as defined in this paragraph (f)(2)(iii) without regard to the substantially all requirement) of commodities and its gross receipts from all of its qualified hedging transactions (as defined in paragraph (f)(2)(iv) of this section, applied without regard to the substantially all requirement of this paragraph (f)(2)(iii)(C)) equals or exceeds 85 percent of its total gross receipts for the taxable year (computed as though the corporation were a domestic corporation). In computing gross receipts, the District Director may disregard any sale or hedging transaction that has as a principal purpose manipulation of the 85 percent gross receipts test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(D) *Activities of employees of a related entity.* For purposes of this paragraph (f), activities of employees of an entity related to the controlled foreign corporation, who are made available to and supervised on a day-to-day basis by, and whose salaries are paid by (or reimbursed to the related entity by), the controlled foreign corporation, are treated as activities engaged in directly by the controlled foreign corporation.

(E) *Financial activities.* For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant or handler of commodities if its business is primarily financial. For example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

(iv) *Qualified hedging transaction*—(A) *In general.* The term *qualified hedging transaction* means a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to qualified active sales (other than transactions described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)).

(B) *Exception.* The term *qualified hedging transaction* does not include transactions that are not reasonably necessary to the conduct of business of the controlled foreign corporation as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others.

(g) *Foreign currency gain or loss—*
(1) *Scope and purpose.* This paragraph (g) provides rules for the treatment of foreign currency gains and losses. Paragraph (g)(2) of this section provides the general rule. Paragraph (g)(3) of this section provides an election to include foreign currency gains or losses that would otherwise be treated as foreign personal holding company income under this paragraph (g) in the computation of another category of subpart F income. Paragraph (g)(4) of this section provides an alternative election to treat any net foreign currency gain or loss as foreign personal holding company income. Paragraph (g)(5) of this section provides rules for certain gains and losses not subject to this paragraph (g).

(2) *In general—*(i) *Inclusion.* Except as otherwise provided in this paragraph (g), foreign personal holding company income includes the excess of foreign currency gains over foreign currency losses attributable to any section 988 transactions (foreign currency gain or loss). Section 1.954–1(c)(1)(ii) provides rules for the treatment of foreign currency losses in excess of foreign currency gains. However, if an election is made under paragraph (g)(4) of this section, the excess of foreign currency losses over foreign currency gains to which the election would apply may be apportioned to, and offset, other categories of foreign personal holding company income.

(ii) *Exclusion for business needs—*
(A) *General rule.* Foreign currency gain or loss directly related to the business needs of the controlled foreign corporation is excluded from foreign personal holding company income.

(B) *Business needs.* Foreign currency gain or loss is directly related to the business needs of a controlled foreign corporation if—

(I) The foreign currency gain or loss—

(i) Arises from a transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business;

(ii) Arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss;

(iii) Does not arise from a transaction described in section 988(c)(1)(B)(iii); and

(iv) Is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; or

(2) The foreign currency gain or loss arises from a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property that satisfies the requirements of paragraph (g)(2)(ii)(B)(I) of this section. For purposes of this paragraph (g)(2)(ii)(B)(2), a hedging transaction will satisfy the aggregate hedging rules of §1.1221–2(c)(7) only if all (or all but a *de minimis* amount) of the aggregate risk being hedged arises in connection with transactions that satisfy the requirements of paragraph (g)(2)(ii)(B)(I) of this section.

(C) *Regular dealers.* Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1)(B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(D) *Example.* The following example illustrates the provisions of this paragraph (g)(2).

Example. (i) *CFC1* and *CFC2* are controlled foreign corporations located in Country B, and are members of the same controlled group. *CFC1* is engaged in the active conduct of a trade or business that does not produce any subpart F income. *CFC2* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. Pursuant to this arrangement, and to hedge the currency risk on a non-interest bearing receivable incurred by *CFC1* in the normal course of its business, on Day 1 *CFC1* enters into a forward contract to sell Japanese Yen to *CFC2* in 30 days. Also on Day 1, *CFC2* enters into a forward contract to sell Yen to unrelated Bank X on Day 30. *CFC2* is not a regular dealer in Yen spot and forward contracts, and the Yen is not the functional currency for either *CFC1* or *CFC2*.

(ii) Because the forward contract entered into by *CFC1* to sell Yen hedges a transaction entered into in the normal course of *CFC1*'s business that does not give rise to subpart F income, it qualifies as a bona fide hedging transaction as defined in paragraph (a)(4)(ii) of this section. Therefore, *CFC1*'s foreign exchange gain or loss from that forward contract will not be treated as foreign personal holding company income or loss under this paragraph (g).

(iii) Because the forward contract to purchase Yen was entered into by *CFC2* in order to

assume currency risks incurred by *CFC1* it does not qualify as a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section. Thus, foreign exchange gain or loss recognized by *CFC2* from that forward contract will be foreign personal holding company income. Because *CFC2* entered into the forward contract to sell Yen in order to hedge currency risks of *CFC1*, that forward contract also does not qualify as a bona fide hedging transaction. Thus, *CFC2*'s foreign currency gain or loss arising from that forward contract will be foreign personal holding company income.

(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability.* Except as provided in paragraph (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§1.861–9T and 1.861–12T.

(3) *Election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category—*(i) *In general.* For taxable years of a controlled foreign corporation beginning on or after November 6, 1995, elect, under this paragraph (g)(3), to exclude foreign currency gain or loss otherwise includible in the computation of foreign personal holding company income under this paragraph (g) from the computation of foreign personal holding company income under this paragraph (g) and include such foreign currency gain or loss in the category (or categories) of subpart F income (described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A)(I) or (2)) to which such gain or loss relates. If an election is made under this paragraph (g)(3) with respect to a category (or categories) of subpart F income described in section 952(a), or, in the case of foreign base company income, described in §1.954–1(c)(1)(iii)(A)(I) or (2), the election shall apply to all foreign currency gain or loss that arises from—

(A) A transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business that gives rise to income in that category (or categories) and that is clearly determinable from the records of the controlled foreign corporation as being

derived from such transaction or property; and

(B) A bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property described in paragraph (g)(3)-(i)(A) of this section. For purposes of this paragraph (g)(3)(i)(B), a hedging transaction will satisfy the aggregate hedging rules of §1.1221-2(c)(7) only if all (or all but a *de minimis* amount) of the aggregate risk being hedged arises in connection with transactions or property that generate the same category of subpart F income described in section 952(a), or, in the case of foreign base company income, described in §1.954-1(c)(1)(iii)(A)(I) or (2).

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in §1.964-1(c)(5), make the election on behalf of the controlled foreign corporation by filing a statement with their original income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is made, clearly indicating that such election has been made. If the controlling United States shareholders elect to apply these regulations retroactively, under §1.954-0(a)(1)(ii), the election under this paragraph (g)(3) may be made by the amended return filed pursuant to the election under §1.954-0(a)(1)(ii). The controlling United States shareholders filing the election statement described in this paragraph (g)(3)(ii) must provide copies of the election statement to all other United States shareholders of the electing controlled foreign corporation. Failure to provide copies of such statement will not cause an election under this paragraph (g)(3) to be voidable by the controlled foreign corporation or the controlling United States shareholders. However, the District Director has discretion to void the election if it is determined that there was no reasonable cause for the failure to provide copies of such statement. The statement shall include the following information—

(A) The name, address, taxpayer identification number, and taxable year of each United States shareholder;

(B) The name, address, and taxable year of the controlled foreign corporation for which the election is effective; and

(C) Any additional information required by the Commissioner by administrative pronouncement.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(iv) *Example.* The following example illustrates the provisions of this paragraph (g)(3).

Example. (i) *CFC*, a controlled foreign corporation, is a sales company that earns foreign base company sales income under section 954(d). *CFC* makes an election under this paragraph (g)(3) to treat foreign currency gains or losses that arise from a specific category (or categories) of subpart F income (as described in section 952(a), or, in the case of foreign base company income, as described in §1.954-1(c)(1)(iii)(A)(I) or (2)) as that type of income. *CFC* aggregates the currency risk on all of its transactions that generate foreign base company sales income and hedges this net currency exposure.

(ii) Assuming no more than a *de minimis* amount of risk in the pool of risks being hedged arises from transactions or property that generate income other than foreign base company sales income, pursuant to its election under (g)(3), *CFC*'s net foreign currency gain from the pool and the hedging transactions will be treated as foreign base company sales income under section 954(d), rather than as foreign personal holding company income under section 954(c)(1)(D). If the pool of risks and the hedging transactions generate a net foreign base company sales, however, *CFC* must apply the rules of §1.954-1(c)(1)(ii).

(4) *Election to treat all foreign currency gains or losses as foreign personal holding company income—(i) In general.* If the controlling United States shareholders make an election under this paragraph (g)(4), the controlled foreign corporation shall include in its computation of foreign personal holding company income the excess of foreign currency gains over losses or the excess of foreign currency losses over gains attributable to any section 988 transaction (except those described in paragraph (g)(5) of this section) and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D). Separate elections for section 1256 contracts and section 988 transactions are not permitted. An election under this paragraph (g)(4) supersedes an election under paragraph (g)(3) of this section.

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in §1.964-1(c)(5), make the election on behalf of the

controlled foreign corporation in the same time and manner as provided in paragraph (g)(3)(ii) of this section.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(5) *Gains and losses not subject to this paragraph—(i) Capital gains and losses.* Gain or loss that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss for purposes of this paragraph (g). Such gain or loss is treated as gain or loss from the sale or exchange of property that is included in the computation of foreign personal holding company income under paragraph (e)(1) of this section. Paragraph (a)(2) of this section provides other rules concerning income described in more than one category of foreign personal holding company income.

(ii) *Income not subject to section 988.* Gain or loss that is not treated as foreign currency gain or loss by reason of section 988(a)(2) or (d) is not foreign currency gain or loss for purposes of this paragraph (g). However, such gain or loss may be included in the computation of other categories of foreign personal holding company income in accordance with its characterization under section 988(a)(2) or (d) (for example, foreign currency gain that is treated as interest income under section 988(a)(2) will be included in the computation of foreign personal holding company income under paragraph (b)(ii) of this section).

(iii) *Qualified business units using the dollar approximate separate transactions method.* This paragraph (g) does not apply to any DASTM gain or loss computed under §1.985-3(d). Such gain or loss is allocated under the rules of §1.985-3(e)(2)(iv) or (e)(3). However, the provisions of this paragraph (g) do apply to section 988 transactions denominated in a currency other than the United States dollar or the currency that would be the qualified business unit's functional currency were it not hyperinflationary.

(iv) *Gain or loss allocated under §1.861-9.* [Reserved]

(h) *Income equivalent to interest—(1) In general—(i) Inclusion in foreign personal holding company income.* Except as provided in this paragraph (h),

foreign personal holding company income includes income equivalent to interest as defined in paragraph (h)(2) of this section.

(ii) *Exceptions*—(A) *Liability hedging transactions*. Income, gain, deduction or loss that is allocated and apportioned in the same manner as interest expense under the provisions of §1.861-9T is not income equivalent to interest for purposes of this paragraph (h).

(B) *Interest*. Amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest for purposes of this paragraph (h).

(2) *Definition of income equivalent to interest*—(i) *In general*. The term *income equivalent to interest* includes income that is derived from—

(A) A transaction or series of related transactions in which the payments, net payments, cash flows or return predominantly reflect the time value of money;

(B) Transactions in which the payments (or a predominant portion thereof) are, in substance, for the use or forbearance of money;

(C) Notional principal contracts, to the extent provided in paragraph (h)(3) of this section;

(D) Factoring, to the extent provided in paragraph (h)(4) of this section;

(E) Conversion transactions, but only to the extent that gain realized with respect to such a transaction is treated as ordinary income under section 1258;

(F) The performance of services, to the extent provided in paragraph (h)(5) of this section;

(G) The commitment by a lender to provide financing, if any portion of such financing is actually provided;

(H) Transfers of debt securities subject to section 1058; and

(I) Other transactions, as provided by the Commissioner in published guidance. See §601.601(d)(2) of this chapter.

(ii) *Income from the sale of property*. Income from the sale of property will not be treated as income equivalent to interest by reason of paragraph (h)(2)(i)(A) or (B) of this section. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an ar-

angement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes an advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-day payment terms from one person and sells that property to another person on 90-day payment terms and at prearranged prices and terms such that the foreign corporation bears no substantial economic risk with respect to the purchase and sale other than the risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(3) *Notional principal contracts*—(i) *In general*. Income equivalent to interest includes income from notional principal contracts denominated in the functional currency of the taxpayer (or a qualified business unit of the taxpayer, as defined in section 989(a)), the value of which is determined solely by reference to interest rates or interest rate indices, to the extent that the income from such transactions accrues on or after August 14, 1989.

(ii) *Regular dealers*. Income equivalent to interest does not include income earned by a regular dealer (as defined in paragraph (a)(4)(iv) of this section) from notional principal contracts that are dealer property (as defined in paragraph (a)(4)(v) of this section).

(4) *Income equivalent to interest from factoring*—(i) *General rule*. Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(4)(ii) of this section, the term *factoring income* includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable). The rules of this paragraph (h)(4) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored

receivable or the obligor under a receivable.

(ii) *Exceptions*. Factoring income shall not include—

(A) Income treated as interest under section 864(d)(1) or (6) (relating to income derived from trade or service receivables of related persons), even if such income is treated as not described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short-term rate (as defined under section 1274) (or the analogous rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable*. For purposes of this paragraph (h)(4), the term *factored receivable* includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(4), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Examples*. The following examples illustrate the application of this paragraph (h)(4).

Example 1. DP, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. FS acquires accounts receivable arising from the sale of property by unrelated corporation X. The receivables have a face amount of \$100, and after 30 days bear

stated interest equal to at least 120 percent of the applicable Federal short-term rate (determined as of the date the receivables are acquired by FS). FS purchases the receivables from X for \$95 on Day 1 and collects \$100 plus stated interest from the obligor under the receivables on Day 40. Income (other than stated interest) derived by FS from the factored receivables is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

Example 2. The facts are the same as in *Example 1*, except that, rather than collecting \$100 plus stated interest from the obligor under the factored receivables on Day 40, FS sells the receivables to controlled foreign corporation Y on Day 15 for \$97. Both the income derived by FS on the factored receivables and the income derived by Y (other than stated interest) on the receivables are factoring income within the meaning of paragraph (h)(4)(i) of this section, and therefore, constitute income equivalent to interest.

Example 3. The facts are the same as in *Example 1*, except that FS purchases the receivables from X for \$98 on Day 30. Income derived by FS from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

Example 4. The facts are the same as in *Example 3*, except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by FS from this maturity factoring of the receivables is excluded from factoring income under paragraph (h)(4)(ii)(C) of this section and, therefore, does not give rise to income equivalent to interest.

Example 5. The facts are the same as in *Example 4*, except that FS sells the factored receivables to Y for \$99 on day 45, at which time stated interest is accruing on the unpaid balance of \$100. Because interest was accruing at the time Y acquired the receivables at a rate equal to at least 120 percent of the applicable Federal short-term rate, income derived by Y from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

Example 6. DP, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of FS, a controlled foreign corporation. On Day 1, individual A uses a credit card issued by DP to purchase shoes priced at \$100 from X, a foreign corporation unrelated to DP, FS, or A. On Day 7, X transfers the receivable (which does not bear stated interest) arising from A's purchase to FS in exchange for \$95. FS collects \$100 from A on Day 45. Income derived by FS on the factored receivable is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the controlled foreign corporation constitutes income equivalent to interest to the extent that interest income would be

imputed under the principles of section 483 or the original issue discount provisions (sections 1271 through 1275), if—

(i) Such provisions applied to contracts for the performance of services;

(ii) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months; and

(iii) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

(6) *Examples.* The following examples illustrate the application of this paragraph (h).

Example 1. CFC, a controlled foreign corporation, promises that Corporation A may borrow up to \$500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, Corporation A pays CFC a commitment fee of \$2. Pursuant to this agreement, CFC lends \$80 to Corporation A. As a result, the entire \$2 fee is included in the computation of CFC's foreign personal holding company income under paragraph (h)(2)(i)(G) of this section.

Example 2. (i) At the beginning of its current taxable year, CFC, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by Corporation A having a \$100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (LIBOR) plus one percentage point. Contemporaneously, CFC borrows \$100 from Corporation B for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, CFC accrues \$11 of interest from Corporation A on the bond. Because interest is excluded from the definition of income equivalent to interest under paragraph (h)(1)(ii)(B) of this section, the \$11 is not income equivalent to interest.

(iii) During its current taxable year, CFC incurs \$10 of interest expense with respect to the borrowing from Corporation B. That expense is allocated and apportioned to, and reduces, subpart F income to the extent provided in section 954(b)(5) and §§1.861-9T through 1.861-12T and 1.954-1(c).

Example 3. (i) On January 1, 1994, CFC, a controlled foreign corporation with the United States dollar as its functional currency, purchases at face value a 10-year debt instrument issued by Corporation A having a \$100 principal amount and bearing a floating rate of interest set at the LIBOR plus one percentage point payable on December 31st of each year. CFC subsequently determines that it would prefer receiving a fixed rate of return. Accordingly, on January 1, 1995, CFC enters into a 9-year interest rate swap agreement with Corporation B whereby Corporation B promises to pay CFC on December 31st of each year an amount equal to 10 percent on a notional principal amount of \$100. In exchange, CFC promises to pay Corporation B an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) On December 31, 1995, CFC receives \$9 of interest income from Corporation A with respect to the debt instrument. On the same day, CFC receives a total of \$10 from Corporation B

and pays \$9 to Corporation B with respect to the interest rate swap.

(iii) The \$9 of interest income is foreign personal holding income under section 954(c)(1). Pursuant to §1.446-3(d), CFC recognizes \$1 of swap income for its 1995 taxable year that is also foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(C) of this section.

Example 4. (i) CFC, a controlled foreign corporation, purchases commodity X on the spot market for \$100 and, contemporaneously, enters into a 3-month forward contract to sell commodity X for \$104, a price set by the forward market.

(ii) Assuming that substantially all of CFC's expected return is attributable to the time value of the net investment, as described in section 1258(c)(1), the transaction is a conversion transaction under section 1258(c). Accordingly, any gain treated as ordinary income under section 1258(a) will be foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(E) of this section.

Par. 4. Section 1.957-1 is amended by adding paragraphs (a), (c) *Examples 8 through 10*, and (d) to read as follows:

§1.957-1 Definition of controlled foreign corporation.

(a) *In general.* The term *controlled foreign corporation* means any foreign corporation of which more than 50 percent (or such lesser amount as is provided in section 957(b) or section 953(c)) of either—

(1) The total combined voting power of all classes of stock of the corporation entitled to vote; or

(2) The total value of the stock of the corporation, is owned within the meaning of section 958(a), or (except for purposes of section 953(c)) is considered as owned by applying the rules of section 958(b) and §1.958-2, by United States shareholders on any day during the taxable year of such foreign corporation. For the definition of the term *United States shareholder*, see sections 951(b) and 953(c)(1)(A). For the definition of the term *foreign corporation*, see §301.7701-5 of this chapter (Procedure and Administration Regulations). For the treatment of associations as corporations, see section 7701(a)(3) and §§301.7701-1 and 301.7701-2 of this chapter. For the definition of the term *stock*, see sections 958(a)(3) and 7701(a)(7). For the classification of a member in an association, joint stock company or insurance company as a shareholder, see section 7701(a)(8).

* * * * *

(c) * * *

Example 8. For its prior taxable year, JV, a foreign corporation, had outstanding 1000 shares of class A stock, which is voting common, and 1000 shares of class B stock, which is nonvoting preferred. DP, a domestic corporation, and FP, a foreign corporation, each owned precisely 500 shares of both class A and class B stock, and each elected 5 of the 10 members of JV's board of directors. The other facts and circumstances were such that JV was not a controlled foreign corporation on any day of the prior taxable year. On the first day of the current taxable year, DP purchased one share of class B stock from FP. JV was a controlled foreign corporation on that day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b).

Example 9. The facts are the same as in Example 8 except that the stock of FP was publicly traded, FP had one class of stock, and on the first day of the current taxable year DP purchased one share of FP stock on the foreign stock exchange instead of purchasing one share of JV stock from FP. JV became a controlled foreign corporation on that day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b).

Example 10. X, a foreign corporation, is incorporated under the laws of country Y. Under the laws of country Y, X is considered a mutual insurance company. X issues insurance policies that provide the policyholder with the right to vote for directors of the corporation, the right to a share of the assets upon liquidation in proportion to premiums paid, and the right to receive policyholder dividends in proportion to premiums paid. Only policyholders are provided with the right to vote for directors, share in assets upon liquidation, and receive distributions. United States policyholders contribute 25 percent of the premiums and have 25 percent of the outstanding rights to vote for the board of directors. Based on these facts, the United States policyholders are United States shareholders owning the requisite combined voting power and value. Thus, X is a controlled foreign corporation for purposes of taking into account related person insurance income under section 953(c).

(d) *Effective date.* Paragraphs (a) and (c) Examples 8 through 10 of this section are effective for taxable years of a controlled foreign corporation beginning after March 7, 1996.

§1.954A-1 and 1.954A-2 [Removed]

Par. 5. Sections 1.954A-1 and 1.954A-2 are removed.

§1.957-1T [Removed]

Par. 6. Section 1.957-1T is removed.

PART 4 [ADDED]

Par. 7. 26 CFR part 4 is added to read as follows:

PART 4—TEMPORARY INCOME TAX REGULATIONS UNDER SECTION 954 OF THE INTERNAL REVENUE CODE

Sec.

4.954-0 Introduction.

4.954-1 Foreign base company income; taxable years beginning after December 31, 1986.

4.954-2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

Authority: 26 U.S.C. 7805.

§4.954-0 also issued under 26 U.S.C. 954(b) and (c).

§4.954-1 also issued under 26 U.S.C. 954(b) and (c).

§4.954-2 also issued under 26 U.S.C. 954(b) and (c).

§§1.954-0T, 1.954-1T and 1.954-2T [Redesignated as §§4.954-0, 4.954-1 and 4.954-2]

Par. 8. Sections 1.954-0T, 1.954-1T and 1.954-2T are redesignated as §§4.954-0, 4.954-1 and 4.954-2, respectively, and the language "temporary" is removed at the end of each section heading.

Par. 9. Newly designated §4.954-0 is amended by:

1. Removing the language "§§1.954-1T and 1.954-2T" from the first sentence of paragraph (a)(1) and adding "§§4.954-1 and 4.954-2" in its place.

2. Adding a sentence at the end of paragraph (a)(1) to read as set forth below.

3. In paragraph (b) by removing the entries numbered (I), (II), and (III) and adding in their places entries for the headings of §§4.954-0 through 4.954-2 as follows:

§4.954-0 Introduction.

(a) * * * (1) * * * For further guidance, see §1.954-0(a) of this chapter.

(b) * * *

§4.954-0 Introduction.

* * * * *

§4.954-1 Foreign base company income.

* * * * *

§4.954-2 Foreign personal holding company income.

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* * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows: Authority: 26 USC 7805.

Par. 11. In §602.101, paragraph c is amended by:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described Current OMB control number

* * * * *

1.954-1T 1545-1068
1.954-2T 1545-1068

* * * * *

1.954A-2 1545-0755

2. Adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described Current OMB control number

* * * * *

1.954-1 1545-1068
1.954-2 1545-1068

* * * * *

4.954-1 1545-1068
4.954-2 1545-1068

* * * * *

Margaret Milner Richardson,
Commissioner of
Internal Revenue.

Approved August 22, 1995.

Cynthia Gibson Beerbower,
Acting Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on September 6, 1995, 8:45 a.m., and published in the issue of the Federal Register for September 7, 1995, 60 F.R. 46500 as corrected by 60 F.R. 62024)

Section 960.—Special Rules for Foreign Tax Credits

Rev. Rul. 92-63, 1992-2 C.B. 195, (as corrected by Rev. Rul. 92-63A, 1992-2 C.B. 197) is modified and superseded with respect to countries listed under section 901(j)(2)(A) of the Code. See Rev. Rul. 95-63, page 85.

Part IV.—Domestic International Sales Corporations Subpart B.—Treatment of Distribution to Shareholders

Section 995.—Taxation of DISC Income to Shareholders

1995 base period T-bill rate. The “base period T-bill rate” for the period ending September 30, 1995, is published, as required by section 995(f)(4) of the Code.

Rev. Rul. 95-77

Section 995(f)(1) of the Internal Revenue Code provides that a shareholder of a DISC shall pay interest each taxable year in an amount equal to the product of the shareholder’s DISC-related deferred tax liability for the year and the “base period T-bill rate.” Under section 995(f)(4), the base period T-bill rate is the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of United States Treasury bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with (or of the most recent calendar year ending before) the close of the taxable year of the shareholder. The base period T-bill rate for the period ending September 30, 1995, is 6.30 percent.

Pursuant to section 6622 of the Code, interest must be compounded daily. The table below provides factors for compounding the base period T-bill rate daily for any number of days in the shareholder’s taxable year (including a 52-53 week accounting period)

| Days | 6.30 Percent Factor |
|------|---------------------|
| 30 | 0.005191062 |
| 31 | 0.005364561 |
| 32 | 0.005538090 |
| 33 | 0.005711649 |
| 34 | 0.005885237 |
| 35 | 0.006058856 |
| 36 | 0.006232504 |
| 37 | 0.006406183 |
| 38 | 0.006579891 |
| 39 | 0.006753630 |
| 40 | 0.006927398 |
| 41 | 0.007101196 |
| 42 | 0.007275025 |
| 43 | 0.007448883 |
| 44 | 0.007622772 |
| 45 | 0.007796690 |
| 46 | 0.007970639 |
| 47 | 0.008144617 |
| 48 | 0.008318626 |
| 49 | 0.008492664 |
| 50 | 0.008666733 |
| 51 | 0.008840831 |
| 52 | 0.009014960 |
| 53 | 0.009189119 |
| 54 | 0.009363308 |
| 55 | 0.009537527 |
| 56 | 0.009711776 |
| 57 | 0.009886055 |
| 58 | 0.010060364 |
| 59 | 0.010234703 |
| 60 | 0.010409072 |
| 61 | 0.010583471 |
| 62 | 0.010757901 |
| 63 | 0.010932361 |
| 64 | 0.011106850 |
| 65 | 0.011281370 |
| 66 | 0.011455920 |
| 67 | 0.011630500 |
| 68 | 0.011805110 |
| 69 | 0.011979751 |
| 70 | 0.012154421 |
| 71 | 0.012329122 |
| 72 | 0.012503852 |
| 73 | 0.012678613 |
| 74 | 0.012853404 |
| 75 | 0.013028226 |
| 76 | 0.013203077 |
| 77 | 0.013377959 |
| 78 | 0.013552871 |
| 79 | 0.013727813 |
| 80 | 0.013902785 |
| 81 | 0.014077787 |
| 82 | 0.014252820 |
| 83 | 0.014427883 |
| 84 | 0.014602976 |
| 85 | 0.014778099 |
| 86 | 0.014953252 |
| 87 | 0.015128436 |
| 88 | 0.015303650 |
| 89 | 0.015478894 |
| 90 | 0.015654169 |

1995 Annual Rate, Compounded Daily

Days 6.30 Percent Factor

| | |
|----|-------------|
| 1 | 0.000172603 |
| 2 | 0.000345235 |
| 3 | 0.000517898 |
| 4 | 0.000690590 |
| 5 | 0.000863312 |
| 6 | 0.001036063 |
| 7 | 0.001208845 |
| 8 | 0.001381656 |
| 9 | 0.001554498 |
| 10 | 0.001727369 |
| 11 | 0.001900270 |
| 12 | 0.002073200 |
| 13 | 0.002246161 |
| 14 | 0.002419151 |
| 15 | 0.002592172 |
| 16 | 0.002765222 |
| 17 | 0.002938302 |
| 18 | 0.003111412 |
| 19 | 0.003284551 |
| 20 | 0.003457721 |
| 21 | 0.003630921 |
| 22 | 0.003804150 |
| 23 | 0.003977409 |
| 24 | 0.004150699 |
| 25 | 0.004324018 |
| 26 | 0.004497367 |
| 27 | 0.004670746 |
| 28 | 0.004844155 |
| 29 | 0.005017594 |

| Days | 6.30 Percent Factor | Days | 6.30 Percent Factor | Days | 6.30 Percent Factor |
|------|---------------------|------|---------------------|------|---------------------|
| 91 | 0.015829473 | 152 | 0.026580476 | 213 | 0.037445261 |
| 92 | 0.016004808 | 153 | 0.026757666 | 214 | 0.037624327 |
| 93 | 0.016180174 | 154 | 0.026934887 | 215 | 0.037803424 |
| 94 | 0.016355569 | 155 | 0.027112139 | 216 | 0.037982551 |
| 95 | 0.016530995 | 156 | 0.027289422 | 217 | 0.038161710 |
| 96 | 0.016706451 | 157 | 0.027466735 | 218 | 0.038340899 |
| 97 | 0.016881937 | 158 | 0.027644078 | 219 | 0.038520120 |
| 98 | 0.017057454 | 159 | 0.027821452 | 220 | 0.038699371 |
| 99 | 0.017233001 | 160 | 0.027998857 | 221 | 0.038878654 |
| 100 | 0.017408578 | 161 | 0.028176293 | 222 | 0.039057967 |
| 101 | 0.017584185 | 162 | 0.028353759 | 223 | 0.039237311 |
| 102 | 0.017759823 | 163 | 0.028531255 | 224 | 0.039416686 |
| 103 | 0.017935491 | 164 | 0.028708783 | 225 | 0.039596093 |
| 104 | 0.018111190 | 165 | 0.028886341 | 226 | 0.039775530 |
| 105 | 0.018286919 | 166 | 0.029063929 | 227 | 0.039954998 |
| 106 | 0.018462678 | 167 | 0.029241548 | 228 | 0.040134497 |
| 107 | 0.018638467 | 168 | 0.029419198 | 229 | 0.040314027 |
| 108 | 0.018814287 | 169 | 0.029596879 | 230 | 0.040493588 |
| 109 | 0.018990137 | 170 | 0.029774590 | 231 | 0.040673180 |
| 110 | 0.019166018 | 171 | 0.029952332 | 232 | 0.040852803 |
| 111 | 0.019341928 | 172 | 0.030130105 | 233 | 0.041032457 |
| 112 | 0.019517870 | 173 | 0.030307908 | 234 | 0.041212142 |
| 113 | 0.019693841 | 174 | 0.030485742 | 235 | 0.041391858 |
| 114 | 0.019869843 | 175 | 0.030663607 | 236 | 0.041571605 |
| 115 | 0.020045875 | 176 | 0.030841502 | 237 | 0.041751384 |
| 116 | 0.020221938 | 177 | 0.031019428 | 238 | 0.041931193 |
| 117 | 0.020398031 | 178 | 0.031197385 | 239 | 0.042111033 |
| 118 | 0.020574155 | 179 | 0.031375372 | 240 | 0.042290904 |
| 119 | 0.020750309 | 180 | 0.031553390 | 241 | 0.042470806 |
| 120 | 0.020926493 | 181 | 0.031731439 | 242 | 0.042650740 |
| 121 | 0.021102708 | 182 | 0.031909519 | 243 | 0.042830704 |
| 122 | 0.021278953 | 183 | 0.032087629 | 244 | 0.043010699 |
| 123 | 0.021455228 | 184 | 0.032265771 | 245 | 0.043190726 |
| 124 | 0.021631534 | 185 | 0.032443943 | 246 | 0.043370784 |
| 125 | 0.021807871 | 186 | 0.032622145 | 247 | 0.043550872 |
| 126 | 0.021984238 | 187 | 0.032800379 | 248 | 0.043730992 |
| 127 | 0.022160635 | 188 | 0.032978643 | 249 | 0.043911143 |
| 128 | 0.022337063 | 189 | 0.033156938 | 250 | 0.044091325 |
| 129 | 0.022513521 | 190 | 0.033335263 | 251 | 0.044271538 |
| 130 | 0.022690009 | 191 | 0.033513620 | 252 | 0.044451782 |
| 131 | 0.022866528 | 192 | 0.033692007 | 253 | 0.044632057 |
| 132 | 0.023043078 | 193 | 0.033870425 | 254 | 0.044812363 |
| 133 | 0.023219658 | 194 | 0.034048874 | 255 | 0.044992701 |
| 134 | 0.023396269 | 195 | 0.034227354 | 256 | 0.045173070 |
| 135 | 0.023572910 | 196 | 0.034405864 | 257 | 0.045353469 |
| 136 | 0.023749581 | 197 | 0.034584406 | 258 | 0.045533900 |
| 137 | 0.023926283 | 198 | 0.034762978 | 259 | 0.045714362 |
| 138 | 0.024103016 | 199 | 0.034941581 | 260 | 0.045894855 |
| 139 | 0.024279779 | 200 | 0.035120214 | 261 | 0.046075380 |
| 140 | 0.024456572 | 201 | 0.035298879 | 262 | 0.046255935 |
| 141 | 0.024633396 | 202 | 0.035477574 | 263 | 0.046436522 |
| 142 | 0.024810251 | 203 | 0.035656301 | 264 | 0.046617140 |
| 143 | 0.024987136 | 204 | 0.035835058 | 265 | 0.046797789 |
| 144 | 0.025164051 | 205 | 0.036013846 | 266 | 0.046978469 |
| 145 | 0.025340997 | 206 | 0.036192665 | 267 | 0.047159180 |
| 146 | 0.025517974 | 207 | 0.036371514 | 268 | 0.047339923 |
| 147 | 0.025694981 | 208 | 0.036550395 | 269 | 0.047520696 |
| 148 | 0.025872019 | 209 | 0.036729306 | 270 | 0.047701501 |
| 149 | 0.026049087 | 210 | 0.036908249 | 271 | 0.047882337 |
| 150 | 0.026226186 | 211 | 0.037087222 | 272 | 0.048063205 |
| 151 | 0.026403316 | 212 | 0.037266226 | 273 | 0.048244103 |

| Days | 6.30 Percent Factor |
|------|---------------------|
| 274 | 0.048425033 |
| 275 | 0.048605994 |
| 276 | 0.048786986 |
| 277 | 0.048968010 |
| 278 | 0.049149065 |
| 279 | 0.049330151 |
| 280 | 0.049511268 |
| 281 | 0.049692417 |
| 282 | 0.049873596 |
| 283 | 0.050054807 |
| 284 | 0.050236050 |
| 285 | 0.050417323 |
| 286 | 0.050598628 |
| 287 | 0.050779964 |
| 288 | 0.050961332 |
| 289 | 0.051142731 |
| 290 | 0.051324161 |
| 291 | 0.051505622 |
| 292 | 0.051687115 |
| 293 | 0.051868639 |
| 294 | 0.052050195 |
| 295 | 0.052231781 |
| 296 | 0.052413399 |
| 297 | 0.052595049 |
| 298 | 0.052776730 |
| 299 | 0.052958442 |
| 300 | 0.053140185 |
| 301 | 0.053321960 |
| 302 | 0.053503766 |
| 303 | 0.053685604 |
| 304 | 0.053867473 |
| 305 | 0.054049373 |
| 306 | 0.054231305 |
| 307 | 0.054413268 |
| 308 | 0.054595263 |
| 309 | 0.054777289 |
| 310 | 0.054959347 |
| 311 | 0.055141435 |
| 312 | 0.055323556 |
| 313 | 0.055505707 |
| 314 | 0.055687891 |
| 315 | 0.055870105 |
| 316 | 0.056052351 |
| 317 | 0.056234629 |
| 318 | 0.056416938 |
| 319 | 0.056599278 |
| 320 | 0.056781650 |
| 321 | 0.056964054 |
| 322 | 0.057146489 |
| 323 | 0.057328955 |
| 324 | 0.057511453 |
| 325 | 0.057693982 |
| 326 | 0.057876543 |
| 327 | 0.058059135 |
| 328 | 0.058241759 |
| 329 | 0.058424415 |
| 330 | 0.058607102 |
| 331 | 0.058789820 |
| 332 | 0.058972570 |

| Days | 6.30 Percent Factor |
|------|---------------------|
| 333 | 0.059155352 |
| 334 | 0.059338165 |
| 335 | 0.059521010 |
| 336 | 0.059703886 |
| 337 | 0.059886794 |
| 338 | 0.060069733 |
| 339 | 0.060252704 |
| 340 | 0.060435706 |
| 341 | 0.060618741 |
| 342 | 0.060801806 |
| 343 | 0.060984904 |
| 344 | 0.061168032 |
| 345 | 0.061351193 |
| 346 | 0.061534385 |
| 347 | 0.061717609 |
| 348 | 0.061900864 |
| 349 | 0.062084151 |
| 350 | 0.062267470 |
| 351 | 0.062450820 |
| 352 | 0.062634202 |
| 353 | 0.062817616 |
| 354 | 0.063001061 |
| 355 | 0.063184538 |
| 356 | 0.063368046 |
| 357 | 0.063551587 |
| 358 | 0.063735158 |
| 359 | 0.063918762 |
| 360 | 0.064102397 |
| 361 | 0.064286064 |
| 362 | 0.064469763 |
| 363 | 0.064653493 |
| 364 | 0.064837256 |
| 365 | 0.065021049 |
| 366 | 0.065204875 |
| 367 | 0.065388732 |
| 368 | 0.065572621 |
| 369 | 0.065756542 |
| 370 | 0.065940494 |
| 371 | 0.066124479 |

Subchapter O.—Gain or Loss on Disposition of Property

Part II.—Basis Rules of General Application

Sectin 1016.—Adjustments to Basis

26 CFR 1.1016-3: Exhaustion, wear and tear, obsolescence, amortization, and depletion for periods since February 28, 1913.

Reduction of basis for business use of an automobile under either the optional standard mileage rate method or a mileage allowance under a reimbursement or other expense allowance arrangement. See Rev. Proc. 95-54, page 450.

Subchapter P.—Capital Gains or Losses
Part IV.—Special Rules for Determining Capital Gains and Losses

Section 1231.—Property Used in the Trade or Business and Involuntary Conversions

26 CFR 1.1231-1: Gains and losses from the sale or exchange of certain property used in the trade or business.

Guidance is provided concerning the use of an optional method of accounting that treats certain rent-to-own contracts as leases for federal income tax purposes. See Rev. Proc. 95-38, page 397.

Part V.—Special Rules for Bonds and Other Debt Instruments

Subpart A.—Original Issue Discount

Section 1273.—Determination of Amount of Original Issue Discount

26 CFR 1.1273-1: Definition of OID.

Definition of qualified stated interest. For purposes of the definition of “qualified stated interest” in § 1.1273-1(c), scheduled interest payments on a debt instrument are not “unconditionally payable” merely because, under the terms of the debt instrument, the failure to make interest payments when due requires (1) that the issuer forgo paying dividends, or (2) that interest accrue on the past-due payments at a rate that is 2 percentage points greater than the stated yield.

Rev. Rul. 95-70

ISSUE

For purposes of the definition of “qualified stated interest” in § 1.1273-1(c) of the Income Tax Regulations, are scheduled interest payments on a debt instrument “unconditionally payable” if, under the terms of the debt instrument, the failure to make interest payments when due requires (1) that the issuer forgo paying dividends, or (2) that interest accrue on the past-due payments at a rate that is 2 percentage points greater than the stated yield?

FACTS

Situation 1. On January 1, 1995, Y corporation issued a 15-year debt in-

strument to A for \$100x. The debt instrument provides for a principal payment of \$100x at maturity and for quarterly interest payments of \$2x, beginning on March 31, 1995, and ending on the maturity date. Thus, the yield on the debt instrument is 8 percent, compounded quarterly. Under the terms of the debt instrument, if Y corporation fails to make one or more interest payments when due, interest will accrue on the past-due interest at the 8 percent yield. The failure of Y corporation to make interest payments when due for 12 consecutive quarters will entitle A to sue for payment.

If past-due interest is outstanding, the terms of the debt instrument provide that Y corporation may not declare or pay any dividend on, redeem, purchase, acquire, or make a liquidation payment with respect to, its stock. Y corporation has a policy and a long-established history of regularly paying dividends on its stock. Any failure of Y corporation to pay regular dividends on its stock is reasonably expected to result in a significant decline in the value of its stock.

Situation 2. The facts are the same as in *Situation 1*, except that, under the terms of the debt instrument, if Y corporation fails to make one or more interest payments when due, interest will accrue on the past-due interest at the rate of 10 percent, compounded quarterly, rather than 8 percent. This higher interest rate, which the documents describe as a “penalty” rate, is in addition to the restriction on dividend payments.

LAW AND ANALYSIS

Sections 163(e) and 1271 through 1275 of the Internal Revenue Code provide rules for the treatment of debt instruments that have original issue discount. If a debt instrument is issued with original issue discount, the discount is includible in income by the holder of the instrument, and deductible by the issuer of the instrument, as it accrues. See §§ 163(e) and 1272.

Section 1273(a)(1) defines original issue discount as the excess (if any) of a debt instrument’s stated redemption price at maturity over the debt instrument’s issue price. Under § 1273(a)(2), a debt instrument’s stated redemption price at maturity includes all amounts payable on the instrument (other than any interest based on a fixed rate, and

payable unconditionally at fixed periodic intervals of 1 year or less during the entire term of the debt instrument).

The regulations under § 1273(a)(2) refer to interest that is excluded from the definition of stated redemption price at maturity as “qualified stated interest.” See § 1.1273-1(b). In general, § 1.1273-1(c)(1)(i) defines qualified stated interest as stated interest that is unconditionally payable at least annually at a single fixed rate. Under § 1.1273-1(c)(1)(ii), interest is unconditionally payable only if late payment or nonpayment is expected to be penalized or reasonable remedies exist to compel payment. Interest is not unconditionally payable, however, if the lending transaction does not reflect arm’s length dealing and the holder does not intend to enforce such remedies. For purposes of determining whether interest is unconditionally payable, the possibility of nonpayment due to default, insolvency, or similar circumstances is ignored.

The definition of unconditionally payable in § 1.1273-1(c)(1)(ii) is designed to limit qualified stated interest to interest that must be paid on a current basis. Stated interest is unconditionally payable only if the holder has the right to compel payment or to extract a penalty from the issuer for nonpayment. See S. Rep. No. 169 (Vol. 1), 98th Cong., 2d Sess. 255 (1984) (“[I]n general, interest will be considered payable unconditionally only if the failure to timely pay interest results in an acceleration of all amounts under the debt obligation or similar consequences.”) If the terms of the debt instrument do not provide the holder with the right to compel payment, they must provide for a penalty that inures directly to the benefit of the holder and that is large enough to ensure that, at the time the debt instrument is issued, it is reasonably certain that, absent insolvency, the issuer will make interest payments when due.

In *Situation 1*, the failure of Y corporation to make interest payments when due limits Y corporation’s ability to pay dividends on its stock. This dividend restriction is not a penalty within the meaning of § 1.1273-1(c)(1)(ii) because it does not inure directly to the benefit of the holder, A.

In *Situation 2*, if Y corporation fails to make interest payments when due, interest will accrue on the past-due interest at the “penalty” rate of 10

percent, compounded quarterly. This 10 percent rate increases the yield on the entire debt instrument above its stated 8 percent rate, and, therefore, inures directly to the benefit of the holder. Nevertheless, the increase in yield is not large enough to ensure that it is reasonably certain that, absent insolvency, Y corporation will make interest payments when due. It is possible that there may be circumstances in which the benefit of deferring is worth the additional cost. This increase in yield is thus not a penalty within the meaning of § 1.1273-1(c)(1)(ii). Depending on the facts and circumstances, however, an increase in yield that is 12 percentage points greater than the stated yield might be sufficient to ensure that, absent insolvency, interest payments are reasonably certain to be paid when due.

HOLDING

For purposes of the definition of “qualified stated interest” in § 1.1273-1(c), scheduled interest payments on a debt instrument are not “unconditionally payable” merely because, under the terms of the debt instrument, the failure to make interest payments when due requires (1) that the issuer forgo paying dividends, or (2) that interest accrue on the past-due payments at a rate that is 2 percentage points greater than the stated yield.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for July 1995.

Rev. Rul. 95-48

This revenue ruling provides various prescribed rates for federal income tax purposes for July 1995 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d)

of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-

exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for

determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the blended annual rate for purposes of section 7872.

REV. RUL. 95-48 TABLE 1

Applicable Federal Rates (AFR) for July 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-Term</i> | | | | |
| AFR | 5.97% | 5.88% | 5.84% | 5.81% |
| 110% AFR | 6.57% | 6.47% | 6.42% | 6.38% |
| 120% AFR | 7.18% | 7.06% | 7.00% | 6.96% |
| <i>Mid-Term</i> | | | | |
| AFR | 6.28% | 6.18% | 6.13% | 6.10% |
| 110% AFR | 6.92% | 6.80% | 6.74% | 6.71% |
| 120% AFR | 7.56% | 7.42% | 7.35% | 7.31% |
| 150% AFR | 9.48% | 9.27% | 9.17% | 9.10% |
| 175% AFR | 11.11% | 10.82% | 10.68% | 10.58% |
| <i>Long-Term</i> | | | | |
| AFR | 6.76% | 6.65% | 6.60% | 6.56% |
| 110% AFR | 7.45% | 7.32% | 7.25% | 7.21% |
| 120% AFR | 8.14% | 7.98% | 7.90% | 7.85% |

REV. RUL. 95-48 TABLE 2

Adjusted AFR for July 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------------|---------------|-------------------|------------------|----------------|
| Short-term adjusted AFR | 4.08% | 4.04% | 4.02% | 4.01% |
| Mid-term adjusted AFR | 4.64% | 4.59% | 4.56% | 4.55% |
| Long-term adjusted AFR | 5.60% | 5.52% | 5.48% | 5.46% |

REV. RUL. 95-48 TABLE 3

Rates Under Section 382 for July 1995

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 5.60% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months). | 5.88% |

REV. RUL. 95-48 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for July 1995

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.53% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.66% |

REV. RUL. 95-48 TABLE 5

Rate Under Section 7520 for July 1995

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 7.6% |
|---|------|

REV. RUL. 95-48 TABLE 6

Blended Annual Rate for 1995

| | |
|---|-------|
| Section 7872(e)(2) blended annual rate for 1995 | 6.58% |
|---|-------|

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for August 1995.

Rev. Rul. 95-51

This revenue ruling provides various

prescribed rates for federal income tax purposes for August 1995 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-

exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 95-51 TABLE 1

Applicable Federal Rates (AFR) for August 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-Term</i> | | | | |
| AFR | 5.73% | 5.65% | 5.61% | 5.58% |
| 110% AFR | 6.32% | 6.22% | 6.17% | 6.14% |
| 120% AFR | 6.89% | 6.78% | 6.72% | 6.69% |
| <i>Mid-Term</i> | | | | |
| AFR | 6.04% | 5.95% | 5.91% | 5.88% |
| 110% AFR | 6.66% | 6.55% | 6.50% | 6.46% |
| 120% AFR | 7.27% | 7.14% | 7.08% | 7.04% |
| 150% AFR | 9.13% | 8.93% | 8.83% | 8.77% |
| 175% AFR | 10.68% | 10.41% | 10.28% | 10.19% |
| <i>Long-Term</i> | | | | |
| AFR | 6.56% | 6.46% | 6.41% | 6.37% |
| 110% AFR | 7.24% | 7.11% | 7.05% | 7.01% |
| 120% AFR | 7.90% | 7.75% | 7.68% | 7.63% |

REV. RUL. 95-51 TABLE 2

Adjusted AFR for August 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------------|---------------|-------------------|------------------|----------------|
| Short-term adjusted AFR | 3.87% | 3.83% | 3.81% | 3.80% |
| Mid-term adjusted AFR | 4.63% | 4.58% | 4.55% | 4.54% |
| Long-term adjusted AFR | 5.67% | 5.59% | 5.55% | 5.53% |

REV. RUL. 95-51 TABLE 3

Rates Under Section 382 for August 1995

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 5.67% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months). | 5.88% |

REV. RUL. 95-51 TABLE 4

Appropriate Percentages Under Section 42(b)(2)
for August 1995

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.48% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.63% |

REV. RUL. 95-51 TABLE 5

Rate Under Section 7520 for August 1995

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest 7.2%

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1995.

Rev. Rul. 95-62

This revenue ruling provides various

prescribed rates for federal income tax purposes for September 1995 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-

term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 95-62 TABLE 1

Applicable Federal Rates (AFR) for September 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-Term</i> | | | | |
| AFR | 5.91% | 5.83% | 5.79% | 5.76% |
| 110% AFR | 6.51% | 6.41% | 6.36% | 6.33% |
| 120% AFR | 7.12% | 7.00% | 6.94% | 6.90% |
| <i>Mid-Term</i> | | | | |
| AFR | 6.38% | 6.28% | 6.23% | 6.20% |
| 110% AFR | 7.03% | 6.91% | 6.85% | 6.81% |
| 120% AFR | 7.68% | 7.54% | 7.47% | 7.42% |
| 150% AFR | 9.64% | 9.42% | 9.31% | 9.24% |
| 175% AFR | 11.29% | 10.99% | 10.84% | 10.75% |
| <i>Long-Term</i> | | | | |
| AFR | 6.91% | 6.79% | 6.73% | 6.70% |
| 110% AFR | 7.61% | 7.47% | 7.40% | 7.36% |
| 120% AFR | 8.32% | 8.15% | 8.07% | 8.01% |

REV. RUL. 95-62 TABLE 2
Adjusted AFR for September 1995

| | <i>Period for Compounding</i> | | | |
|-------------------------|-------------------------------|-------------------|------------------|----------------|
| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
| Short-term adjusted AFR | 3.91% | 3.87% | 3.85% | 3.84% |
| Mid-term adjusted AFR | 4.55% | 4.50% | 4.47% | 4.46% |
| Long-term adjusted AFR | 5.75% | 5.67% | 5.63% | 5.60% |

REV. RUL. 95-62 TABLE 3

Rates Under Section 382 for September 1995

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 5.75% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months). | 5.75% |

REV. RUL. 95-62 TABLE 4

Appropriate Percentages Under Section 42(b)(2)
for September 1995

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.56% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.67% |

REV. RUL. 95-62 TABLE 5

Rate Under Section 7520 for September 1995

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 7.6% |
|---|------|

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for October 1995.

Rev. Rul. 95-67

This revenue ruling provides various prescribed rates for federal income tax purposes for October 1995 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current

month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-

exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in

section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an

annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 95-67 TABLE 1

Applicable Federal Rates (AFR) for October 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-Term</i> | | | | |
| AFR | 5.90% | 5.82% | 5.78% | 5.75% |
| 110% AFR | 6.50% | 6.40% | 6.35% | 6.32% |
| 120% AFR | 7.10% | 6.98% | 6.92% | 6.88% |
| <i>Mid-Term</i> | | | | |
| AFR | 6.31% | 6.21% | 6.16% | 6.13% |
| 110% AFR | 6.95% | 6.83% | 6.77% | 6.73% |
| 120% AFR | 7.59% | 7.45% | 7.38% | 7.34% |
| 150% AFR | 9.54% | 9.32% | 9.21% | 9.14% |
| 175% AFR | 11.17% | 10.87% | 10.73% | 10.63% |
| <i>Long-Term</i> | | | | |
| AFR | 6.77% | 6.66% | 6.61% | 6.57% |
| 110% AFR | 7.46% | 7.33% | 7.26% | 7.22% |
| 120% AFR | 8.15% | 7.99% | 7.91% | 7.86% |

REV. RUL. 95-67 TABLE 2

Adjusted AFR for October 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-term</i> | | | | |
| adjusted AFR | 3.99% | 3.95% | 3.93% | 3.92% |
| <i>Mid-term</i> | | | | |
| adjusted AFR | 4.56% | 4.51% | 4.48% | 4.47% |
| <i>Long-term</i> | | | | |
| adjusted AFR | 5.75% | 5.67% | 5.63% | 5.60% |

REV. RUL. 95-67 TABLE 3

Rates Under Section 382 for October 1995

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 5.75% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.) | 5.75% |

REV. RUL. 95-67 TABLE 4

Appropriate Percentages Under Section 42(b)(2)
for October 1995

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.54% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.66% |

REV. RUL. 95-67 TABLE 5

Rate Under Section 7520 for October 1995

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 7.6% |
|---|------|

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for November 1995.

Rev. Rul. 95-73

This revenue ruling provides various

prescribed rates for federal income tax purposes for November 1995 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-

term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 95-73 TABLE 1

Applicable Federal Rates (AFR) for November 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------|---------------|-------------------|------------------|----------------|
| <i>Short-Term</i> | | | | |
| AFR | 5.79% | 5.71% | 5.67% | 5.64% |
| 110% AFR | 6.38% | 6.28% | 6.23% | 6.20% |
| 120% AFR | 6.97% | 6.85% | 6.79% | 6.75% |
| <i>Mid-Term</i> | | | | |
| AFR | 6.11% | 6.02% | 5.98% | 5.95% |
| 110% AFR | 6.73% | 6.62% | 6.57% | 6.53% |
| 120% AFR | 7.35% | 7.22% | 7.16% | 7.11% |
| 150% AFR | 9.23% | 9.03% | 8.93% | 8.86% |
| 175% AFR | 10.82% | 10.54% | 10.40% | 10.32% |
| <i>Long-Term</i> | | | | |
| AFR | 6.55% | 6.45% | 6.40% | 6.36% |
| 110% AFR | 7.23% | 7.10% | 7.04% | 7.00% |
| 120% AFR | 7.89% | 7.74% | 7.67% | 7.62% |

REV. RUL. 95-73 TABLE 2

Adjusted AFR for November 1995

Period for Compounding

| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
|-------------------------|---------------|-------------------|------------------|----------------|
| Short-term adjusted AFR | 3.97% | 3.93% | 3.91% | 3.90% |
| Mid-term adjusted AFR | 4.49% | 4.44% | 4.42% | 4.40% |
| Long-term adjusted AFR | 5.65% | 5.57% | 5.53% | 5.51% |

REV. RUL. 95-73 TABLE 3

Rates Under Section 382 for November 1995

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 5.65% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.) | 5.75% |

REV. RUL. 95-73 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for November 1995

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.48% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.64% |

REV. RUL. 95-73 TABLE 5

Rate Under Section 7520 for November 1995

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 7.4% |
|---|------|

(Also Sections 42, 280G, 382, 412, 467, 468, 483, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate, and the long-term exempt rate. For purposes of sections 1274, 1288, 382, and other sections of the Code, tables set forth the rates for December 1995.

Rev. Rul. 95-79

This revenue ruling provides various

prescribed rates for federal income tax purposes for December 1995 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-

exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the applicable rate of interest for 1996 for purposes of sections 846 and 807.

| REV. RUL. 95-79 TABLE 1 | | | | |
|--|-------------------------------|-------------------|------------------|----------------|
| Applicable Federal Rates (AFR) for December 1995 | | | | |
| | <i>Period for Compounding</i> | | | |
| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
| <i>Short-Term</i> | | | | |
| AFR | 5.65% | 5.57% | 5.53% | 5.51% |
| 110% AFR | 6.22% | 6.13% | 6.08% | 6.05% |
| 120% AFR | 6.79% | 6.68% | 6.63% | 6.59% |
| <i>Mid-Term</i> | | | | |
| AFR | 5.91% | 5.83% | 5.79% | 5.76% |
| 110% AFR | 6.51% | 6.41% | 6.36% | 6.33% |
| 120% AFR | 7.12% | 7.00% | 6.94% | 6.90% |
| 150% AFR | 8.94% | 8.75% | 8.66% | 8.59% |
| 175% AFR | 10.46% | 10.20% | 10.07% | 9.99% |
| <i>Long-Term</i> | | | | |
| AFR | 6.36% | 6.26% | 6.21% | 6.18% |
| 110% AFR | 7.01% | 6.89% | 6.83% | 6.79% |
| 120% AFR | 7.65% | 7.51% | 7.44% | 7.40% |

| REV. RUL. 95-79 TABLE 2 | | | | |
|--------------------------------|-------------------------------|-------------------|------------------|----------------|
| Adjusted AFR for December 1995 | | | | |
| | <i>Period for Compounding</i> | | | |
| | <i>Annual</i> | <i>Semiannual</i> | <i>Quarterly</i> | <i>Monthly</i> |
| <i>Short-term</i> | | | | |
| adjusted AFR | 3.82% | 3.78% | 3.76% | 3.75% |
| <i>Mid-term</i> | | | | |
| adjusted AFR | 4.44% | 4.39% | 4.37% | 4.35% |
| <i>Long-term</i> | | | | |
| adjusted AFR | 5.46% | 5.39% | 5.35% | 5.33% |

REV. RUL. 95-79 TABLE 3

Rates Under Section 382 for December 1995

| | |
|--|-------|
| Adjusted federal long-term rate for the current month | 5.46% |
| Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months). | 5.75% |

REV. RUL. 95-79 TABLE 4

Appropriate Percentages Under Section 42(b)(2)
for December 1995

| | |
|--|-------|
| Appropriate percentage for the 70% present value low-income housing credit | 8.44% |
| Appropriate percentage for the 30% present value low-income housing credit | 3.62% |

REV. RUL. 95-79 TABLE 5

Rate Under Section 7520 for December 1995

| | |
|---|------|
| Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest | 7.2% |
|---|------|

REV. RUL. 95-79 TABLE 6

Rate Under Sections 846 and 807

| | |
|---|-------|
| Applicable rate of interest for 1996 for purposes of sections 846 and 807 | 6.63% |
|---|-------|

Subpart D.—Miscellaneous Provisions

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for

the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Subchapter S.—Tax Treatment of S Corporations and Their Shareholders
Part I.—In General

Section 1361.—S Corporation Defined

26 CFR 1.1361-1: S corporation defined.

T.D. 8600

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 18 and 602

Definition of an S corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the definition of an *S corporation* under section 1361 of the Internal Revenue Code of 1986. Changes to the applicable tax law were made by the Subchapter S Revision Act of 1982, the Tax Reform Act of 1984, the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, and the Omnibus Budget Reconciliation Act of 1989. The final regulations provide guidance on the requirements to be an *S corporation*.

EFFECTIVE DATE: These regulations are effective July 21, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-0731. The estimated annual burden per respondent varies from 30 minutes to 60 minutes, depending on individual circumstances, with an estimated average of 45 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On October 7, 1986, the IRS published in the Federal Register a notice of proposed rulemaking [LR-262-82, 1986-2 C.B. 789] containing proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 1361 of the Internal Revenue Code (Code). These amendments were proposed to conform the regulations to sections 2 and 6 of the Subchapter S Revision Act of 1982 and to section 721(c) and (f) of the Tax Reform Act of 1984. After consideration of all

comments received by Treasury and the IRS regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision. The final regulations also reflect the amendments made to section 1361 by sections 901(d)(4)(G) and 1879(m) of the Tax Reform Act of 1986, section 1018(q)(2) of the Technical and Miscellaneous Revenue Act of 1988, and section 7811(c)(6) of the Omnibus Budget Reconciliation Act of 1989.

On January 26, 1983, the IRS published temporary regulation §18.1361-1 under section 1361(d)(2) of the Internal Revenue Code of 1954 (TD 7872 [1983-1 C.B. 193]) in the Federal Register to provide guidance as to the election to treat a qualified subchapter S trust as a wholly-owned grantor trust. The temporary regulations are adopted as revised by this Treasury decision, and §18.1361-1 of the temporary regulations is removed.

Explanation of Provisions

The proposed regulations define a domestic corporation as a corporation as defined in section 7701(a)(2) created or organized in the United States or under the law of the United States or any state or territory. Commentators recommended that this definition be clarified to provide that an association, unincorporated but taxable as a corporation, may elect to be treated as an *S corporation*. The final regulations revise the definition of a domestic corporation for purposes of the *S corporation* provisions by providing that an entity that is classified as an association taxable as a corporation under §301.7701-2 of the Procedure and Administration Regulations may elect to be treated as an *S corporation* provided it meets the other requirements of a small business corporation.

Section 1361(b)(2)(C) provides that an insurance company subject to tax under subchapter L may not elect to be treated as an *S corporation*. However, the Subchapter S Revision Act of 1982 (the Act) provided a grandfather rule for a *qualified casualty insurance electing small business corporation*. The proposed regulations provide the grandfather rules for a *qualified casualty insurance electing small business corporation*. Additionally, the Act provided a grandfather rule with regard to the affiliation rule under section 1361(b)(2)(A) for a corporation that is affiliated with a foreign corporation or

DISC. The final regulations remove the grandfather rules for a *qualified casualty insurance electing small business corporation* since they are no longer generally applicable. However, corporations that fit within those grandfather rules and certain corporations having oil and gas production should refer to section 6(c) of Pub. L. 97-354 for appropriate guidance.

The proposed regulations provide a special rule for a corporation having a shareholder who has a legal life estate or usufruct interest in the stock. The proposed regulations provide requirements for such shareholder to qualify as an eligible shareholder. Upon further consideration by the IRS and Treasury, the final regulations remove this special rule from the proposed regulations. The issue will be addressed in other published guidance.

The proposed regulations provide that persons for whom stock of a corporation is held by a nominee, guardian, custodian, or agent are generally considered to be shareholders of the corporation, but if stock is owned by a partnership, the partnership (and not its partners) is considered to be the shareholder and the corporation does not qualify as a small business corporation. Commentators questioned why stock which is held by a partnership as nominee for an individual should not be considered to be owned by the individual rather than the partnership for purposes of determining whether a corporation qualifies as an *S corporation*. Commentators suggested that this point be clarified. The final regulations adopt this suggestion by providing that a partnership may hold *S corporation* stock as a nominee for a person who will be treated as the shareholder.

The proposed regulations contain a rule that prohibits a nonresident alien from being an eligible *S corporation* shareholder. Commentators recommended an additional rule that would warn that a U.S. citizen married to a nonresident alien who, under applicable local law, has an interest in the U.S. citizen's stock could not be a shareholder of an *S corporation*. The final regulations provide that, if a U.S. shareholder's nonresident alien spouse has a current ownership interest in the shareholder's stock under applicable local law, the *S corporation* has an ineligible shareholder and therefore does not qualify as a small business corporation. For example, the laws of a nonresident alien spouse's country may

give the nonresident alien spouse a community property interest in the U.S. spouse's property. In that case, the corporation would not constitute a small business corporation as of the date the nonresident spouse acquired an interest in the stock of the corporation, and the corporation's S election would terminate. See *Ward v. United States*, 661 F.2d 226 (Ct. Cl. 1981). If the termination is inadvertent, relief may be available under section 1362(f) of the Code.

The final regulations add and reserve §1.1361-1(g)(2) addressing the status of dual residents. When the proposed regulations under §301.7701(b)-7(a)(4) (published in the Federal Register (26 CFR 518) on April 27, 1992) are finalized, this section will contain a cross reference to those final regulations.

For purposes of section 1361(c)(2)-(A)(i), the proposed regulations define a subpart E trust as a trust all of which (income and corpus) is treated (under subpart E, part I, subchapter J, chapter 1 of the Code) as owned by one individual (whether or not the grantor) who is a citizen or resident of the United States. Commentators expressed concern regarding the definition of a subpart E trust and suggested that for purposes of determining whether a trust meets the subpart E requirements under section 1361(c)(2)(A)(i), the relevant period for making that determination is the period during which the trust holds S corporation stock. The final regulations adopt the commentators' suggestion. Therefore, whether the trust is a wholly-owned trust during any period in which the trust does not hold S corporation stock is not relevant. In addition, the final regulations define a subpart E trust as a trust all of which is treated as owned by an individual. This definition tracks the language of section 1361(c)(2)(A)(i). Therefore, the trust is a permitted shareholder if the grantor or another person includes in computing taxable income and credits all of the trust's items of income, deductions, and credits against tax under the rules in §1.671-3.

The final regulations clarify that a voting trust is a permitted shareholder only if it is a subpart E trust. Further, the final regulations add rules concerning who is treated as the shareholder for purposes of sections 1366, 1367, and 1368 when certain permitted trusts hold stock of an S corporation. For example, when stock of an S corpora-

tion is held by a trust that ceases to be a subpart E trust upon the death of the deemed owner, and the trust is a permitted shareholder for a 60-day period (or a 2-year period if applicable) under section 1361(c)(2)(A)(ii), the trust (and not the estate of the deemed owner) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, even though the estate is treated as the shareholder for purposes of section 1361(b)(1).

The final regulations provide that if a husband and wife file a joint return, are both U.S. citizens or residents, and are both designated beneficiaries of a trust, they are treated as one beneficiary for purposes of meeting the requirements of a qualified subchapter S trust (QSST). In addition, the final regulations add a rule that if any distribution from the trust satisfies the grantor's legal obligation to support the income beneficiary, the trust ceases to be a QSST as of the date of the distribution because under section 677(b) the grantor would be treated either as the owner of the ordinary income portion of the trust or as a beneficiary of the trust under section 662 and §1.662(a)-4.

The proposed regulations provide the general rule that would deny a trust qualification as a QSST if the terms of the trust do not preclude the possibility that in the future the trust may not meet the requirements of section 1361(d)(3)(A). Commentators suggested that the general rule be deleted because it should be sufficient if a trust currently complies with those requirements. For example, it was suggested that if the income beneficiary has a lifetime special power to appoint the income and corpus of the trust to another person, the trust would qualify as a QSST until the power is exercised. The final regulations do not adopt this suggestion because the statute clearly requires that the terms of the trust instrument provide that, during the life of the current income beneficiary, there be only one income beneficiary, and that any corpus distributed may be distributed only to such beneficiary. The statute generally precludes the possibility of future non-compliance. However, because of the concern expressed that a trust instrument could not feasibly preclude the addition to a trust of a beneficiary that is mandated by a court of law, the final regulations provide for this exception to the general rule.

Commentators requested guidance as to whether a qualified terminable interest property (QTIP) trust qualifies as a permitted shareholder of an S corporation. The final regulations provide that a trust treated as a QTIP trust under section 2056(b)(7) will qualify as a QSST, and a trust treated as a QTIP trust under section 2523(f) may qualify as a subpart E trust if wholly-owned by the grantor. In the latter case, the trust does not satisfy all of the QSST requirements because the grantor is treated as the owner of the income portion of the trust under sections 672(e) and 677.

Commentators also requested guidance as to whether an income beneficiary of a trust that meets the QSST requirements, and who is treated as the owner of all of the trust, or the portion of the trust that consists of S corporation stock under subpart E (and thus is a permitted shareholder under section 1361(c)(2)(A)(i)), may nevertheless make a protective QSST election. The final regulations add provisions for a protective QSST election for income beneficiaries of certain grantor trusts.

The final regulations also change the result in Rev. Rul. 92-84, 1992-2 C.B. 216. Rev. Rul. 92-84 holds that if a QSST sells its S corporation stock, the current income beneficiary and not the trust must recognize any gain or loss. After the publication of Rev. Rul. 92-84, practitioners expressed concern with respect to the sale of the stock by a QSST in an installment sale. Practitioners questioned whether the trust could effectively use the installment method under section 453 to report gain realized on the sale of the stock and expressed concern about how the IRS would treat an installment sale of S stock by a QSST. Practitioners suggested that since the income beneficiary was treated as the owner of the stock sold, the income beneficiary would be treated as the owner of the installment obligation received in exchange for the sale of the stock. However, concern was expressed that because the QSST ceases to be a QSST as to the S corporation stock that was sold, the income beneficiary would no longer be treated as the owner of the installment obligation held by the trust and there may have occurred a disposition of the installment obligation under section 453B(a).

On further consideration, the IRS and Treasury have determined that the income beneficiary of a QSST who is a

section 678 deemed owner of the S corporation stock solely by reason of section 1361(d)(1) should not be treated as the owner of the consideration received by a QSST upon its disposition of S corporation stock. Under the final regulations, the consideration is treated as received by the trust in its status as a separate taxpayer under section 641. Thus, for example, any gain recognized on a sale of the S corporation stock is the gross income of the trust. Similarly, the trust may report any gain realized upon the sale under section 453 if the sale otherwise qualifies as an installment sale. This provision of the final regulations reflects an interpretation of section 1361(d)(1) and has no bearing upon the operation or effect of the principles of sections 671 through 679 beyond the context of a QSST.

If a QSST has sold or otherwise disposed of all or a portion of its S corporation stock in a tax year that is open under the statutes for both the QSST and the income beneficiary but before the effective date of these final regulations, the QSST and the income beneficiary may treat the transaction under Rev. Rul. 92-84 or under these final regulations. However, the QSST and the income beneficiary must take consistent reporting positions. The final regulations require that the QSST and the income beneficiary must state on their respective returns that they are taking consistent reporting positions.

Effect on other documents

Rev. Rul. 92-84, 1992-2 C.B. 216 is obsolete as of July 21, 1995.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 18 and 602 are amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805. * * *
Sections 1.1361-1(j)(6), (10) and (11) also issued under 26 U.S.C. 1361(d)(2)-(B)(iii). * * *

Par. 2. Section 1.1361-0 is revised to read as follows:

§1.1361-0 Table of contents.

This section lists captions contained in §1.1361-1.

§1.1361-1 S Corporation defined.

- (a) In general.
- (b) Small business corporation defined.
 - (1) In general.
 - (2) Estate in bankruptcy.
 - (3) Treatment of restricted stock.
 - (4) Treatment of deferred compensation plans.
 - (5) Treatment of straight debt.
 - (6) Effective date provisions.
 - (c) Domestic corporation.
 - (d) Ineligible corporation.
 - (1) General rule.
 - (2) Exceptions.
 - (3) Inactive corporation exception.
 - (e) Number of shareholders.
 - (1) General rule.
 - (2) Special rules relating to stock owned by husband and wife.
 - (f) Shareholder must be an individual or estate.
 - (g) No nonresident alien shareholder.
 - (1) General rule.
 - (2) Special rule for dual residents.
 - (h) Special rules relating to trusts.
 - (1) General rule.
 - (2) Foreign trust.
 - (3) Determination of shareholders
 - (i) [Reserved]
 - (j) Qualified subchapter S trust.
 - (1) Definition.
 - (2) Special rules.
 - (3) Separate and independent shares of a trust.
 - (4) Qualified terminable interest property trust.
 - (5) Ceasing to meet the QSST requirements.

- (6) Qualified subchapter S trust election.
- (7) Treatment as shareholder.
- (8) Coordination with grantor trust rules.
 - (9) Successive income beneficiary.
 - (10) Affirmative refusal to consent.
 - (11) Revocation of QSST election.
 - (k)(1) Examples.
 - (2) Effective date.
 - (1) Classes of stock.
 - (1) General rule.
 - (2) Determination of whether stock confers identical rights to distribution and liquidation proceeds.
 - (3) Stock taken into account.
 - (4) Other instruments, obligations, or arrangements treated as a second class of stock.
 - (5) Straight debt safe harbor.
 - (6) Inadvertent terminations.
 - (7) Effective date.

Par. 3. Section 1.1361-1 is amended by adding paragraphs (a), and (c) through (k) to read as follows:

§1.1361-1 S corporation defined.

(a) *In general.* For purposes of this title, with respect to any taxable year—
(1) The term *S corporation* means a small business corporation (as defined in paragraph (b) of this section) for which an election under section 1362(a) is in effect for that taxable year.

(2) The term *C corporation* means a corporation that is not an S corporation for that taxable year.

* * * * *

(c) *Domestic corporation.* For purposes of paragraph (b) of this section, the term *domestic corporation* means a domestic corporation as defined in §301.7701-5 of this chapter, and the term *corporation* includes an entity that is classified as an association taxable as a corporation under §301.7701-2 of this chapter.

(d) *Ineligible corporation*—(1) *General rule.* Except as otherwise provided in this paragraph (d), the term *ineligible corporation* means a corporation that is—

(i) A member of an affiliated group (determined under section 1504 without regard to any exception contained in section 1504(b)), whether or not that affiliated group has ever filed a consolidated return;

(ii) A financial institution to which section 585 applies (or would apply but for section 585(c)) or to which section 593 applies;

(iii) An insurance company subject to tax under subchapter L;

(iv) A corporation to which an election under section 936 applies; or

(v) A DISC or former DISC.

(2) *Exceptions.* See the special rules and exceptions provided in sections 6(c)(2), (3) and (4) of Pub. L. 97-354 that are applicable for certain casualty insurance companies and qualified oil corporations.

(3) *Inactive corporation exception.*

(i) For purposes of paragraph (d)(1)(i) of this section, a corporation (parent corporation) will not be treated as a member of an affiliated group during any period within a taxable year by reason of the ownership of stock in another corporation (subsidiary corporation) if the subsidiary corporation—

(A) Has not begun business at any time on or before the close of that period; and

(B) Does not have gross income for that period.

(ii) The determination under paragraph (d)(3)(i) of this section of the date on which a subsidiary corporation begins business is made by taking into account all the facts and circumstances of the particular case. A corporation has not begun business, however, merely because it is in existence. Ordinarily, a corporation begins business when it starts the business operations for which it was organized. Mere organizational activities, such as the obtaining of the corporate charter, are not alone sufficient to constitute the beginning of business. An example of a corporation that has not begun business is a corporation incorporated for the sole purpose of reserving a corporate name in a state or states in which the parent corporation is not doing business. If the activities of a corporation have advanced to the extent necessary to establish the nature of its business operations, however, the corporation is deemed to have begun business. For example, a corporation that acquires operating assets necessary for the type of business contemplated may be deemed to have begun business.

(iii) If a subsidiary corporation ceases to be an inactive corporation as defined in paragraph (d)(3)(i) of this section, then the parent corporation's election under section 1362(a) will

terminate on the earlier of the first day that the subsidiary corporation begins business, or the first day, determined under the subsidiary corporation's method of accounting, that the subsidiary corporation realizes gross income.

(iv) The application of paragraph (d)(3) of this section is illustrated by the following examples:

Example 1. In 1996, Corporation P, a C corporation, owns all of the stock of Corporation Q. P and Q both use the calendar year as their taxable year. For purposes of paragraph (d)(1)(i) of this section, P would not be considered at any time during 1996 to be a member of an affiliated group solely by reason of its ownership of Q's stock if Q has not begun business at any time on or before January 1, 1997, and has no gross income for calendar year 1996 or any prior calendar year. Thus, P could qualify as a small business corporation during 1996 if it meets the other requirements provided in section 1361(b). Assuming that P's ownership of Q stock remains unchanged, P would cease to be a small business corporation on the day that Q either begins business or realizes gross income (determined under Q's method of accounting), whichever day occurs earlier.

Example 2. Assume the same facts as in *Example 1*, except that Corporation Q had begun business prior to 1995, but became inactive in 1995. For purposes of paragraph (d)(1)(i) of this section, P is considered to be a member of an affiliated group because Q had begun business prior to becoming inactive in 1995. Therefore, even though Q was inactive in 1996, P is not eligible to make the S election until P liquidates Q.

(e) *Number of shareholders*—(1)

General rule. A corporation does not qualify as a small business corporation if it has more than 35 shareholders. Ordinarily, the person who would have to include in gross income dividends distributed with respect to the stock of the corporation (if the corporation were a C corporation) is considered to be the shareholder of the corporation. For example, if stock (owned other than by a husband and wife) is owned by tenants in common or joint tenants, each tenant in common or joint tenant is generally considered to be a shareholder of the corporation. (For special rules relating to stock owned by husband and wife, see paragraph (e)(2) of this section; for special rules relating to restricted stock, see paragraphs (b)(3) and (6) of this section.) The person for whom stock of a corporation is held by a nominee, guardian, custodian, or an agent is considered to be the shareholder of the corporation for purposes of this paragraph (e) and paragraphs (f) and (g) of this section. For example, a partnership may be a nominee of S corporation stock for a person who

qualifies as a shareholder of an S corporation. However, if the partnership is the beneficial owner of the stock, then the partnership is the shareholder, and the corporation does not qualify as a small business corporation. In addition, in the case of stock held for a minor under a uniform gifts to minors or similar statute, the minor and not the custodian is the shareholder. For purposes of this paragraph (e) and paragraphs (f) and (g) of this section, if stock is held by a decedent's estate, the estate (and not the beneficiaries of the estate) is considered to be the shareholder; however, if stock is held by a subpart E trust (which includes voting trusts), the deemed owner is considered to be the shareholder.

(2) *Special rules relating to stock owned by husband and wife.* For purposes of paragraph (e)(1) of this section, stock owned by a husband and wife (or by either or both of their estates) is treated as if owned by one shareholder, regardless of the form in which they own the stock. For example, if husband and wife are owners of a subpart E trust, they will be treated as one individual. Both husband and wife must be U.S. citizens or residents, and a decedent spouse's estate must not be a foreign estate as defined in section 7701(a)(31). The treatment described in this paragraph (e)(2) will cease upon dissolution of the marriage for any reason other than death.

(f) *Shareholder must be an individual or estate.* Except as otherwise provided in paragraph (e)(1) (relating to nominees and paragraph (h) (relating to certain trusts) of this section, a corporation in which any shareholder is a corporation, partnership, or trust does not qualify as a small business corporation.

(g) *Nonresident alien shareholder*—(1) *General rule.* (i) A corporation having a shareholder who is a nonresident alien as defined in section 7701(b)(1)(B) does not qualify as a small business corporation. If a U.S. shareholder's spouse is a nonresident alien who has a current ownership interest (as opposed, for example, to a survivorship interest) in the stock of the corporation by reason of any applicable law, such as a state community property law or a foreign country's law, the corporation does not qualify as a small business corporation from the time the nonresident alien spouse acquires the interest in the stock. If a corporation's S election is

inadvertently terminated as a result of a nonresident alien spouse being considered a shareholder, the corporation may request relief under section 1362(f).

(ii) The following examples illustrate this paragraph (g)(1)(i):

Example 1. In 1990, W, a U.S. citizen, married H, a citizen of a foreign country. At all times H is a nonresident alien under section 7701(b)(1)(B). Under the foreign country's law, all property acquired by a husband and wife during the existence of the marriage is community property and owned jointly by the husband and wife. In 1996 while residing in the foreign country, W formed X, a U.S. corporation, and X simultaneously filed an election to be an S corporation. X issued all of its outstanding stock in W's name. Under the foreign country's law, X's stock became the community property of and jointly owned by H and W. Thus, X does not meet the definition of a small business corporation and therefore could not file a valid S election because H, a nonresident alien, has a current interest in the stock.

Example 2. Assume the same facts as *Example 1*, except that in 1991, W and H filed a section 6013(g) election allowing them to file a joint U.S. tax return and causing H to be treated as a U.S. resident for purposes of chapters 1, 5, and 24 of the Internal Revenue Code. The section 6013(g) election applies to the taxable year for which made and to all subsequent taxable years until terminated. Because H is treated as a U.S. resident under section 6013(g), X does meet the definition of a small business corporation. Thus, the election filed by X to be an S corporation is valid.

(2) *Special rule for dual residents.*
[Reserved]

(h) *Special rules relating to trusts—*

(1) *General rule.* In general, a trust is not a permitted small business corporation shareholder. However, except as provided in paragraph (h)(2) of this section, the following trusts are permitted shareholders:

(i) *Qualified Subpart E trust.* A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual (whether or not the grantor) who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock.

(ii) *Subpart E trust ceasing to be a qualified subpart E trust after the death of deemed owner.* A trust which was a qualified subpart E trust immediately before the death of the deemed owner and which continues in existence after the death of the deemed owner, but only for the 60-day period beginning on the day of the deemed owner's death. However, if a trust is described in the preceding sentence and the entire corpus of the trust is includible in the

gross estate of the deemed owner, the trust is a permitted shareholder for the 2-year period beginning on the day of the deemed owner's death. A trust is considered to continue in existence if the trust continues to hold the stock of the S corporation during the period of administration of the decedent's estate or if, after the period of administration, the trust continues to hold the stock pursuant to the terms of the will or the trust agreement. See §1.641(b)-3 for rules concerning the termination of estates and trusts for federal income tax purposes. If the trust consists of community property, and the decedent's community property interest in the trust is includible in the decedent's gross estate under chapter 11 (section 2001 and following, relating to estate tax), then the entire corpus of the trust will be deemed includible in the decedent's gross estate. Further, for the purpose of determining whether the entire corpus of the trust is includible in the gross estate of the deemed owner, if the decedent's spouse was treated as an owner of a portion of the trust under subpart E immediately before the decedent's death, the surviving spouse's portion is disregarded.

(iii) *Electing Qualified subchapter S trusts.* A qualified subchapter S trust (QSST) that has a section 1361(d)(2) election in effect (an electing QSST). See paragraph (j) of this section for rules concerning QSSTs including the manner for making the section 1361(d)-(2) election.

(iv) *Testamentary trusts.* A trust (other than a qualified subpart E trust or an electing QSST) to which S corporation stock is transferred pursuant to the terms of a will, but only for the 60-day period beginning on the day the stock is transferred to the trust.

(v) *Qualified Voting trusts.* A trust created primarily to exercise the voting power of S corporation stock transferred to it. To qualify as a voting trust for purposes of this section (a qualified voting trust), the beneficial owners must be treated as the owners of their respective portions of the trust under subpart E and the trust must have been created pursuant to a written trust agreement entered into by the shareholders, that—

(A) Delegates to one or more trustees the right to vote;

(B) Requires all distributions with respect to the stock of the corporation held by the trust to be paid to, or on

behalf of, the beneficial owners of that stock;

(C) Requires title and possession of that stock to be delivered to those beneficial owners upon termination of the trust; and

(D) Terminates, under its terms or by state law, on or before a specific date or event.

(2) *Foreign trust.* For purposes of paragraph (h)(1) of this section, in any case where stock is held by a foreign trust as defined in section 7701(a)(31), the trust is considered to be the shareholder and is an ineligible shareholder. Thus, even if a foreign trust qualifies as a subpart E trust (e.g., a qualified voting trust), any corporation in which the trust holds stock does not qualify as a small business corporation.

(3) *Determination of shareholders—*

(i) *General rule.* For purposes of paragraph (b) of this section (qualification as a small business corporation), and, except as provided in paragraph (h)(3)(ii) of this section, for purposes of sections 1366 (relating to the pass-through of items of income, loss, deduction, or credit), 1367 (relating to adjustments to basis of shareholder's stock), and 1368 (relating to distributions), the shareholder of S corporation stock held by a trust that is a permitted shareholder under paragraph (h)(1) of this section is determined as follows:

(A) If stock is held by a qualified subpart E trust, the deemed owner of the trust is treated as the shareholder.

(B) If stock is held by a trust defined in paragraph (h)(1)(ii) of this section, the estate of the deemed owner is generally treated as the shareholder as of the day of the deemed owner's death. However, if stock is held by such a trust in a community property state, the decedent's estate is the shareholder only of the portion of the trust included in the decedent's gross estate (and the surviving spouse continues to be the shareholder of the portion of the trust owned by that spouse under the applicable state's community property law). The estate ordinarily will cease to be treated as the shareholder upon the earlier of the transfer of the stock by the trust or the expiration of the 60-day period (or, if applicable, the 2-year period) beginning on the day of the deemed owner's death. If the trust qualifies and becomes an electing QSST, the beneficiary and not the estate is treated as the shareholder as of the effective date of

the QSST election, and the rules provided in paragraph (j)(7) of this section apply.

(C) If stock is held by an electing QSST, see paragraph (j)(7) of this section for the rules on who is treated as the shareholder.

(D) If stock is transferred to a testamentary trust (other than a qualified subpart E trust or an electing QSST), the estate of the testator is treated as the shareholder until the earlier of the transfer of that stock by the trust or the expiration of the 60-day period beginning on the day that the stock is transferred to the trust.

(E) If stock is held by a qualified voting trust, each beneficial owner of the stock, as determined under subpart E, is treated as a shareholder with respect to the owner's proportionate share of the stock held by the trust.

(ii) *Exceptions.* Solely for purposes of section 1366, 1367, and 1368 the shareholder of S corporation stock held by a trust is determined as follows—

(A) If stock is held by a trust (as defined in paragraph (h)(1)(ii) of this section) that does not qualify as a QSST, the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 60-day period (or, if applicable, the 2-year period), the corporation's S election will terminate unless the trust is otherwise a permitted shareholder. If the trust is a QSST described in section 1361(d) and the income beneficiary of the trust makes a timely QSST election, the beneficiary and not the trust is treated as the shareholder from the effective date of the QSST election; and

(B) If stock is transferred to a testamentary trust described in paragraph (h)(1)(iii) of this section (other than a qualified subpart E trust or a trust that has a QSST election in effect), the trust is treated as the shareholder. If the trust continues to own the stock after the expiration of the 60-day period, the corporation's S election will terminate unless the trust otherwise qualifies as a permitted shareholder.

(i) [Reserved]

(j) *Qualified subchapter S trust—(1) Definition.* A qualified subchapter S trust (QSST) is a trust (whether inter vivos or testamentary), other than a foreign trust described in section 7701(a)(31), that satisfies the following requirements:

(i) All of the income (within the meaning of §1.643(b)-1) of the trust is distributed (or is required to be distributed) currently to one individual who is a citizen or resident of the United States. For purposes of the preceding sentence, unless otherwise provided under local law (including pertinent provisions of the governing instrument that are effective under local law), income of the trust includes distributions to the trust from the S corporation for the taxable year in question, but does not include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit determined under section 1366. See §§1.651(a)-2(a) and 1.663(b)-1(a) for rules relating to the determination of whether all of the income of a trust is distributed (or is required to be distributed) currently. If under the terms of the trust income is not required to be distributed currently, the trustee may elect under section 663(b) to consider a distribution made in the first 65 days of a taxable year as made on the last day of the preceding taxable year. See section 663(b) and §1.663(b)-2 for rules on the time and manner for making the election. The income distribution requirement must be satisfied for the taxable year of the trust or for that part of the trust's taxable year during which it holds S corporation stock.

(ii) The terms of the trust must require that—

(A) During the life of the current income beneficiary, there will be only one income beneficiary of the trust;

(B) Any corpus distributed during the life of the current income beneficiary may be distributed only to that income beneficiary;

(C) The current income beneficiary's income interest in the trust will terminate on the earlier of that income beneficiary's death or the termination of the trust; and

(D) Upon termination of the trust during the life of the current income beneficiary, the trust will distribute all of its assets to that income beneficiary.

(iii) The terms of the trust must satisfy the requirements of paragraph (j)(1)(ii) of this section from the date the QSST election is made or from the effective date of the QSST election, whichever is earlier, throughout the entire period that the current income beneficiary and any successor income beneficiary is the income beneficiary of

the trust. If the terms of the trust do not preclude the possibility that any of the requirements stated in paragraph (j)(1)(ii) of this section will not be met, the trust will not qualify as a QSST. For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted under local law during the life of the current income beneficiary, then the terms of the trust do not preclude the possibility that corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST.

(2) *Special rules—(i)* If a husband and wife are income beneficiaries of the same trust, the husband and wife file a joint return, and each is a U.S. citizen or resident, the husband and wife are treated as one beneficiary for purposes of paragraph (j) of this section. If a husband and wife are treated by the preceding sentence as one beneficiary, any action required by this section to be taken by an income beneficiary requires joinder of both of them. For example, each spouse must sign the QSST election, continue to be a U.S. citizen or resident, and continue to file joint returns for the entire period that the QSST election is in effect.

(ii) (A) *Terms of the trust and applicable local law.* The determination of whether the terms of a trust meet all of the requirements under paragraph (j)(1)(ii) of this section depends upon the terms of the trust instrument and the applicable local law. For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust.

(B) *Legal obligation to support.* If under local law a distribution to the income beneficiary is in satisfaction of the grantor's legal obligation of support to that income beneficiary, the trust will not qualify as a QSST as of the date of distribution because, under section 677(b), if income is distributed, the grantor will be treated as the owner of the ordinary income portion of the trust or, if trust corpus is distributed, the grantor will be treated as a beneficiary under section 662. See §1.677(b)-1 for rules on the treatment of trusts for support and §1.662(a)-4 for rules concerning amounts used in discharge of a legal obligation.

(C) *Example.* The following example illustrates the rules of paragraph (j)(2)(ii)(B) of this section:

Example. F creates a trust for the benefit of F's minor child, G. Under the terms of the trust, all income is payable to G until the trust terminates on the earlier of G's attaining age 35 or G's death. Upon the termination of the trust, all corpus must be distributed to G or G's estate. The trust includes all of the provisions prescribed by section 1361(d)(3)(A) and paragraph (j)(1)(ii) of this section, but does not preclude the trustee from making income distributions to G that will be in satisfaction of F's legal obligation to support G. Under the applicable local law, distributions of trust income to G will satisfy F's legal obligation to support G. If the trustee distributes income to G in satisfaction of F's legal obligation to support G, the trust will not qualify as a QSST because F will be treated as the owner of the ordinary income portion of the trust. Further, the trust will not be a qualified subpart E trust because the trust will be subject to tax on the income allocable to corpus.

(iii) If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section.

(iv) If the terms of a trust or local law do not preclude the current income beneficiary from transferring the beneficiary's interest in the trust or do not preclude a person other than the current income beneficiary named in the trust instrument from being treated as a beneficiary of the trust under §1.643(c)-1, the trust will still qualify as a QSST. However, if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary's income interest and any person treated as a beneficiary under §1.643(c)-1 will be treated as a current income beneficiary for purposes of paragraph (j)(1)(ii) of this section and the trust may no longer meet the QSST requirements.

(v) If the terms of the trust do not preclude a person other than the current income beneficiary named in the trust instrument from being awarded an interest in the trust by the order of a

court, the trust will qualify as a QSST assuming the trust meets the requirements of paragraphs (j)(1)(i) and (ii) of this section. However, if as a result of such court order, the trust no longer meets the QSST requirements, the trust no longer qualifies as a QSST and the corporation's S election will terminate.

(vi) A trust may qualify as a QSST even though a person other than the current income beneficiary is treated under subpart E as the owner of a part or all of that portion of a trust which does not consist of the S corporation stock, provided the entire trust meets the QSST requirements stated in paragraphs (j)(1)(i) and (ii) of this section.

(3) *Separate and independent shares of a trust.* For purposes of sections 1361(c) and (d), a substantially separate and independent share of a trust, within the meaning of section 663(c) and the regulations thereunder, is treated as a separate trust. For a separate share which holds S corporation stock to qualify as a QSST, the terms of the trust applicable to that separate share must meet the QSST requirements stated in paragraphs (j)(1)(i) and (ii) of this section.

(4) *Qualified terminable interest property trust.* If property, including S corporation stock, or stock of a corporation that intends to make an S election, is transferred to a trust and an election is made to treat all or a portion of the transferred property as qualified terminable interest property (QTIP) under section 2056(b)(7), the income beneficiary may make the QSST election if the trust meets the requirements set out in paragraphs (j)(1)(i) and (ii) of this section. However, if property is transferred to a QTIP trust under section 2523(f), the income beneficiary may not make a QSST election even if the trust meets the requirements set forth in paragraph (j)(1)(ii) of this section because the grantor would be treated as the owner of the income portion of the trust under section 677. In addition, if property is transferred to a QTIP trust under section 2523(f), the trust does not qualify as a permitted shareholder under section 1361(c)(2)(A)(i) and paragraph (h)(1)(i) of this section (a qualified subpart E trust), unless under the terms of the QTIP trust, the grantor is treated as the owner of the entire trust under sections 671 to 677. If the grantor ceases to be the income beneficiary's spouse, the trust may qualify as a QSST if it otherwise satisfies the requirements

under paragraphs (j)(1)(i) and (ii) of this section.

(5) *Ceasing to meet the QSST requirements.* If a QSST for which an election under section 1361(d)(2) has been made (as described in paragraph (j)(6) of this section) ceases to meet any of the requirements specified in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day on which that requirement ceases to be met. If such a trust ceases to meet the income distribution requirement specified in paragraph (j)(1)(i) of this section, but continues to meet all of the requirements in paragraph (j)(1)(ii) of this section, the provisions of this paragraph (j) will cease to apply as of the first day of the first taxable year beginning after the first taxable year for which the trust ceased to meet the income distribution requirement of paragraph (j)(1)(i) of this section. If a corporation's S election is inadvertently terminated as a result of a trust ceasing to meet the QSST requirements, the corporation may request relief under section 1362(f).

(6) *Qualified subchapter S trust election—(i) In general.* This paragraph (j)(6) applies to the election provided in section 1361(d)(2) (the QSST election) to treat a QSST (as defined in paragraph (j)(1) of this section) as a trust described in section 1361(c)(2)(A)(i), and thus a permitted shareholder. This election must be made separately with respect to each corporation whose stock is held by the trust. The QSST election does not itself constitute an election as to the status of the corporation; the corporation must make the election provided by section 1362(a) to be an S corporation. Until the effective date of a corporation's S election, the beneficiary is not treated as the owner of the stock of the corporation for purposes of section 678. Any action required by this paragraph (j) to be taken by a person who is under a legal disability by reason of age may be taken by that person's guardian or other legal representative, or if there be none, by that person's natural or adoptive parent.

(ii) *Filing the QSST election.* The current income beneficiary of the trust must make the election by signing and filing with the service center with which the corporation files its income tax return the applicable form or a statement that—

(A) Contains the name, address, and taxpayer identification number of the

current income beneficiary, the trust, and the corporation;

(B) Identifies the election as an election made under section 1361(d)(2);

(C) Specifies the date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed);

(D) Specifies the date (or dates) on which the stock of the corporation was transferred to the trust; and

(E) Provides all information and representations necessary to show that:

(I) Under the terms of the trust and applicable local law—

(i) During the life of the current income beneficiary, there will be only one income beneficiary of the trust (if husband and wife are beneficiaries, that they will file joint returns and that both are U.S. residents or citizens);

(ii) Any corpus distributed during the life of the current income beneficiary may be distributed only to that beneficiary;

(iii) The current beneficiary's income interest in the trust will terminate on the earlier of the beneficiary's death or upon termination of the trust; and

(iv) Upon the termination of the trust during the life of such income beneficiary, the trust will distribute all its assets to such beneficiary.

(2) The trust is required to distribute all of its income currently, or that the trustee will distribute all of its income currently if not so required by the terms of the trust.

(3) No distribution of income or corpus by the trust will be in satisfaction of the grantor's legal obligation to support or maintain the income beneficiary.

(iii) *When to file the QSST election.*

(A) If S corporation stock is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust. If a C corporation has made an election under section 1362(a) to be an S corporation (S election) and, before that corporation's S election is in effect, stock of that corporation is transferred to a trust, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the stock is transferred to the trust.

(B) If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of

the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is effective. If a trust holds C corporation stock and that C corporation makes an S election effective for the first day of the taxable year following the taxable year in which the S election is made, the QSST election must be made within the 16-day-and-2-month period beginning on the day that the S election is made. If a trust holds C corporation stock and that corporation makes an S election intending the S election to be effective for the first day of the taxable year in which the S election is made but, under §1.1362-6(a)(2), such S election is subsequently treated as effective for the first day of the taxable year following the taxable year in which the S election is made, the fact that the QSST election states that the effective date of the QSST election is the first day of the taxable year in which the S election is made will not cause the QSST election to be ineffective for the first year in which the corporation's S election is effective.

(C) If a trust ceases to be a qualified subpart E trust but also satisfies the requirements of a QSST, the QSST election must be filed within the 16-day-and-2-month period beginning on the date on which the trust ceases to be a qualified subpart E trust. If the estate of the deemed owner of the trust is treated as the shareholder under paragraph (h)(3)(ii) of this section, the QSST election may be filed at any time but no later than the end of the 16-day-and-2-month period beginning on the date on which the estate of the deemed owner ceases to be treated as a shareholder.

(D) If a corporation's S election terminates because of a late QSST election, the corporation may request inadvertent termination relief under section 1362(f). See §1.1362-4 for rules concerning inadvertent terminations.

(iv) *Protective QSST election when a person is an owner under subpart E.* If the grantor of a trust is treated as the owner under subpart E of all of the trust, or of a portion of the trust which consists of S corporation stock, and the current income beneficiary is not the grantor, the current income beneficiary may not make the QSST election, even if the trust meets the QSST requirements stated in paragraph (j)(1)(ii) of this section. See paragraph (j)(6)(iii)(C)

of this section as to when the QSST election may be made. See also paragraph (j)(2)(vi) of this section. However, if the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) of a trust is treated under subpart E as owning all or a portion of the trust consisting of S corporation stock, the current income beneficiary (or beneficiaries who are husband and wife, if both spouses are U.S. citizens or residents and file a joint return) may make the QSST election. See *Example 8* of paragraph (k)(1) of this section.

(7) *Treatment as shareholder.* (i) The income beneficiary who makes the QSST election and is treated (for purposes of section 678(a)) as the owner of that portion of the trust that consists of S corporation stock is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) If, upon the death of an income beneficiary, the trust continues in existence, continues to hold S corporation stock but no longer satisfies the QSST requirements, and is not a qualified subpart E trust, then, solely for purposes of section 1361(b)(1), as of the date of the income beneficiary's death, the estate of that income beneficiary is treated as the shareholder of the S corporation with respect to which the income beneficiary made the QSST election. The estate ordinarily will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 60-day period beginning on the day of the income beneficiary's death. However, if the entire corpus of the trust is includible in the gross estate of that income beneficiary, the estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of that stock by the trust or the expiration of the 2-year period beginning on the day of the income beneficiary's death. For the purpose of determining whether the entire trust corpus is includible in the gross estate of the income beneficiary, any community property interest in the trust held by the income beneficiary's spouse which arises by reason of applicable U.S. state law is disregarded. During the period that the estate is treated as the shareholder for purposes of section 1361(b)(1), the trust is treated as the shareholder for purposes of sections 1366, 1367, and

1368. If, after the 60-day period, or the 2-year period, if applicable, the trust continues to hold S corporation stock, the corporation's S election terminates. If the termination is inadvertent, the corporation may request relief under section 1362(f).

(8) *Coordination with grantor trust rules.* If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code.

(9) *Successive income beneficiary.* (i) If the income beneficiary of a QSST who made a QSST election dies, each successive income beneficiary of that trust is treated as consenting to the election unless a successive income beneficiary affirmatively refuses to consent to the election. For this purpose, the term *successive income beneficiary* includes a beneficiary of a trust whose interest is a separate share within the meaning of section 663(c), but does not include any beneficiary of a trust that is created upon the death of the income beneficiary of the QSST and which is a new trust under local law.

(ii) The application of this paragraph (j)(9) is illustrated by the following examples:

Example 1. Shares of stock in Corporation X, an S corporation, are held by Trust A, a QSST

for which a QSST election was made. B is the sole income beneficiary of Trust A. On B's death, under the terms of Trust A, J and K become the current income beneficiaries of Trust A. J and K each hold a separate and independent share of Trust A within the meaning of section 663(c). J and K are successive income beneficiaries of Trust A, and they are treated as consenting to B's QSST election.

Example 2. Assume the same facts as in *Example 1*, except that on B's death, under the terms of Trust A and local law, Trust A terminates and the principal is to be divided equally and held in newly created Trust B and Trust C. The sole income beneficiaries of Trust B and Trust C are J and K, respectively. Because Trust A terminated, J and K are not successive income beneficiaries of Trust A. J and K must make QSST elections for their respective trusts to qualify as QSSTs, if they qualify. The result is the same whether or not the trustee of Trusts B and C is the same as the trustee of trust A.

(10) *Affirmative refusal to consent—*

(i) *Required statement.* A successive income beneficiary of a QSST must make an affirmative refusal to consent by signing and filing with the service center where the corporation files its income tax return a statement that—

(A) Contains the name, address, and taxpayer identification number of the successive income beneficiary, the trust, and the corporation for which the election was made;

(B) Identifies the refusal as an affirmative refusal to consent under section 1361(d)(2); and

(C) Sets forth the date on which the successive income beneficiary became the income beneficiary.

(ii) *Filing date and effectiveness.* The affirmative refusal to consent must be filed within 15 days and 2 months after the date on which the successive income beneficiary becomes the income beneficiary. The affirmative refusal to consent will be effective as of the date on which the successive income beneficiary becomes the current income beneficiary.

(11) *Revocation of QSST election.* A QSST election may be revoked only with the consent of the Commissioner. The Commissioner will not grant a revocation when one of its purposes is the avoidance of federal income taxes or when the taxable year is closed. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure. The application must be signed by the current income beneficiary and must—

(i) Contain the name, address, and taxpayer identification number of the

current income beneficiary, the trust, and the corporation with respect to which the QSST election was made;

(ii) Identify the election being revoked as an election made under section 1361(d)(2); and

(iii) Explain why the current income beneficiary seeks to revoke the QSST election and indicate that the beneficiary understands the consequences of the revocation.

(k)(1) *Examples.* The provisions of paragraphs (h) and (j) of this section are illustrated by the following examples in which it is assumed that all noncorporate persons are citizens or residents of the United States:

Example 1. (i) *Terms of the trust.* In 1996, A and A's spouse, B, created an inter vivos trust and each funded the trust with separately owned stock of an S corporation. Under the terms of the trust, A and B designated themselves as the income beneficiaries and each, individually, retained the power to amend or revoke the trust with respect to the trust assets attributable to their respective trust contributions. Upon A's death, the trust is to be divided into two separate parts; one part attributable to the assets A contributed to the trust and one part attributable to B's contributions. Before the trust is divided, and during the administration of A's estate, all trust income is payable to B. The part of the trust attributable to B's contributions is to continue in trust under the terms of which B is designated as the sole income beneficiary and retains the power to amend or revoke the trust. The part attributable to A's contributions is to be divided into two separate trusts both of which have B as the sole income beneficiary for life. One trust, the *Credit Shelter Trust*, is to be funded with an amount that can pass free of estate tax by reason of A's available estate tax unified credit. The terms of the Credit Shelter Trust meet the requirements of section 1361(d)(3) as a QSST. The balance of the property passes to a Marital Trust, the terms of which satisfy the requirements of section 1361(d)(3) as a QSST and section 2056(b)(7) as QTIP. The appropriate fiduciary under §20.2056(b)-7(b)(3) is directed to make an election under section 2056(b)(7).

(ii) *Results after deemed owner's death.* On February 3, 1997, A dies and the portion of the trust assets attributable to A's contributions including the S stock contributed by A, is includible in A's gross estate under sections 2036 and 2038. During the administration of A's estate, the trust holds the S corporation stock. Under section 1361(c)(2)(B)(ii), A's estate is treated as the shareholder of the S corporation stock that was included in A's gross estate for purposes of section 1361(b)(1); however, for purposes of sections 1366, 1367, and 1368, the trust is treated as the shareholder. B's part of the trust continues to be a qualified subpart E trust of which B is the owner under sections 676 and 677. B, therefore, continues to be treated as the shareholder of the S corporation stock in that portion of the trust. On May 13, 1997, during the continuing administration of A's estate, the trust is divided into separate trusts in accordance with the terms of the trust instrument. The S corporation stock that was included in A's gross

estate is distributed to the Marital Trust and to the Credit Shelter Trust. A's estate will cease to be treated as the shareholder of the S corporation under section 1361(c)(2)(B)(ii) on May 13, 1997 (the date on which the S corporation stock was transferred to the trusts). B, as the income beneficiary of the Marital Trust and the Credit Shelter Trust, must make the QSST election for each trust by July 28, 1997 (the end of the 16-day-and-2-month period beginning on the date the estate ceases to be treated as a shareholder) to have the trusts become permitted shareholders of the S corporation.

Example 2. (i) *Qualified subpart E trust as shareholder.* In 1997, A, an individual established a trust and transferred to the trust A's shares of stock of Corporation M, an S corporation. A has the power to revoke the entire trust. The terms of the trust require that all income be paid to B and otherwise meet the requirements of a QSST under section 1361(d)(3). The trust will continue in existence after A's death. The trust is a qualified subpart E trust described in section 1361(c)(2)(A)(i) during A's life, and A (not the trust) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Trust ceasing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (i) of this Example 2, except that A dies without having exercised A's power to revoke. Upon A's death, the trust ceases to be a qualified subpart E trust described in section 1361(c)(2)(A)(i). A's estate (and not the trust) is treated as the shareholder for purposes of section 1361(b)(1). Because the entire corpus of the trust is includible in A's gross estate under section 2038, A's estate will cease to be treated as the shareholder for purposes of section 1361(b)(1) upon the earlier of the transfer of the Corporation M stock by the trust (other than to A's estate), the expiration of the 2-year period beginning on the day of A's death, or the effective date of a QSST election if the trust qualifies as a QSST. However, until that time, because the trust continues in existence after A's death and will receive any distributions with respect to the stock it holds, the trust is treated as the shareholder for purposes of sections 1366, 1367, and 1368. After the 2-year period, if no QSST election is made, the corporation ceases to be an S corporation, but the trust continues as the shareholder of a C corporation.

(iii) *Trust continuing to be a qualified subpart E trust on deemed owner's death.* Assume the same facts as paragraph (ii) of this Example 2, except that the terms of the trust also provide that if A does not exercise the power to revoke before A's death, B will have the sole power to withdraw all trust property at any time after A's death. The trust continues to qualify as a qualified subpart E trust after A's death because, upon A's death, B is deemed to be the owner of the entire trust under section 678. Because the trust does not cease to be a qualified subpart E trust upon A's death, B (and not A's estate) is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368. Since the trust qualifies as a QSST, B may make a protective QSST election under paragraph (j)(6)(iv) of this section.

Example 3. *60-day rule under section 1361(c)(2)(A)(ii) and (iii).* F owns stock of Corporation P, an S corporation. In addition, F is the deemed owner of a qualified subpart E trust that holds stock in Corporation O, an S corporation. F dies on July 1, 1996. The trust continues in existence after F's death but is no longer a qualified subpart E trust. The entire corpus of the

trust is not includible in F's gross estate. On August 1, 1996, F's shares of stock in Corporation P are transferred to the trust pursuant to the terms of F's will. Because the stock of Corporation P was not held by the trust when F died, section 1361(c)(2)(A)(ii) does not apply with respect to that stock. Under section 1361(c)(2)(A)(iii), the last day on which F's estate could be treated as a permitted shareholder of Corporation P is September 29, 1996 (that is, the last day of the 60-day period that begins on the date of the transfer from the estate to the trust). With respect to the shares of stock in Corporation O held by the trust at the time of F's death, section 1361(c)(2)(A)(ii) applies and the last day on which F's estate could be treated as a permitted shareholder of Corporation O is August 29, 1996 (that is, the last day of the 60-day period that begins on the date of F's death).

Example 4. (i) *QSST when terms do not require current distribution of income.* Corporation Q, a calendar year corporation, makes an election to be an S corporation effective for calendar year 1996. On July 1, 1996, G, a shareholder of Corporation Q, transfers G's shares of Corporation Q stock to a trust with H as its current income beneficiary. The terms of the trust otherwise satisfy the QSST requirements, but authorize the trustee in its discretion to accumulate or distribute the trust income. However, the trust, which uses the calendar year as its taxable year, initially satisfies the income distribution requirement because the trustee is currently distributing all of the income. On August 1, 1996, H makes a QSST election with respect to Corporation Q that is effective as of July 1, 1996. Accordingly, as of July 1, 1996, the trust is a QSST and H is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *QSST when trust income is not distributed currently.* Assume the same facts as in paragraph (i) of this Example 4, except that, for the taxable year ending on December 31, 1997, the trustee accumulates some trust income. The trust ceases to be a QSST on January 1, 1998, because the trust failed to distribute all of its income for the taxable year ending December 31, 1997. Thus, Corporation Q ceases to be an S corporation as of January 1, 1998, because the trust is not a permitted shareholder.

(iii) *QSST when a person other than the current income beneficiary may receive trust corpus.* Assume the same facts as in paragraph (i) of this Example 4, except that H dies on November 1, 1996. Under the terms of the trust, after H's death, L is the income beneficiary of the trust and the trustee is authorized to distribute trust corpus to L as well as to J. The trust ceases to be a QSST as of November 1, 1996, because corpus distributions may be made to someone other than L, the current (successive) income beneficiary. Under section 1361(c)(2)(A)(ii), H's estate (and not the trust) is considered to be the shareholder for purposes of section 1361(b)(1) for the 60-day period beginning on November 1, 1996. However, because the trust continues in existence after H's death and will receive any distributions from the corporation, the trust (and not H's estate) is treated as the shareholder for purposes of sections 1366, 1367, and 1368, during that 60-day period. After the 60-day period, the S election terminates and the trust continues as a shareholder of a C corporation. If the termination is inadvertent, Corporation Q may request relief under section 1362(f). However, the S election would not terminate if the trustee distributed all Corporation Q shares to

L, J, or both before December 30, 1996, (the last day of the 60-day period) assuming that neither L nor J becomes the 36th shareholder of Corporation Q as a result of the distribution.

Example 5. *QSST when current income beneficiary assigns the income interest to a person not named in the trust.* On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's income interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on N's death). Accordingly, as of the date of the assignment, the trust ceases to be a QSST and Corporation R ceases to be an S corporation.

Example 6. *QSST when terms fail to provide for distribution of trust assets upon termination during life of current income beneficiary.* A contributes S corporation stock to a trust the terms of which provide for one income beneficiary, annual distributions of income, discretionary invasion of corpus only for the benefit of the income beneficiary, and termination of the trust only upon the death of the current income beneficiary. Since the trust can terminate only upon the death of the income beneficiary, the governing instrument fails to provide for any distribution of trust assets during the income beneficiary's life. The governing instrument's silence on this point does not disqualify the trust under section 1361(d)(3)(A)(ii) or (iv).

Example 7. *QSST when settlor of trust retains a reversion in the trust.* On January 10, 1996, M transfers to a trust shares of stock in corporation X, an S corporation. D, who is 13 years old and not a lineal descendant of M, is the sole income beneficiary of the trust. On termination of the trust, the principal (including the X shares) is to revert to M. The trust instrument provides that the trust will terminate upon the earlier of D's death or D's 21st birthday. The terms of the trust satisfy all of the requirements to be a QSST except those of section 1361(d)(3)(A)(ii) (that corpus may be distributed during the current income beneficiary's life only to that beneficiary) and (iv) (that, upon termination of the trust during the life of the current income beneficiary, the corpus, must be distributed to that beneficiary). On February 10, 1996, M makes a gift of M's reversionary interest to D. Until M assigns M's reversion in the trust to D, M is deemed to own the entire trust under section 673(a) and the trust is a qualified subpart E trust. For purposes of section 1361(b)(1), 1366, 1367, and 1368, M is the shareholder of X. The trust ceases to be a qualified subpart E trust on February 10, 1996. Assuming that, by virtue of the assignment to D of M's reversionary interest, D (upon his 21st birthday) or D's estate (in the case of D's death before reaching age 21) is entitled under local law to receive the trust principal, the trust will be deemed as of February 10, 1996, to have satisfied the conditions of section 1361(d)(3)(A)(ii) and (iv) even though the terms of the trust do not explicitly so provide. D must make a QSST election by no later than April 25, 1996 (the end of the 16-day-and-2-month period that begins on February 10, 1996, the date on which the X stock is deemed transferred to the

trust by M). See example (5) of §1.1001-2(c) of the regulations.

Example 8. QSST when the income beneficiary has the power to withdraw corpus. On January 1, 1996, F transfers stock of an S corporation to an irrevocable trust whose income beneficiary is F's son, C. Under the terms of the trust, C is given the noncumulative power to withdraw from the corpus of the trust the greater of \$5,000 or 5 percent of the value of the corpus on a yearly basis. The terms of the trust meet the QSST requirements. Assuming the trust distributions are not in satisfaction of F's legal obligation to support C, the trust qualifies as a QSST. C (or if C is a minor, C's legal representative) must make the QSST election no later than March 16, 1996 (the end of the 16-day-and-2-month period that begins on the date the stock is transferred to the trust).

Example 9. (i) Filing the QSST election. On January 1, 1996, stock of Corporation T, a calendar year C corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. On January 31, 1996, Corporation T files an election to be an S corporation that is to be effective for its taxable year beginning on January 1, 1996. In order for the S election to be effective for the 1996 taxable year, the QSST election must be effective January 1, 1996, and must be filed within the period beginning on January 1, 1996, and ending March 16, 1996 (the 16-day-and-2-month period beginning on the first day of the first taxable year for which the election to be an S corporation is intended to be effective).

(ii) *QSST election when the S election is filed late.* Assume the same facts as in paragraph (i) of this *Example 9*, except that Corporation T's election to be an S corporation is filed on April 1, 1996 (after the 15th day of the 3rd month of the first taxable year for which it is to be effective but before the end of that taxable year). Because the election to be an S corporation is not timely filed for the 1996 taxable year, under section 1362(b)(3), the S election is treated as made for the taxable year beginning on January 1, 1997. The QSST election must be filed within the 16-day-and-2-month period beginning on April 1, 1996, the date the S election was made, and ending on June 16, 1996.

Example 10. (i) Transfers to QTIP trust. On June 1, 1996, A transferred S corporation stock to a trust for the benefit of A's spouse B, the terms of which satisfy the requirements of section 2523(f)(2) as qualified terminable interest property. Under the terms of the trust, B is the sole income beneficiary for life. In addition, corpus may be distributed to B, at the trustee's discretion, during B's lifetime. However, under section 677(a), A is treated as the owner of the trust. Accordingly, the trust is a permitted shareholder of the S corporation under section 1361(c)(2)(A)(i), and A is treated as the shareholder for purposes of sections 1361(b)(1), 1366, 1367, and 1368.

(ii) *Transfers to QTIP trust where husband and wife divorce.* Assume the same facts as in paragraph (i) of this *Example 10*, except that A and B divorce on May 2, 1997. Under section 682, A ceases to be treated as the owner of the trust under section 677(a) because A and B are no longer husband and wife. Under section 682, after the divorce, B is the income beneficiary of the trust and corpus of the trust may only be distributed to B. Accordingly, assuming the trust otherwise meets the requirements of section 1361(d)(3), B must make the QSST election

within 2 months and 15 days after the date of the divorce.

(iii) *Transfers to QTIP trust where no corpus distribution is permitted.* Assume the same facts as in paragraph (i) of this *Example 10*, except that the terms of the trust do not permit corpus to be distributed to B and require its retention by the trust for distribution to A and B's surviving children after the death of B. Under section 677, A is treated as the owner of the ordinary income portion of the trust, but the trust will be subject to tax on gross income allocable to corpus. Accordingly, the trust does not qualify as an eligible shareholder of the S corporation because it is neither a qualified subpart E trust nor a QSST.

(2) *Effective date—(i) In general.* Paragraph (a), and paragraphs (c) through (k) of this section apply to taxable years of a corporation beginning after July 21, 1995. For taxable years beginning on or before July 21, 1995, to which paragraph (a), and paragraphs (c) through (k) do not apply, see §18.1361-1 of this chapter (as contained in the 26 CFR edition revised April 1, 1995).

(ii) *Exception.* If a QSST has sold or otherwise disposed of all or a portion of its S corporation stock in a tax year that is open for the QSST and the income beneficiary but on or before July 21, 1995, the QSST and the income beneficiary may both treat the transaction as if the beneficiary was the owner of the stock sold or disposed of, and thus recognize any gain or loss, or as if the QSST was the owner of the stock sold or disposed of as described in paragraph (j)(8) of this section. This exception applies only if the QSST and the income beneficiary take consistent reporting positions. The QSST and the income beneficiary must disclose by a statement on their respective returns (or amended returns), that they are taking consistent reporting positions.

PART 18—TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Par. 4. The authority citation for part 18 is revised to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. Section 18.0 is revised to read as follows:

§18.0 Effective date of temporary regulations under the Subchapter S Revision Act of 1982.

The temporary regulations provided under §18.1377-1, 18.1379-1, and

18.1379-2 are effective with respect to taxable years beginning after 1982, and the temporary regulations provided under §18.1378-1 are effective with respect to elections made after October 19, 1982.

§§18.1361-1 and 18.1366-5 [Removed]

Par. 6. Sections 18.1361-1 and 18.1366-5 are removed.

§18.1378-1 [Amended]

Par. 7. Section 18.1378-1 is amended as follows:

1. The fourth sentence of paragraph (b)(2)(i) is amended by removing the language “§18.1362-1(b)” and adding the language “§1.1362-6(b)(2)(ii) of this chapter” in its place.

2. The fifth sentence of paragraph (b)(2)(i) is removed.

3. The second sentence of paragraph (b)(2)(ii) is amended by removing the language “§18.1362-1(a)” and adding the language “§1.1362-6(b)(2)(i) of this chapter” in its place.

4. Paragraph (b)(3) is removed.

5. Paragraph (c) is removed and reserved.

6. Paragraph (e) is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§602.101 [Amended]

Par. 9. Section 602.101, paragraph (c) is amended by removing the entry for 18.1361-1 from the table and adding the entry “1.1361-1 ... 1545-0731” in numerical order to the table.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved May 9, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on July 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 21, 1995, 60 F.R. 37578 as corrected by 60 F.R. 58234)

Section 1441.—Withholding of Tax on Nonresident Aliens

Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 85-163, 1985-2 C.B. 349; and Rev. Rul. 87-89, Situations (1) and (2), 1987-2 C.B. 195, are rendered obsolete for payments made after September 10, 1995, that are subject to the final regulations under section 7701(1). See Rev. Rul. 95-56, page 322.

Section 1442.—Withholding of Tax on Foreign Corporations

Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 85-163, 1985-2 C.B. 349; and Rev. Rul. 87-89, Situations (1) and (2), 1987-2 C.B. 195, are rendered obsolete for payments made after September 10, 1995, that are subject to the final regulations under section 7701(1). See Rev. Rul. 95-56, page 322.

Section 1502.—Regulations

26 CFR 1.1502-13: *Intercompany transactions.*

T.D. 8597

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Consolidated Groups and Controlled Groups—Intercompany Transactions and Related Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations amending the intercompany transaction system of the consolidated return regulations. The final regulations also revise the regulations under section 267(f), limiting losses and deductions from transactions between members of a controlled group. Amendments to other related regulations are also included in this document.

DATES: These regulations are effective July 18, 1995.

For dates of applicability, see the “Effective dates” section under the “SUPPLEMENTARY INFORMATION” portion of the preamble and the effective date provisions of the new or revised regulations.

SUPPLEMENTARY INFORMATION:

A. Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1433. The estimated average annual burden per respondent is .5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

B. Background

This document contains final regulations under section 1502 of the Internal Revenue Code of 1986 (Code) that comprehensively revise the intercompany transaction system of the consolidated return regulations. Amendments are also made to related regulations, including the regulations under section 267(f), which apply to transactions between members of a controlled group.

The proposed regulations were published in the Federal Register on April 15, 1994 (59 FR 18011 [CO-11-91, 1994-1 C.B. 724]). The notice of hearing on the proposed regulations, Notice 94-49, 1994-1 C.B. 358, 59 FR 18048, contains an extensive discussion of the issues considered in developing the proposed regulations. The IRS received many comments on the proposed regulations and held public hearings on May 4, 1994 and August 8, 1994.

After consideration of the comments and the statements made at the hearings, the proposed regulations are adopted as revised by this Treasury

decision. The principal comments and revisions are discussed below. However, a number of other changes have been made to the proposed regulations. References in the preamble to P, S, and B are references to the common parent, the selling member, and the buying member, respectively. No inference is intended as to the operation of the prior regulations or other rules.

C. Principal Issues Considered in Adopting the Final Regulations.

1. Retention and modification of the deferred sale approach.

The proposed regulations generally retain the deferred sale approach of prior law but comprehensively revise the manner in which deferral is achieved to eliminate many of the inconsistent combinations of single and separate entity treatment under prior law. Notwithstanding these revisions, the results for most common intercompany transactions remain unchanged.

Commentators uniformly supported the retention of the deferred sale approach. Some comments, however, suggested that the rules of prior law should be retained, with modifications only where necessary to address a specific problem. Since the adoption of the prior regulations in 1966, however, developments in business practice and the tax law have greatly increased the problems of accounting for intercompany transactions. Although additional amendments could have been made to the prior regulations, further amendments would risk raising additional inconsistencies or uncertainties without providing a unified regime. By comprehensively revising the intercompany transaction system, the proposed regulations provide a unified regime and eliminate many of the inconsistencies of prior law, without changing the results of most common transactions. The final regulations therefore generally retain the approach of the proposed regulations.

2. General v. mechanical rules.

The prior intercompany transaction regulations were generally mechanical in operation. The proposed regulations rely less on mechanical rules and, instead, provide broad rules of general application based on the underlying principles of the regulations. To supplement the broad rules, the proposed

regulations provide examples illustrating the application of the rules to many common intercompany transactions.

Some commentators supported the proposed regulations' use of broad rules based on principles. Others suggested that the final regulations should retain the mechanical rules of prior law. Mechanical rules provide more certainty for transactions clearly covered by those rules. For transactions that are not clearly covered, however, mechanical rules provide much less guidance.

The final regulations retain the approach of the proposed regulations. This approach is flexible enough to apply to the wide range of transactions that can be intercompany transactions. For example, the final regulations do not require special rules to coordinate with the depreciation rules under section 168, the installment reporting rules under sections 453 through 453B, and the limitations under sections 267, 382, and 469. Flexible rules adapt to changes in the tax law and reduce the need for continuous updating of the regulations.

3. Timing rules of §1.1502-13 as a method of accounting.

The proposed regulations provide that "the timing rules of this section are a method of accounting that overrides otherwise applicable accounting methods." A group's ability to change the manner of applying the intercompany transaction regulations is therefore subject to the generally applicable rules for accounting method changes. Several comments objected to this treatment.

Commentators pointed out that treating the timing provisions of these regulations as a group's method of accounting may increase the burden and complexity of correcting improper applications of the regulations (for example, necessitating requests for accounting method changes for the treatment of intercompany transactions). This treatment also raises questions about members coming into a group and leaving a group (for example, whether requests to change a method of accounting are required when a taxpayer becomes, or ceases to be, a member). Various technical points were also raised as to the effect of a shared accounting method on each member of a group, the propriety of applying accounting method rules only to certain

transactions or classes of transactions, the interaction of the intercompany transaction rules with separate entity accounting methods of members, and the linkage of the selling member's method of accounting for its intercompany items with the buying member's method of accounting for its corresponding items.

The intercompany transaction regulations provide guidance on the appropriate time for taking into account items of income, deduction, gain, and loss from intercompany transactions to clearly reflect the consolidated taxable income of the group. Clear reflection of income is the central principle of section 446. Under section 446, any treatment that does or could change the taxable year in which taxable income is reported is a method of accounting. See Rev. Proc. 92-20, 1992-1 C.B. 685. The timing rules of the intercompany transaction regulations affect the taxable year in which items from intercompany transactions are taken into account in the computation of consolidated taxable income. Accordingly, the timing rules of these regulations are properly viewed as a method of accounting. Moreover, treating the timing rules as a method of accounting assures that the provisions will be applied consistently from year to year under the principles of section 446.

The final regulations retain the general approach of the proposed regulations, treating the timing rules of §1.1502-13 as a method of accounting under section 446. The regulations also contain several provisions intended to reduce the administrative burden that commentators believe might result from this treatment. The final regulations treat the timing rules as an accounting method for intercompany transactions, to be applied by each member, and not as an accounting method of the group as a whole. However, an application of the timing rules of this section to an intercompany transaction will be considered to clearly reflect income only if the effect of the transaction on consolidated taxable income is clearly reflected. This treatment more closely conforms to the general practice of separate taxpayers having their own methods of accounting, thereby alleviating technical and administrative issues that were raised with respect to characterization of the method as the method of the group as a whole, rather than as the method of each member.

To reduce potential administrative burdens further, the final regulations

generally provide automatic consent under section 446(e) to the extent changes in method are required when a member enters or leaves a group. In addition, for the first taxable year of the group to which the final regulations apply, consent is granted for any changes in method that are necessary to comply with the final regulations. For other years, members must obtain the Commissioner's consent to change their methods of accounting for intercompany transactions under applicable administrative procedures of section 446(e), currently Rev. Proc. 92-20. The regulations provide that changes will generally be effected on a cut-off basis (that is, the new method will apply to intercompany transactions occurring on or after the first day of the consolidated return year for which the change is effective). Changes in methods of accounting for intercompany transactions generally will otherwise be subject to the terms and conditions of applicable administrative procedures. The IRS may determine, however, that other terms and conditions are appropriate in the interest of sound tax administration (for example, if a taxpayer misapplies the regulations to avoid matching S's intercompany item with B's corresponding item). See section 10 of Rev. Proc. 92-20.

Paragraph (e)(3) of the final regulations continues the procedure whereby the common parent may request consent from the IRS to report intercompany transactions on a separate entity basis. Rev. Proc. 82-36 (1982-1 C.B. 490), which provides procedures for obtaining consent under the prior regulations, will be updated and revised. Until new procedures are provided, taxpayers may rely on the principles of Rev. Proc. 82-36 in making applications under these final regulations.

If consent under paragraph (e)(3) of these regulations is obtained or revoked, the final regulations provide the Commissioner's consent under section 446(e) for each member to make any changes in methods of accounting necessary to conform members' methods of accounting to the consent or revocation. Any change in method under this provision must be made as of the beginning of the first year for which the consent (or revocation of consent) under paragraph (e)(3) is effective.

A group that has received consent under the prior intercompany transaction regulations not to defer items from

deferred intercompany transactions will be considered to have obtained the consent of the Commissioner to take items from the same class (or classes) of intercompany transactions into account on a separate entity basis under these regulations.

4. Single entity treatment of attributes.

a. In general

The prior intercompany transaction system used a deferred sale approach that treated the members of a consolidated group as separate entities for some purposes and as a single entity for other purposes. In general, the *amount, location, character, and source* of items from an intercompany transaction were given separate entity treatment, but the *timing* of items was determined under rules that produced a single entity effect.

The matching rule of the proposed regulations expands single entity treatment by requiring the redetermination of the *attributes* (such as *character and source*) of items to produce a single entity effect. Several comments supported the broader single entity approach taken by the proposed regulations. Other comments asked that separate entity treatment of attributes be retained.

The commentators arguing for retention of separate entity treatment claimed that single entity treatment does not always result in more rational tax treatment, and may not reflect the economic results of a group's activities as accurately as separate entity treatment. They also argued that taxpayers should have the ability to avoid arbitrary results or administrative burdens by separately incorporating business operations. The Treasury and the IRS believe that single entity treatment of both timing and attributes generally results in a clear reflection of consolidated taxable income. In particular, single entity treatment minimizes the effect of an intercompany transaction on consolidated taxable income. In addition, single entity treatment minimizes the tax differences between a business structured divisionally and one structured with separate subsidiaries. The final regulations therefore retain the approach of the proposed regulations and generally adopt single entity treatment of attributes.

Nevertheless, in certain situations it may be appropriate to provide separate entity treatment. The Treasury and the IRS believe that these situations are relatively rare, and that any exceptions from single entity treatment should be specifically provided in regulations. For example, a separate entity election is permitted under Prop. Reg. §1.1221-2(d) (published in the Federal Register on July 18, 1994, 59 FR 36394) in the case of certain hedging transactions. See also §1.263A-9(g)(5). The Treasury and the IRS welcome comments on other situations in which this type of relief might be appropriate.

b. Conflict or allocation of attributes.

The proposed regulations provide specific rules for certain cases in which separate entity attributes are redetermined under the matching rule. Some commentators believe that the proposed regulations do not provide sufficient guidance as to the manner in which these rules are to be applied. In response to these comments, the attribute redetermination provisions of the matching rule have been revised.

For example, the regulations have been revised to clarify that the separate entity attributes of S's intercompany item and B's corresponding item are redetermined under the matching rule only *to the extent necessary* to produce the same effect on consolidated taxable income as if the intercompany transaction had been between divisions. Thus, the redetermination is required only to the extent the separate entity attributes differ from the single entity attributes.

The final regulations generally retain the rule of the proposed regulations under which the attributes of B's corresponding item control the attributes of S's intercompany items to the extent the corresponding and intercompany items offset in amount. However, the final regulations provide an exception to this rule to the extent its application would lead to a result that is inconsistent with treating S and B as divisions of a single corporation. To the extent B's corresponding item on a separate entity basis is excluded from gross income or is a noncapital, nondeductible amount (such as a deduction disallowed under section 265), however, the attribute of B's item will always control. This assures the proper operation of attribute limitation provisions contained elsewhere in the regulations.

To the extent B's corresponding item and S's intercompany item do not offset in amount, the final regulations provide that redetermined attributes are allocated to S's intercompany item and B's corresponding item using a method that is reasonable in light of all of the facts and circumstances, including the purposes of these regulations and any other rule affected by the attributes of S's items or B's items. This rule provides taxpayers considerable flexibility to allocate attributes, but the regulations also provide that an allocation method will be treated as unreasonable if it is not used consistently by all members of the group from year to year.

c. Source of income.

Several commentators opposed single entity treatment for determining the source of income or loss from an intercompany transaction, arguing that the separate entity treatment under prior law more accurately measures the source of income of the members of the group. The final regulations, however, retain the single entity treatment of source for the same reasons that the single entity treatment of other attributes is retained. The final regulations modify the example in the proposed regulations to reflect the changes made to the attribute allocation rules.

Some comments suggested that a single entity approach would inappropriately reduce the foreign source income of consolidated groups that produce a natural resource abroad and sell it to customers within the United States. For example, assume that one member extracts a commodity abroad and sells it to a second member, with title passing within a foreign country. The second member sells the commodity to unrelated customers with title passing in the United States. Assume that the first member's income is 80 percent of the group's income and would be treated solely as foreign source income under a separate entity approach. Under a single entity approach, the intercompany transaction is treated as occurring between divisions of a single corporation. If the special sourcing rule for production and sale of natural resources under the section 863 regulations does not apply because of "peculiar circumstances," the income of the group will be subject to the so-called 50/50 rule of the section 863 regulations, and a portion of the

group's foreign source income could be recharacterized as domestic source. Revisions to the section 863 regulations are being considered to address these issues. The Treasury and the IRS welcome comments regarding possible revisions to the section 863 regulations.

Another commentator noted that under the single entity approach, a pro rata allocation of the group's foreign and U.S. source income (as illustrated in *Example 17* of paragraph (c) of the proposed regulations) could cause a member that qualified as an "80/20" company under section 861(a)(1)(A) to lose that status. As a result, the member could be required to withhold Federal income tax on interest payments to a foreign lender. As indicated above, the final regulations revise the attribute rules to clarify that a redetermination is made only to the extent it is necessary to achieve the effect of treating S and B as divisions of a single corporation and to provide that redetermined attributes are allocated to S and B using a method that is reasonable in light of the purposes of §1.1502-13 and any other affected rule. Thus, the group is not required to allocate U.S. and foreign source income on a pro rata basis, and a member that qualifies as an 80/20 company under current law generally need not lose that status solely as the result of the allocation from a transaction similar to that described in the example.

Commentators also suggested that the pro rata allocation methodology of the proposed regulations could be inconsistent with U.S. income tax treaties that require the United States to treat income that may be taxed by the treaty partner as derived from sources within the treaty partner. As revised, the attribute rules do not require the group to allocate U.S. and foreign source income on a pro rata basis. Thus, the regulations will generally be consistent with any source rules contained in U.S. income tax treaties. To the extent, however, that a U.S. income tax treaty provides benefits to a taxpayer, these regulations do not prevent a taxpayer from claiming those benefits.

The final regulations expand the example to illustrate the determination of source if an independent factory or production price exists, and also for a sale of mixed source property within the group that is subsequently sold outside the group if, incident to the sale, services are performed by one member for another member or intang-

ibles are licensed from one member to another member.

Example 18 of paragraph (c) of the proposed regulations (*Example 15* of the final regulations) addresses the application of section 1248 to intercompany transactions and has been revised to reflect the changes made to the attribute allocation provisions. Issue 3 of Rev. Rul. 87-96 (1987-2 C.B. 709) will no longer be applicable to the extent it is inconsistent with *Example 15* and these regulations.

d. Limitation on attribute redetermination.

The proposed regulations contain a provision limiting the treatment of S's intercompany income or gain as excluded from gross income under the matching rule to situations in which B's corresponding item is a deduction or loss that is permanently disallowed directly under other provisions of the Code or regulations. The final regulations clarify that the Code or regulations must explicitly provide for the disallowance of B's deduction or loss. Thus, B's amount that is realized but not recognized under any provision of the Code or regulations, such as in a liquidation under section 332, is not permanently and explicitly disallowed, notwithstanding that the amount may be considered a corresponding item because it is a "disallowed or eliminated amount."

5. Deemed Items.

The proposed regulations provide rules under which certain basis adjustments are deemed to be items, and certain amounts are deemed not to be items. Under the proposed regulations an adjustment reflected in S's basis that is a substitute for an intercompany item is generally treated as an intercompany item (the deemed intercompany item rule). An adjustment reflected in B's basis that is a substitute for a corresponding item is generally treated as a corresponding item (the deemed corresponding item rule). In addition, a deduction or loss is not treated as an intercompany item or a corresponding item to the extent it does not reduce basis (the amounts not deemed to be items rule). Commentators found these rules to be confusing. In addition, the rules generally overlap with other rules of the proposed regulations.

For example, the deemed intercompany item rule overlaps with the rule of

the proposed regulations under which S's items must be taken into account even if they have not yet been taken into account under S's separate entity accounting method. If, under its method of accounting, S's income from an intercompany transaction is treated as a basis reduction, both rules could apply.

Similarly, the deemed corresponding item rule overlaps with the acceleration rule. S's intercompany item is taken into account under the acceleration rule to the extent it will not be taken into account under the matching rule. Thus, an adjustment to B's basis may result in accelerating S's intercompany item, to the extent the intercompany item is not reflected in B's basis following the adjustment. Because this is the same result that would occur under the deemed corresponding item rule, it is not necessary to treat the basis adjustment as a corresponding item under the matching rule. For example, B's reduction in the basis of property acquired from S under section 108(b) will cause S's intercompany gain to be accelerated to the extent the basis reduction exceeds S's basis in the property prior to the intercompany transaction.

The amounts deemed not to be items rule treats certain amounts that are within the definition of intercompany items as not being intercompany items to achieve a result consistent with these regulations and other Code provisions. Commentators indicated that this rule has limited application, does not achieve its desired effect in all cases, and is confusing to readers.

For these reasons, the deemed item rules and the amounts deemed not to be items rule have been eliminated in the final regulations. Because the deemed item rules overlap with other provisions, their effects have been retained in the final regulations. In addition, to achieve the intended effect of the amounts deemed not to be items rule, the attribute provisions of the final regulations have been modified to permit the Commissioner to treat intercompany gain as excluded from gross income when that treatment is consistent with these regulations and other applicable provisions of the Code.

6. The acceleration rule.

The acceleration rule requires S and B to take into account their items from an intercompany transaction to the extent the items cannot be taken into account to produce the effect of treat-

ing S and B as divisions of a single corporation. The acceleration rule applies, for example, when either S or B leaves the group. Under the proposed regulations, the attributes of S's items from intercompany property transactions are determined under the principles of the matching rule "as if B resold the property to a nonmember affiliate." Under this rule, S's gain from the sale of depreciable property is always treated as ordinary income under section 1239. This treatment is appropriate if the property remains in the group, as it would, for example, if the acceleration rule applies because S leaves the group. Many commentators objected to this treatment of S's attributes in other situations, arguing, for example, that if B leaves the group while it still owns the property, the rules should treat the property as sold to a person whose relationship to the group is the same as B's relationship to the group after it becomes a nonmember. The commentators argued that section 1239 should not apply if B is unrelated.

In response to these comments, the final regulations revise the acceleration rule to provide that if the property is owned by a nonmember immediately after the event causing acceleration occurs, S's attributes are determined under the principles of the matching rule as if B had sold the property to that nonmember. In applying this rule, if the nonmember is related for purposes of any provision of the Code or regulations to any party to the intercompany transaction (or any related transaction) or to P, the nonmember is treated as related to B for purposes of that provision. Accordingly, that relationship may affect the attributes of S's intercompany item.

Under both the prior regulations and the proposed regulations, if S sells an asset to B at a gain and B then transfers the asset to a partnership, S's gain is taken into account under the acceleration rule. Some commentators argued that gain should not be taken into account, at least to the extent of the member's share of the asset owned through the partnership, treating the partnership, in effect, as an aggregate of its partners, rather than as an entity. One commentator argued that continued deferral would be similar to the treatment currently available under the remedial allocation method under §1.704-3 if appreciated property is transferred to the partnership without a prior intercompany transfer.

The final regulations retain the rule of the proposed regulations. One of the purposes of the acceleration rule is to prevent basis created in an intercompany transaction from affecting nonmembers prior to the time the group takes into account the transaction that created the basis. Allowing property that B purchased from S at a gain to be contributed to a partnership without acceleration would allow the basis created in the intercompany transaction to be reflected by the partnership prior to the group taking into account the gain. While rules could be developed to prevent this basis from affecting nonmembers in most circumstances, the rules would be unduly complex. For example, the rules would have to take into account the allocation of liabilities under section 752 and basis adjustments under section 755. Moreover, these rules would not resemble the remedial allocation method under §1.704-3 but instead would more closely resemble the deferred sale method under the proposed regulations under section 704(c). However, this method was explicitly rejected when final regulations were issued. See §1.704-3(a)(1).

7. Transactions involving stock of members.

a. Single entity treatment of stock.

In contrast to their predominantly single entity approach, the proposed regulations generally retain separate entity treatment of stock of members. For example, section 1032, which enables a member to sell its own stock without recognition of gain or loss, is not extended to sales of the stock of other members. Notice 94-49 (1994-1 C.B. 358) discusses the difficulties of extending single entity treatment to stock.

Several comments recommended greater single entity treatment of stock. Some recommended a limited approach under which single entity treatment would apply only to stock of the common parent. Under this approach section 1032 treatment would be expanded so that any member could sell stock of the common parent without recognizing any gain or loss. As a corollary, gain or loss would be recognized when a corporation owning stock of the common parent joined the group, treating the stock, in effect, as redeemed.

This suggestion was generally not adopted in the final regulations, because single entity treatment of P stock would significantly increase the complexity of the regulations and would require significant additional guidance dealing with the effect of this treatment on other provisions of the Code. For example, the regulations would have to coordinate single entity treatment of P stock with the reorganization provisions of the Code and applicable case law. Similarly, the regulations would have to address situations in which the common parent of the group changes, as well as a variety of collateral consequences.

Nevertheless, the Treasury and the IRS believe that limited single entity treatment of stock is needed to prevent disparities caused by separate entity treatment. Therefore, temporary regulations published elsewhere in ***[CO-24-95, page 466, this Bulletin] provide a limited single entity approach to P stock that generally limits the ability of a group to create loss with respect to P stock and eliminates gain in certain circumstances. The feasibility of expanding single entity treatment for stock of members will continue to be studied. Comments and suggestions on this subject are welcome.

b. Liquidations.

The proposed regulations provide that if S sells stock of a corporation (T) to B and T later liquidates into B in a transaction to which section 332 applies, S's intercompany gain is taken into account under the matching rule, even though the T stock is never held by a nonmember after the intercompany transaction. This treatment is similar to the treatment under prior regulations and has applied to liquidations under section 332 since 1966 and to deemed liquidations under 338(h)(10) since 1986, although the proposed regulations provide relief not previously available for these transactions.

Some commentators suggested that this rule should be eliminated because it could lead to two layers of tax inside the consolidated group. The final regulations, however, retain the rule (with the elective relief as described below). As more fully explained in Notice 94-49, the location of items within a group is a core principle underlying the operation of these regulations, which like the prior regulations, adopt a deferred sale approach, not a carryover

basis approach. Taking intercompany gain into account in the event of a subsequent nonrecognition transaction is necessary to prevent the transfer and liquidation of subsidiaries from being used to affect consolidated taxable income or tax liability by changing the location of items within a group (a result that would be equivalent to a carryover basis system). For example, assume that S has an asset with a zero basis and a \$100 value. The group would like to shift this built-in gain to B. To do so, S could transfer the asset to T, a newly formed subsidiary. After the transfer, S has a zero basis in the T stock under section 358, and T has a zero basis in the asset under section 362. S then sells the T stock to B for \$100 and realizes a \$100 gain, which is not taken into account. T later liquidates into B, which receives the asset with a zero basis under section 334. If the transaction is not recharacterized as a direct transfer of assets or is not subject to adjustment under section 482, and S's gain on the sale of the T stock is treated as tax-exempt (or if it is indefinitely deferred), the series of transactions has the effect of a transfer of the asset by S to B in a carryover basis transaction.

The Treasury and the IRS rejected a carryover basis system for the reasons detailed in Notice 94-49. While a carryover basis system might be feasible in limited circumstances, extensive rules to prevent avoidance transactions would be required. The result would be to burden the consolidated return regulations with an unworkable combination of rules for both a deferred sale approach and a carryover basis approach. Accordingly, the rule of the proposed regulations has been retained. The regulations have been modified, however, to permit S to determine the amount of its taxable gain by offsetting intercompany gain with intercompany loss on shares of stock having the same material terms.

c. Liquidation relief.

The proposed regulations provide elective relief that, in certain circumstances, eliminates or offsets gain taken into account under the matching rule as a result of a section 332 liquidation (or a comparable nonrecognition transaction, such as a downstream merger). In response to comments, the final regulations broaden the circumstances under which this relief is available by

eliminating the requirements that T have no minority shareholders and that T not have made substantial noncash distributions during the previous 12-month period.

The available relief depends on the form of the transaction that causes S's intercompany gain to be taken into account. In the case of a liquidation of T under section 332, relief is provided by treating the formation by B of a new subsidiary (new T) as if it were pursuant to the same plan or arrangement as the liquidation (thus allowing treatment as a reorganization if other applicable requirements are met). The final regulations expand the scope of this relief over that provided in the proposed regulations by allowing the transfer of assets to new T to be completed up to 12 months after the timely filing (including extensions) of the group's return for the year of T's liquidation, so long as the transaction occurs pursuant to a written plan, a copy of which is attached to the return. In the case of a deemed liquidation of T as the result of an election under section 338(h)(10) in connection with B's sale of the T stock to a nonmember, relief is provided by treating the deemed liquidation as if it were governed by section 331 instead of section 332. The amount of loss taken into account on the deemed liquidation is limited to the amount of the intercompany gain with respect to the T stock that is taken into account as a result of the deemed liquidation.

Some commentators requested that the relief applicable for a deemed liquidation resulting from a section 338(h)(10) election be extended to actual liquidations under section 332—that is, the liquidation would be a taxable event both to T and to B (with T's gain or loss not deferred, and B's basis in the T stock adjusted under §1.1502-32 to reflect T's gain or loss from the taxable liquidation). This suggestion was not adopted. The suggestion would result in the group currently taking into account gain from, and increasing the basis of, property that continues to be held within the group. Adopting the commentators' suggestion could give groups the ability to selectively avoid the deferral of gain on intercompany transactions by instead engaging in stock sales and liquidations. Such selectivity would be contrary to the purpose of these regulations and could create the potential for abusive transactions.

d. Effective date of relief provisions.

As proposed, the effective date of the relief provisions follows the general effective date of the regulations, applying only if both the intercompany transaction and the triggering event occur in years beginning after the final regulations are filed with the Federal Register. Commentators requested retroactive application of the relief provisions to varying degrees. For example, some commentators suggested that the relief should extend to transactions after the date the regulations are finalized. Others suggested that the relief should apply for any open year.

In response to these comments, the final regulations adopt an effective date that allows groups to elect to apply the relief provisions to certain transactions that occur on or after July 12, 1995, regardless of whether the sale of the T stock from S to B occurred prior to July 12, 1995.

The final regulations neither provide relief for duplicated gains nor preclude losses taken into account under the prior regulations in periods prior to the effective date of the regulations. Broader retroactivity would result in significant additional administrative burdens for the IRS. In addition to an increase in amended returns, taxpayers that made elections to avoid triggering S's gain (for example, under section 338) might seek to revoke these elections. Revocation of these elections could raise difficult valuation issues for assets that were disposed of long ago, as well as questions with respect to other rules that have since been amended. In addition, relief for prior years would be somewhat arbitrary. For example, many taxpayers, such as those whose gain was taken into account from a liquidation of T into B, would be unable to benefit from the relief (because the relief requires T to be reformed within a limited time period). By allowing elective relief only for transactions occurring after the date the regulations are filed, the final regulations provide the most relief possible without creating these problems.

8. Obligations of members.

a. Deemed satisfaction and reissuance.

In addition to the general matching provisions, the proposed regulations provide rules applicable to intercom-

pany obligations that generally operate to match an obligor's items with an obligee's items from intercompany obligations. This matching results from a deemed satisfaction and reissuance of an intercompany obligation when either member realizes income or loss with respect to the intercompany obligation from the assignment or extinguishment of all or part of the remaining rights or obligations under the intercompany obligation, or from a comparable transaction, such as marking to market. For example, if one member is a dealer in securities that holds a security issued by another member, the dealer might be required to mark to market the security issued by the other member at year-end under section 475. Under the proposed regulations, marking to market the other member's security will result in a deemed satisfaction and reissuance of the security, so that the marking member and the issuing member take offsetting gain and loss into account.

Commentators objected to the deemed satisfaction and reissuance provision as requiring significant recordkeeping and burdensome computations that are not required for financial statement or internal management reporting purposes. Commentators suggested that Prop. Reg. §1.446-4(e)(9) (published in the Federal Register on July 18, 1994, 59 FR 36394), which permits separate entity treatment for certain hedging transactions between members, should be extended beyond hedging transactions to other intercompany obligations, provided one party to the transaction marks its position to market. Separate entity treatment would avoid the deemed satisfaction and reissuance rule if one member is a dealer in securities required to mark its securities to market.

The final regulations do not adopt this suggestion. The rules of §1.446-4 limit the nonmarking member's ability to selectively recognize gain or loss on its position in the intercompany obligation. Without a limitation of this type, separate entity treatment would allow taxpayers to achieve results that are contrary to the purposes of these regulations (for example, by allowing a member to mark a loss position in an intercompany obligation while the other member defers realization of the associated gain). Accordingly, separate entity treatment is not made available in the final regulations to other types of intercompany obligations.

The Treasury and the IRS recognize that Prop. Reg. §1.446-4(e)(9) provides an important exception to the general single entity treatment of these final regulations. The Treasury and the IRS anticipate that the proposed section 446 regulations will be finalized shortly.

b. Cancellation of intercompany indebtedness.

The proposed regulations do not affect the application of section 108 to the cancellation of intercompany indebtedness. For example, under the proposed regulations if S loans money to B, a cancellation of the loan subject to section 108(a) may result in: (i) excluded income to B; (ii) a noncapital, nondeductible expense to S (under the matching rule); and (iii) a reduction of B's tax attributes (such as its basis in depreciable property). As a result, B's tax attributes are reduced even though the group has not excluded any income on a net basis. Accordingly, the final regulations provide that section 108(a) does not apply to the cancellation of intercompany indebtedness. As a result of this change, the general principles of the matching rule will prevent transactions to which section 108(a) would otherwise apply from having inappropriate effects on basis and consolidated taxable income. In the preceding example, S and B will have offsetting ordinary income and ordinary loss, and B's tax attributes will not be reduced. However, no inference is intended as to whether the extinguishment of a loan between S and B would be properly characterized as a transaction giving rise to cancellation of indebtedness income within the meaning of sections 61(a)(12) and 108, or as a contribution to capital, a dividend or other transaction.

c. Obligations becoming intercompany obligations.

Under the proposed regulations, if an obligation becomes an intercompany obligation, it is treated as satisfied and reissued immediately after the obligation becomes an intercompany obligation. This treatment applies to both the issuer and the holder. The attributes of the issuer's items and the holder's items are separately determined, and thus may not match. Commentators requested that the rules be revised to allow for single entity treatment of attributes, to avoid the mismatch of ordinary income with capital loss.

This suggestion was not adopted. The use of separate return attributes for gain and loss assures that the attributes of gain or loss will be the same whether the obligation is retired immediately before the transaction in which the obligation becomes an intercompany obligation, or is deemed retired as a result of that transaction. Providing for the use of single entity attributes would result in undue selectivity. In addition, the separate entity treatment of attributes in these circumstances best reflects the fact that the income and loss taken into account accrued before the issuer and the holder joined in filing a consolidated return.

Commentators also noted that, under §1.1502-32, downward stock basis adjustments would be required upon the expiration of any capital losses created by the deemed satisfaction if a member joins the group while holding an obligation of another member. Because the proposed regulations provide that the deemed satisfaction and reissuance is treated as occurring immediately after the obligation becomes an intercompany obligation, these losses could not be waived under §1.1502-32(b)(4). In response to this comment, the final regulations provide that, solely for purposes of §1.1502-32(b)(4) and the effect of any elections under that provision, the joining member's loss from the deemed satisfaction and reissuance is treated as a loss carryover from a separate return limitation year. Thus, the group may elect to waive the capital losses and avoid the downward basis adjustment.

d. Warrants and similar instruments.

The proposed regulations do not provide special rules for the treatment of warrants to acquire a member's stock. The proposed regulations could, however, be read to include warrants within the definition of intercompany obligations.

Under section 1032, warrants and other positions in stock of the issuer are treated like stock. See, for example, Rev. Rul. 88-31, 1988-1 C.B. 302. The treatment of warrants as intercompany obligations subject to a single entity regime is inconsistent with the general separate entity treatment of stock under these regulations. Accordingly, the final regulations provide that warrants and other positions with respect to a member's stock are not treated as

obligations of that member. Instead, these instruments are governed by the rules generally applicable to stock of a member. In addition, the final regulations provide that the deemed satisfaction and reissuance rule for intercompany obligations will not apply to the conversion of an intercompany obligation into the stock of the obligor.

9. *Anti-avoidance rule.*

The purpose of the intercompany transaction regulations is to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability). The proposed regulations provide that transactions which are engaged in or structured with a principal purpose to achieve a contrary result are subject to adjustment under the anti-avoidance rule, notwithstanding compliance with other applicable authorities. Some commentators criticized this rule as being overly broad, unnecessary, and more appropriately placed in other regulations, such as §1.701-2 (the partnership anti-abuse regulation). Other commentators supported the use of anti-avoidance rules but criticized the particular examples. The Treasury and the IRS continue to believe that the anti-avoidance rule is necessary to prevent transactions that are designed to achieve results inconsistent with the purpose of the regulations and therefore the final regulations retain the rule. Routine intercompany transactions that are undertaken for legitimate business purposes generally will be unaffected by the anti-avoidance rule.

The anti-avoidance provision can apply to transactions that are structured to avoid treatment as intercompany transactions. For example, if property is indirectly transferred from one member to another using a nonmember intermediary to achieve a result that could not be achieved by a direct transfer within the group, the anti-avoidance rule might apply. Thus, transactions that take place indirectly between members but are not intercompany transactions (including, for example, transactions involving the use of fungible property, trusts, partnerships, and intermediaries) will be analyzed to determine whether they are substantially similar (in whole or in part) to an intercompany transaction, in which

case the anti-avoidance rule might apply.

The examples from the proposed regulations have been revised to better illustrate the effect of the anti-avoidance rule. *Example 2* of the proposed regulations, which involved a transfer outside of the group to a partnership, has been eliminated. However, the transaction described in that example, as with any other transaction, is subject to challenge under other authorities. See, for example, §1.701-2.

10. *Transitional anti-avoidance rule.*

To prevent manipulation, the proposed regulations provide that if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the final regulations, to duplicate, omit, or eliminate an item in determining taxable income (or tax liability), or to treat items inconsistently, appropriate adjustments must be made in years to which the final regulations apply to prevent the avoidance, duplication, omission, elimination, or inconsistency.

Commentators objected to this rule, arguing that it had the effect of treating the proposed regulation as an immediately effective temporary regulation. These commentators also raised questions as to when the rule applies and what "appropriate adjustments" will be necessary.

Because of the prospective application of the regulations, and particularly because members could otherwise engage in transactions entirely within the group with a principal purpose to avoid the application of the final regulations with almost no transaction costs, this rule is retained in the final regulations, with minor clarifications.

11. *Dealers in securities.*

If S is a dealer in securities under section 475 and sells securities to B, a nondealer, the proposed regulations require S to treat any gain or loss on the sale as an intercompany item. Furthermore, under the single entity approach of the matching rule, B must continue to mark to market securities acquired from S.

Several commentators argued that this approach is inconsistent with proposed regulations under section 475, which require S to mark to market the security immediately before the trans-

fer, and take any gain or loss into account immediately (that is, the gain or loss is not subject to deferral under the prior intercompany transaction regulations).

Although the rules applicable to these types of transactions under the proposed regulations and the proposed section 475 regulations differ, the effects of these transactions on consolidated taxable income are generally the same. That is, the dealer's gain or loss is taken into account in the taxable year of the transfer.

The approach of the proposed intercompany transaction regulations is consistent with the general single entity principle, and has been retained in the final regulations. Nevertheless, the Treasury and the IRS will continue to consider the most appropriate treatment of these transactions, in view of the underlying purposes of these regulations and section 475. The Treasury and the IRS anticipate that upcoming regulations under section 475 will address any remaining inconsistencies in the approach, and will provide exceptions to the single entity approach if appropriate. Comments and suggestions on this subject are welcome.

12. *Changes to section 267 regulations.*

The proposed regulations under section 267(f) generally provide that losses from sales or exchanges of property between related parties are taken into account in the same manner as is provided in the timing provisions of the regulations under §1.1502-13. Several technical changes have been incorporated into the final regulations under section 267.

For example, the regulations clarify that to the extent S's loss would have been treated as a noncapital, nondeductible amount under the attribute rules of the regulations under §1.1502-13, the loss is deferred under section 267(f) until S and B are no longer in a controlled group relationship with each other. Section 267 is intended to prevent a taxpayer from taking a loss into account from the sale or exchange of property when the property continues to be held by a member of the same controlled group. Under §1.1502-13, S's loss might be taken into account but redetermined to be noncapital or nondeductible, permanently preventing the loss from being taken into account. It could be argued that

this is the result of the attribute provisions of §1.1502-13, which do not apply under section 267(f), not a result of the timing provisions of §1.1502-13, and thus, a controlled group member could take its loss into account. The change made in the final regulations assures that the purpose of section 267 is not defeated as a result of the non-application of the attribute redetermination rules of §1.1502-13 for purposes of section 267(f).

The proposed regulations also require loss deferral similar to section 267(d) when B transfers property acquired at a loss from S to a nonmember related party. This provision has been modified in the final regulations to include parties described in section 707(b) as related parties to prevent avoidance of the rules of section 267 through the use of related partnerships.

13. Election to deconsolidate.

Section 1.1502-75 authorizes the Commissioner to grant all groups, or groups in a particular class, permission to discontinue filing consolidated returns if any provision of the Code or regulations has been amended and the amendment could have a substantial adverse effect relative to the filing of separate returns. The Commissioner has determined that it is generally appropriate to grant permission to discontinue filing consolidated returns as a result of the amendments made in these regulations. To lessen taxpayer burden and ease administrability, permission will be granted without requiring the group to demonstrate any adverse effect. The Treasury and the IRS intend to issue, prior to January 1, 1996, a revenue procedure pursuant to which groups may receive permission to deconsolidate effective for their first taxable year to which these regulations apply. Permission for a group to deconsolidate will be granted under terms and conditions similar to those prescribed in Rev. Proc. 95-11 (1995-4 I.R.B. 48).

D. Effective Dates

The regulations are effective in years beginning on or after July 12, 1995. For dates of applicability, see §1.1502-13(l).

E. Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations do not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations will primarily affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. The regulations also govern certain transactions between members of controlled groups of corporations, but generally produce the same results for such transactions as current law. The regulations do not significantly alter the reporting or recordkeeping duties of small entities. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Reporting and recordkeeping requirements

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entries for §§1.1502-13 and 1.1502-33, and 1.1502-80, as set forth below; by removing the entries for sections “1.469-1”, “1.469-1T”, “1.1502-13T”, “1.1502-14”, and “1.1502-14T”; and adding the remaining entries in numerical order to read as follows:

- Authority: 26 U.S.C. 7805 * * *
- Section 1.108-3 also issued under 26 U.S.C. 108, 267, and 1502. * * *
- Section 1.267(f)-1 also issued under 26 U.S.C. 267 and 1502. * * *
- Section 1.460-4 also issued under 26 U.S.C. 460 and 1502. * * *
- Section 1.469-1 also issued under 26 U.S.C. 469.
- Section 1.469-1T also issued under 26 U.S.C. 469. * * *
- Section 1.1502-13 also issued under 26 U.S.C. 108, 337, 446, 1275, 1502 and 1503. * * *
- Section 1.1502-17 also issued under 26 U.S.C. 446 and 1502.
- Section 1.1502-18 also issued under 26 U.S.C. 1502. * * *
- Section 1.1502-26 also issued under 26 U.S.C. 1502. * * *
- Section 1.1502-33 also issued under 26 U.S.C. 1502. * * *
- Section 1.1502-79 also issued under 26 U.S.C. 1502.
- Section 1.1502-80 also issued under 26 U.S.C. 1502. * * *

Par. 2. In the list below, for each location indicated in the left column, remove the language in the middle column from that section, and add the language in the right column.

| <i>Affected Section</i> | <i>Remove</i> | <i>Add</i> |
|--|---|--|
| 1.167(a)–(11)(d)(3)(v)(b), 1st sentence | which results in “deferred gain or loss” within the meaning of paragraph (c) of 1.1502–13 | |
| 1.167(c)–1(a)(5) | , 1.1502–13, and 1.1502–14 | 1.1502–13 |
| 1.263A–1T(b)(2)(vi)(B), 2nd sentence | a deferred intercompany transaction | an intercompany transaction |
| 1.263A–1T(e)(1)(ii), 1st sentence | a deferred intercompany transaction | an intercompany transaction |
| 1.263A–1T(e)(1)(ii), 4th sentence | 1.1502–13(c)(2) | 1.1502–13 |
| 1.263A–1T(e)(1)(ii), 4th sentence | deferred | |
| 1.263A–1T(e)(1)(ii), 7th sentence | “deferred intercompany transaction” | “intercompany transaction” |
| 1.263A–1T(e)(1)(ii), 7th sentence | defined | as used |
| 1.263A–1T(e)(1)(iii)(A) <i>Example</i> , 2nd sentence | 1.1502–13(c) | 1.1502–13 |
| 1.263A–1T(e)(1)(iii)(A) <i>Example</i> , 4th sentence | 1.1502–13(c) | 1.1502–13 |
| 1.279–6(b)(4) | , §1.1502–13T, §1.1502–14, or §1.1502–14T | |
| 1.337(d)–1(a)(5) <i>Example 8(i)</i> , 5th sentence | 1.1502–13(c) | 1.1502–13 |
| 1.337(d)–1(a)(5) <i>Example 8(ii)</i> , 1st sentence | 1.1502–13(c) | 1.1502–13 |
| 1.337(d)–1(a)(5) <i>Example 8(ii)</i> , 2nd sentence | 1.1502–13(f)(1)(i), 1.267(f)–T(e)(1) | 1.1502–13, 1.267(f)–1 |
| 1.337(d)–2(g)(1), 2nd sentence | 1.1502–13T, 1.1502–14, and 1.1502–14T | 1.1502–14 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) |
| 1.338–4(f)(4) <i>Example (2)(a)</i> | 1.1502–13(f) | 1.1502–13 |
| 1.341–7(e)(10) | paragraph (c)(1) of §1.1502–14 for the deferral | §1.1502–13 for the treatment |
| 1.861–8T(d)(2)(i), concluding text | 1.1502–13(c)(2) | 1.1502–13 |
| 1.861–8T(d)(2)(i), concluding text | deferred | |
| 1.861–8T(d)(2)(i), concluding text | 1.1502–13(a)(2) | 1.1502–13 |
| 1.861–9T(g)(2)(iv), paragraph heading | deferred | |
| 1.861–9T(g)(2)(iv), 1st sentence | deferred intercompany transactions | intercompany transactions |
| 1.1502–3(a)(2) | 1.1502–13(a)(1) | 1.1502–13(b) |
| 1.1502–4(j) <i>Example (1)</i> , 8th sentence | Under §1.1502–13 | Under §1.1502–13 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) |
| 1.1502–9(f) <i>Example (6)</i> | a restoration event under section 1.1502–13(f) occurs | the intercompany gain is taken into account under section 1.1502–13 |
| 1.1502–12(a) | §§1.1502–13 and 1.1502–14 | §1.1502–13 |
| 1.1502–12(g)(2) | a deferred intercompany transaction as defined in §1.1502–13(a)(2) | an intercompany transaction as defined in §1.1502–13 |
| 1.1502–22(a)(3) | 1.1502–14, | |
| 1.1502–22(a)(5) <i>Example (i)</i> | paragraph (d), (e), or (f) of §1.1502–13 | §1.1502–13 |
| 1.1502–26(b), second sentence | paragraph (a)(1) of §1.1502–14 | §1.1502–13 |
| 1.1502–47(e)(4)(iii), first sentence | §§1.1502–13(f), 1.1502–14, | §§1.1502–13, |
| 1.1502–47(e)(4)(iv) <i>Example 4</i> , third sentence | deferred intercompany transactions (see §1.1502–13(a)(2)) | intercompany transactions (see §1.1502–13) |
| 1.1502–47(e)(4)(iv) <i>Example 4</i> , fourth sentence | 1.1502–13(f)(1)(iv) | 1.1502–13 |

| <i>Affected Section</i> | <i>Remove</i> | <i>Add</i> |
|--|--|-----------------------------------|
| 1.1502-47(e)(4)(iv) <i>Example 4</i> , chart header | Deferred intercompany transactions between | Intercompany transactions between |
| 1.1502-47(e)(4)(iv) <i>Example 4</i> , chart header | 1.1502-13(f)(1)(iv) | 1.1502-13 |
| 1.1502-47(f)(3), first sentence | 1.1502-14, | |
| 1.1502-47(r), second sentence | deferred | |
| 1.1503-2(d)(4) <i>Example 1</i> (iii), fourth sentence | deferred | |
| 1.1503-2(d)(4) <i>Example 1</i> (iii), fourth sentence | 1.1502-13(a)(2) | 1.1502-13 |
| 1.1552-1(a)(2)(ii)(c) | 1.1502-14 | 1.1502-13(f) and (g) |

Par. 3. Section 1.108-3 is added to read as follows:

§1.108-3 Intercompany losses and deductions.

(a) *General rule.* This section applies to certain losses and deductions from the sale, exchange, or other transfer of property between corporations that are members of a consolidated group or a controlled group (an intercompany transaction). See section 267(f) (controlled groups) and §1.1502-13 (consolidated groups) for applicable definitions. For purposes of determining the attributes to which section 108(b) applies, a loss or deduction not yet taken into account under section 267(f) or §1.1502-13 (an intercompany loss or deduction) is treated as basis described in section 108(b) that the transferor retains in property. To the extent a loss not yet taken into account is reduced under this section, it cannot subsequently be taken into account under section 267(f) or §1.1502-13. For example, if S and B are corporations filing a consolidated return, and S sells land with a \$100 basis to B for \$90 and the \$10 loss is deferred under section 267(f) and §1.1502-13, the deferred loss is treated for purposes of section 108(b) as \$10 of basis that S has in land (even though S has no remaining interest in the land sold to B) and is subject to reduction under section 108(b)(2)(E). Similar principles apply, with appropriate adjustments, if S and B are members of a controlled group and S's loss is deferred only under section 267(f).

(b) *Effective date.* This section applies with respect to discharges of indebtedness occurring on or after September 11, 1995.

§1.167(a)-11 [Amended]

Par. 4. Section 1.167(a)-11(d)(3)-(v)(e) is amended by removing the second sentence of *Example (3)*.

Par. 5. In § 1.263A-1, paragraph (j)-(1)(ii)(B), the last sentence is revised to read as follows:

§1.263A-1 Uniform capitalization of costs.

- * * * * *
- (j) * * *
- (1) * * *
- (ii) * * *
- (B) * * * See §1.1502-13.

* * * * *

Par. 6. Section 1.267(f)-1 is revised to read as follows:

§1.267(f)-1 Controlled groups.

(a) *In general—(1) Purpose.* This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B).

(2) *Application of consolidated return principles.* Under this section, S's loss or deduction from an intercompany sale is taken into account under the timing principles of §1.1502-13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. For this purpose:

(i) The matching and acceleration rules of §1.1502-13(c) and (d), the definitions and operating rules of §1.1502-13(b) and (j), and the simplifying rules of §1.1502-13(e)(1) apply with the adjustments in paragraphs (b) and (c) of this section to reflect that this section—

(A) Applies on a controlled group basis rather than consolidated group basis; and

(B) Generally affects only the timing of a loss or deduction, and not its attributes (e.g., its source and character) or the holding period of property.

(ii) The special rules under §1.1502-13(f) (stock of members) and (g) (obligations of members) apply under this section only to the extent the transaction is also an intercompany transaction to which §1.1502-13 applies.

(iii) Any election under §1.1502-13 to take items into account on a separate entity basis does not apply under this section. See §1.1502-13(e)(3).

(3) *Other law.* The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, to the extent a loss or deduction deferred under this section is from a transaction that is also an intercompany transaction under §1.1502-13(b)(1), attributes of the loss or deduction are also subject to re-characterization under §1.1502-13. See also, sections 269 (acquisitions to evade or avoid income tax) and 482 (allocations among commonly controlled taxpayers). Any loss or deduction taken into account under this section can be deferred, disallowed, or eliminated under other applicable law. See, for example, section 1091 (loss eliminated on wash sale).

(b) *Definitions and operating rules.* The definitions in §1.1502-13(b) and

the operating rules of §1.1502-13(j) apply under this section with appropriate adjustments, including the following:

(1) *Intercompany sale.* An intercompany sale is a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of §1.1502-13, determined by treating the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns.

(2) *S's losses or deductions.* Except to the extent the intercompany sale is also an intercompany transaction to which §1.1502-13 applies, S's losses or deductions subject to this section are determined on a separate entity basis. For example, the principles of §1.1502-13(b)(2)(iii) (treating certain amounts not yet recognized as items to be taken into account) do not apply. A loss or deduction is from an intercompany sale whether it is directly or indirectly from the intercompany sale.

(3) *Controlled group; member.* For purposes of this section, a controlled group is defined in section 267(f). Thus, a controlled group includes a FSC (as defined in section 922) and excluded members under section 1563(b)(2), but does not include a DISC (as defined in section 992). Corporations remain members of a controlled group as long as they remain in a controlled group relationship with each other. For example, corporations become nonmembers with respect to each other when they cease to be in a controlled group relationship with each other, rather than by having a separate return year (described in §1.1502-13(j)(7)). Further, the principles of §1.1502-13(j)(6) (former common parent treated as continuation of group) apply to any corporation if, immediately before it becomes a nonmember, it is both the selling member and the owner of property with respect to which a loss or deduction is deferred (whether or not it becomes a member of a different controlled group filing consolidated or separate returns). Thus, for example, if S and B merge together in a transaction described in section 368(a)(1)(A), the surviving corporation is treated as the successor to the other corporation, and the controlled group relationship is treated as continuing.

(4) *Consolidated taxable income.* References to consolidated taxable in-

come (and consolidated tax liability) include references to the combined taxable income of the members (and their combined tax liability). For corporations filing separate returns, it ordinarily will not be necessary to actually combine their taxable incomes (and tax liabilities) because the taxable income (and tax liability) of one corporation does not affect the taxable income (or tax liability) of another corporation.

(c) *Matching and acceleration principles of §1.1502-13—(1) Adjustments to the timing rules.* Under this section, S's losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of §1.1502-13(c) and (d) with appropriate adjustments. For example, if S sells depreciable property to B at a loss, S's loss is deferred and taken into account under the principles of the matching rule of §1.1502-13(c) to reflect the difference between B's depreciation taken into account with respect to the property and the depreciation that B would take into account if S and B were divisions of a single corporation; if S and B subsequently cease to be in a controlled group relationship with each other, S's remaining loss is taken into account under the principles of the acceleration rule of §1.1502-13(d). For purposes of this section, the adjustments to §1.1502-13(c) and (d) include the following:

(i) *Application on controlled group basis.* The matching and acceleration rules apply on a controlled group basis, rather than a consolidated group basis. Thus if S and B are wholly-owned members of a consolidated group and 21% of the stock of S is sold to an unrelated person, S's loss continues to be deferred under this section because S and B continue to be members of a controlled group even though S is no longer a member of the consolidated group. Similarly, S's loss would continue to be deferred if S and B remain in a controlled group relationship after both corporations become nonmembers of their former consolidated group.

(ii) *Different taxable years.* If S and B have different taxable years, the taxable years that include a December 31 are treated as the same taxable years. If S or B has a short taxable year that does not include a December 31, the short year is treated as part of the succeeding taxable year that does include a December 31.

(iii) *Transfer to a section 267(b) or 707(b) related person.* To the extent S's loss or deduction from an intercompany sale of property is taken into account under this section as a result of B's transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b) (for example, if S or B becomes an S corporation), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. The balance not allowed is treated as a loss referred to in section 267(d) if it is from a sale or exchange by B (rather than from a distribution).

(iv) *B's item is excluded from gross income or noncapital and nondeductible.* To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of §1.1502-13 but is not redetermined because of paragraph (c)(2) of this section, then, if paragraph (c)(1)(iii) of this section does not apply, S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship. See §1.1502-13(c)(6)(ii).

(v) *Circularity of references.* References to deferral or elimination under the Internal Revenue Code or regulations do not include references to section 267(f) or this section. See, e.g., §1.1502-13(a)(4) (applicability of other law).

(2) *Attributes generally not affected.* The matching and acceleration rules are not applied under this section to affect the attributes of S's intercompany item, or cause it to be taken into account before it is taken into account under S's separate entity method of accounting. However, the attributes of S's intercompany item may be redetermined, or an item may be taken into account earlier than under S's separate entity method of accounting, to the extent the transaction is also an intercompany transaction to which §1.1502-13 applies. Similarly, except to the extent the transaction is also an inter-

company transaction to which §1.1502-13 applies, the matching and acceleration rules do not apply to affect the timing or attributes of B's corresponding items.

(d) *Intercompany sales of inventory involving foreign persons*—(1) *General rule.* Section 267(a)(1) and this section do not apply to an intercompany sale of property that is inventory (within the meaning of section 1221(1)) in the hands of both S and B, if—

(i) The intercompany sale is in the ordinary course of S's trade or business;

(ii) S or B is a foreign corporation; and

(iii) Any income or loss realized on the intercompany sale by S or B is not income or loss that is recognized as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (unless the income is exempt from taxation pursuant to a treaty obligation of the United States).

(2) *Intercompany sales involving related partnerships.* For purposes of paragraph (d)(1) of this section, a partnership and a foreign corporation described in section 267(b)(10) are treated as members, provided that the income or loss of the foreign corporation is described in paragraph (d)(1)(iii) of this section.

(3) *Intercompany sales in ordinary course.* For purposes of this paragraph (d), whether an intercompany sale is in the ordinary course of business is determined under all the facts and circumstances.

(e) *Treatment of a creditor with respect to a loan in nonfunctional currency.* Sections 267(a)(1) and this section do not apply to an exchange loss realized with respect to a loan of nonfunctional currency if—

(1) The loss is realized by a member with respect to nonfunctional currency loaned to another member;

(2) The loan is described in §1.988-1(a)(2)(i);

(3) The loan is not in a hyperinflationary currency as defined in §1.988-1(f); and

(4) The transaction does not have as a significant purpose the avoidance of Federal income tax.

(f) *Receivables.* If S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market

value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.

(g) *Earnings and profits.* A loss or deduction deferred under this section is not reflected in S's earnings and profits before it is taken into account under this section. See, e.g., §§1.312-6(a), 1.312-7, and 1.1502-33(c)(2).

(h) *Anti-avoidance rule.* If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this section.

(i) [Reserved]

(j) *Examples.* For purposes of the examples in this paragraph (j), unless otherwise stated, corporation P owns 75% of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P controlled group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only activity, and no member has a special status. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred as to M (rather than as S or B). This section is illustrated by the following examples.

Example 1. Matching and acceleration rules.

(a) *Facts.* S holds land for investment with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. On a separate entity basis, S's loss is long-term capital loss. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X for \$110.

(b) *Matching rule.* Under paragraph (b)(1) of this section, S's sale of land to B is an intercompany sale. Under paragraph (c)(1) of this section, S's \$30 loss is taken into account under the timing principles of the matching rule of §1.1502-13(c) to reflect the difference for the year between B's corresponding items taken into account and the recomputed corresponding items. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$130 basis in the land and would have a \$20 loss from the sale to X in Year 3. Consequently, S takes no loss into account in Years 1 and 2, and takes the entire \$30 loss into account in Year 3 to reflect the \$30 difference in that year between

the \$10 gain B takes into account and its \$20 recomputed loss. The attributes of S's intercompany items and B's corresponding items are determined on a separate entity basis. Thus, S's \$30 loss is long-term capital loss and B's \$10 gain is ordinary income.

(c) *Acceleration resulting from sale of B stock.* The facts are the same as in paragraph (a) of this *Example 1*, except that on July 1 of Year 3 P sells all of its B stock to X (rather than B's selling the land to X). Under paragraph (c)(1) of this section, S's \$30 loss is taken into account under the timing principles of the acceleration rule of §1.1502-13(d) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once B becomes a nonmember, S takes its \$30 loss into account in Year 3 immediately before B becomes a nonmember. S's loss is long-term capital loss.

(d) *Subgroup principles applicable to sale of S and B stock.* The facts are the same as in paragraph (a) of this *Example 1*, except that on July 1 of Year 3 P sells all of its S and B stock to X (rather than B's selling the land to X). Under paragraph (b)(3) of this section, S and B are considered to remain members of a controlled group as long as they remain in a controlled group relationship with each other (whether or not in the original controlled group). P's sale of their stock does not affect the controlled group relationship of S and B with each other. Thus, S's loss is not taken into account as a result of P's sale of the stock. Instead, S's loss is taken into account based on subsequent events (e.g., B's sale of the land to a nonmember).

Example 2. Distribution of loss property. (a) *Facts.* S holds land with a basis of \$130 and value of \$100. On January 1 of Year 1, S distributes the land to P in a transaction to which section 311 applies. On July 1 of Year 3, P sells the land to X for \$110.

(b) *No loss taken into account.* Under paragraph (b)(2) of this section, because P and S are not members of a consolidated group, §1.1502-13(f)(2)(iii) does not apply to cause S to recognize a \$30 loss under the principles of section 311(b). Thus, S has no loss to be taken into account under this section. (If P and S were members of a consolidated group, §1.1502-13(f)(2)(iii) would apply to S's loss in addition to the rules of this section, and the loss would be taken into account in Year 3 as a result of P's sale to X.)

Example 3. Loss not yet taken into account under separate entity accounting method. (a) *Facts.* S holds land with a basis of \$130. On January 1 of Year 1, S sells the land to B at a \$30 loss but does not take into account the loss under its separate entity method of accounting until Year 4. On July 1 of Year 3, B sells the land to X for \$110.

(b) *Timing.* Under paragraph (b)(2) of this section, S's loss is determined on a separate entity basis. Under paragraph (c)(1) of this section, S's loss is not taken into account before it is taken into account under S's separate entity method of accounting. Thus, although B takes its corresponding gain into account in Year 3, S has no loss to take into account until Year 4. Once S's loss is taken into account in Year 4, it is not deferred under this section because B's corresponding gain has already been taken into account. (If S and B were members of a consolidated group, S would be treated under

§1.1502-13(b)(2)(iii) as taking the loss into account in Year 3.)

Example 4. Consolidated groups. (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S holds land for investment with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, P sells 25% of B's stock to X. As a result of P's sale, B becomes a nonmember of the P consolidated group but S and B remain in a controlled group relationship with each other for purposes of section 267(f). Assume that if S and B were divisions of a single corporation, the items of S and B from the land would be ordinary by reason of B's activities.

(b) *Timing and attributes.* Under paragraph (a)(3) of this section, S's sale to B is subject to both §1.1502-13 and this section. Under §1.1502-13, S's loss is redetermined to be an ordinary loss by reason of B's activities. Under paragraph (b)(3) of this section, because S and B remain in a controlled group relationship with each other, the loss is not taken into account under the acceleration rule of §1.1502-13(d) as modified by paragraph (c) of this section. See §1.1502-13(a)(4). Nevertheless, S's loss is redetermined by §1.1502-13 to be an ordinary loss, and the character of the loss is not further redetermined under this section. Thus, the loss continues to be deferred under this section, and will be taken into account as ordinary loss based on subsequent events (e.g., B's sale of the land to a nonmember).

(c) *Resale to controlled group member.* The facts are the same as in paragraph (a) of this *Example 4*, except that P owns 75% of X's stock, and B resells the land to X (rather than P's selling any B stock). The results for S's loss are the same as in paragraph (b) of this *Example 4*. Under paragraph (b) of this section, X is also in a controlled group relationship, and B's sale to X is a second intercompany sale. Thus, S's loss continues to be deferred and is taken into account under this section as ordinary loss based on subsequent events (e.g., X's sale of the land to a nonmember).

Example 5. Intercompany sale followed by installment sale. (a) *Facts.* S holds land for investment with a basis of \$130×. On January 1 of Year 1, S sells the land to B for \$100×. B holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's \$110× note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55× in Year 4 and \$55× in Year 5. Section 453A applies to X's note.

(b) *Timing and attributes.* Under paragraph (c) of this section, S's \$30× loss is taken into account under the timing principles of the matching rule of §1.1502-13(c) to reflect the difference in each year between B's gain taken into account and its recomputed loss. Under section 453, B takes into account \$5× of gain in Year 4 and in Year 5. Therefore, S takes \$20× of its loss into account in Year 3 to reflect the \$20× difference in that year between B's \$0 loss taken into account and its \$20× recomputed loss. In addition, S takes \$5× of its loss into account in Year 4 and in Year 5 to reflect the \$5× difference in each year between B's \$5× gain taken into account and its \$0 recomputed gain. Although S takes into account a loss and B takes into account a gain, the attributes of B's \$10× gain are determined on a separate entity basis, and therefore the interest charge under section 453A(c) applies to B's \$10× gain on the installment sale beginning in Year 3.

Example 6. Section 721 transfer to a related nonmember. (a) *Facts.* S owns land with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, B transfers the land to a partnership in exchange for a 40% interest in capital and profits in a transaction to which section 721 applies. P also owns a 25% interest in the capital and profits of the partnership.

(b) *Timing.* Under paragraph (c)(1)(iii) of this section, because the partnership is a nonmember that is a related person under sections 267(b) and 707(b), S's \$30 loss is taken into account in Year 3, but only to the extent of any income or gain taken into account as a result of the transfer. Under section 721, no gain or loss is taken into account as a result of the transfer to the partnership, and thus none of S's loss is taken into account. Any subsequent gain recognized by the partnership with respect to the property is limited under section 267(d). (The results would be the same if the P group were a consolidated group, and S's sale to B were also subject to §1.1502-13.)

Example 7. Receivables. (a) *Controlled group.* S owns goods with a \$60 basis. In Year 1, S sells the goods to X for X's \$100 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for payment of principal in Year 5. S takes into account \$40 of income in Year 1 under its method of accounting. In Year 2, the fair market value of X's note falls to \$90 due to an increase in prevailing market interest rates, and S sells the note to B for its \$90 fair market value.

(b) *Loss not deferred.* Under paragraph (f) of this section, S takes its \$10 loss into account in Year 2. (If the sale were not at fair market value, paragraph (f) of this section would not apply and none of S's \$10 loss would be taken into account in Year 2.)

(c) *Consolidated group.* Assume instead that P owns all of the stock of S and B, and the P group is a consolidated group. In Year 1, S sells to X goods having a basis of \$90 for X's \$100 note (bearing a market rate of interest in excess of the applicable Federal rate, and providing for payment of principal in Year 5), and S takes into account \$10 of income in Year 1. In Year 2, S sells the receivable to B for its \$85 fair market value. In Year 3, P sells 25% of B's stock to X. Although paragraph (f) of this section provides that \$10 of S's loss (i.e., the extent to which S's \$15 loss does not exceed its \$10 of income) is not deferred under this section, S's entire \$15 loss is subject to §1.1502-13 and none of the loss is taken into account in Year 2 under the matching rule of §1.1502-13(c). See paragraph (a)(3) of this section (continued deferral under §1.1502-13). P's sale of B stock results in B becoming a nonmember of the P consolidated group in Year 3. Thus, S's \$15 loss is taken into account in Year 3 under the acceleration rule of §1.1502-13(d). Nevertheless, B remains in a controlled group relationship with S and paragraph (f) of this section permits only \$10 of S's loss to be taken into account in Year 3. See §1.1502-13(a)(4) (continued deferral under section 267). The remaining \$5 of S's loss continues to be deferred under this section and taken into account under this section based on subsequent events (e.g., B's collection of the note or P's sale of the remaining B stock to a nonmember).

Example 8. Selling member ceases to be a member. (a) *Facts.* P owns all of the stock of S and B, and the P group is a consolidated group. S has several historic assets, including land with a

basis of \$130 and value of \$100. The land is not essential to the operation of S's business. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, P transfers all of S's stock to newly formed X in exchange for a 20% interest in X stock as part of a transaction to which section 351 applies. Although X holds many other assets, a principal purpose for P's transfer is to accelerate taking S's \$30 loss into account. P has no plan or intention to dispose of the X stock.

(b) *Timing.* Under paragraph (c) of this section, S's \$30 loss ordinarily is taken into account immediately before P's transfer of the S stock, under the timing principles of the acceleration rule of §1.1502-13(d). Although taking S's loss into account results in a \$30 negative stock basis adjustment under §1.1502-32, because P has no plan or intention to dispose of its X stock, the negative adjustment will not immediately affect taxable income. P's transfer accelerates a loss that otherwise would be deferred, and an adjustment under paragraph (h) of this section is required. Thus, S's loss is never taken into account, and S's stock basis and earnings and profits are reduced by \$30 under §§1.1502-32 and 1.1502-33 immediately before P's transfer of the S stock.

(c) *Nonhistoric assets.* Assume instead that, with a principal purpose to accelerate taking into account any further loss that may accrue in the value of the land without disposing of the land outside of the controlled group, P forms M with a \$100 contribution on January 1 of Year 1 and S sells the land to M for \$100. On December 1 of Year 1, when the value of the land has decreased to \$90, M sells the land to B for \$90. On July 1 of Year 3, while B still owns the land, P sells all of M's stock to X and M becomes a nonmember. Under paragraph (c) of this section, M's \$10 loss ordinarily is taken into account under the timing principles of the acceleration rule of §1.1502-13(d) immediately before M becomes a nonmember. (S's \$30 loss is not taken into account under the timing principles of §1.1502-13(c) or §1.1502-13(d) as a result of M becoming a nonmember, but is taken into account based on subsequent events such as B's sale of the land to a nonmember or P's sale of the stock of S or B to a nonmember.) The land is not an historic asset of M and, although taking M's loss into account reduces P's basis in the M stock under §1.1502-32, the negative adjustment only eliminates the \$10 duplicate stock loss. Under paragraph (h) of this section, M's loss is never taken into account. M's stock basis, and the earnings and profits of M and P, are reduced by \$10 under §§1.1502-32 and 1.1502-33 immediately before P's sale of the M stock.

(k) *Cross-reference.* For additional rules applicable to the disposition or deconsolidation of the stock of members of consolidated groups, see §§1.337(d)-1, 1.337(d)-2, 1.1502-13T(f)(6), and 1.1502-20.

(1) *Effective dates*—(1) *In general.* This section applies with respect to transactions occurring in S's years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items are duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items are

treated inconsistently, prior law (and not this section) applies to the transaction.

(2) *Avoidance transactions.* This paragraph (1)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section applicable to transactions occurring in years beginning on or after July 12, 1995, to duplicate, omit, or eliminate an item in determining taxable income (or tax liability), or to treat items inconsistently. If this paragraph (1)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, elimination, or inconsistency.

(3) *Prior law.* For transactions occurring in S's years beginning before July 12, 1995, see the applicable regulations issued under sections 267 and 1502. See, e.g., §§1.267(f)-1, 1.267(f)-1T, 1.267(f)-2T, 1.267(f)-3, 1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, and 1.1502-31 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

§§1.267(f)-1T, 1.267(f)-2T, and 1.267(f)-3 [Removed]

Par. 7. Sections 1.267(f)-1T, 1.267(f)-2T, and 1.267(f)-3 are removed.

Par. 8. Section 1.460-0 is amended in the table of contents by revising the entries for §1.460-4 to read as follows:

§1.460-0 Outline of regulations under section 460.

* * * * *

§1.460-4 Methods of accounting for long-term contracts.

(a) through (i) [Reserved]

(j) Consolidated groups and controlled groups.

(1) Intercompany transactions.

(i) In general.

(ii) Definitions and nomenclature.

(2) Example.

(3) Effective dates.

(i) In general.

(ii) Prior law.

(4) Consent to change method of accounting.

* * * * *

Par. 9. Section 1.460-4 is amended by:

1. Revising the section heading.
2. Adding and reserving paragraphs (a) through (i).
3. Adding paragraph (j).

The revisions and additions read as follows:

§1.460-4 Methods of accounting for long-term contracts.

(a) through (i) [Reserved]

(j) *Consolidated groups and controlled groups*—(1) *Intercompany transactions*—(i) *In general.* Section 1.1502-13 does not apply to the income, gain, deduction, or loss from an intercompany transaction between members of a consolidated group, and section 267(f) does not apply to these items from an intercompany sale between members of a controlled group, to the extent—

(A) The transaction or sale directly or indirectly benefits, or is intended to benefit, another member's long-term contract with a nonmember;

(B) The selling member is required under section 460 to determine any part of its gross income from the transaction or sale under the percentage-of-completion method (PCM); and

(C) The member with the long-term contract is required under section 460 to determine any part of its gross income from the long-term contract under the PCM.

(ii) *Definitions and nomenclature.* The definitions and nomenclature under §1.1502-13 and §1.267(f)-1 apply for purposes of this paragraph (j).

(2) *Example.* The following example illustrates the principles of paragraph (j)(1) of this section.

Example. Corporations P, S, and B file consolidated returns on a calendar-year basis. In 1996, B enters into a long-term contract with X, a nonmember, to manufacture 5 airplanes for \$500 million, with delivery scheduled for 1999. Section 460 requires B to determine the gross income from its contract with X under the PCM. S enters into a contract with B to manufacture for \$50 million the engines that B will install on X's airplanes. Section 460 requires S to determine the gross income from its contract with B under the PCM. S estimates that it will incur \$40 million of total contract costs during 1997 and 1998 to manufacture the engines. S incurs \$10 million of contract costs in 1997 and \$30 million in 1998. Under paragraph (j) of this section, S determines its gross income from the long-term contract under the PCM rather than taking its income or loss into account under section 267(f) or §1.1502-13. Thus, S includes \$12.5 million of gross receipts and \$10 million of contract costs in gross income in 1997 and includes \$37.5

million of gross receipts and \$30 million of contract costs in gross income in 1998.

(3) *Effective dates*—(i) *In general.* This paragraph (j) applies with respect to transactions and sales occurring pursuant to contracts entered into in years beginning on or after July 12, 1995.

(ii) *Prior law.* For transactions and sales occurring pursuant to contracts entered into in years beginning before July 12, 1995, see the applicable regulations issued under sections 267(f) and 1502, including §§1.267(f)-1T, 1.267(f)-2T, and 1.1502-13(n) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(4) *Consent to change method of accounting.* For transactions and sales to which this paragraph (j) applies, the Commissioner's consent under section 446(e) is hereby granted to the extent any changes in method of accounting are necessary solely to comply with this section, provided the changes are made in the first taxable year of the taxpayer to which the rules of this paragraph (j) apply. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

Par. 10. In §1.469-0, the table of contents is amended by:

1. Revising the entries for §1.469-1:
 - a. Paragraphs (a) through (d)(1).
 - b. Paragraphs (g)(5) through (h)(3).
 - c. Paragraphs (h)(5) through (k).
2. Revising the entries for §1.469-1T, paragraphs (c)(8), and (h)(1), (2), and (6). The revisions read as follows:

§1.469-0 Table of contents.

* * * * *

§1.469-1 General rules.

(a) through (c)(7) [Reserved]

(c)(8) Consolidated groups.

(c)(9) through (d)(1) [Reserved]

* * * * *

(g)(5) [Reserved]

(h)(1) In general.

(h)(2) Definitions.

(h)(3) [Reserved]

* * * * *

(h)(5) [Reserved]

(h)(6) Intercompany transactions.

(i) In general.

- (ii) Example.
- (iii) Effective dates.
- (h)(7) through (k) [Reserved]

§1.469-1T General rules (temporary).

* * * * *

(c)(8) [Reserved]

* * * * *

(h)(1) [Reserved]

(h)(2) [Reserved]

* * * * *

(h)(6) [Reserved]

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Par. 11. Section 1.469-1 is amended by adding paragraphs (c)(8), (h)(1), (h)(2) and (h)(6) to read as follows (paragraphs (a) through (c)(7), (c)(9) through (d)(1), (g)(5), (h)(3), (h)(5) and (h)(7) through (k) continue to be reserved):

§1.469-1 General rules.

(a) through (c)(7) [Reserved]

(c)(8) *Consolidated groups.* Rules relating to the application of section 469 to consolidated groups are contained in paragraph (h) of this section.

(c)(9) through (d)(1) [Reserved]

* * * * *

(g)(5) [Reserved]

(h)(1) *In general.* This paragraph (h) provides rules for applying section 469 in computing a consolidated group's consolidated taxable income and consolidated tax liability (and the separate taxable income and tax liability of each member).

(2) *Definitions.* The definitions and nomenclature in the regulations under section 1502 apply for purposes of this paragraph (h). See, e.g., §§1.1502-1 (definitions of group, consolidated group, member, subsidiary, and consolidated return year), 1.1502-2 (consolidated tax liability), 1.1502-11 (consolidated taxable income), 1.1502-12 (separate taxable income), 1.1502-13 (intercompany transactions), 1.1502-21 (consolidated net operating loss), and 1.1502-22 (consolidated net capital gain or loss).

(3) [Reserved]

* * * * *

(5) [Reserved]

(6) *Intercompany transactions—(i) In general.* Section 1.1502-13 applies to determine the treatment under section 469 of intercompany items and corresponding items from intercompany transactions between members of a consolidated group. For example, the matching rule of §1.1502-13(c) treats the selling member (S) and the buying member (B) as divisions of a single corporation for purposes of determining whether S's intercompany items and B's corresponding items are from a passive activity. Thus, for purposes of applying §1.469-2(c)(2)(iii) and §1.469-2T(d)(5)(ii) to property sold by S to B in an intercompany transaction—

(A) S and B are treated as divisions of a single corporation for determining the uses of the property during the 12-month period preceding its disposition to a nonmember, and generally have an aggregate holding period for the property; and

(B) §1.469-2(c)(2)(iv) does not apply.

(ii) *Example.* The following example illustrates the application of this paragraph (h)(6).

Example. (i) P, a closely held corporation, is the common parent of the P consolidated group. P owns all of the stock of S and B. X is a person unrelated to any member of the P group. S owns and operates equipment that is not used in a passive activity. On January 1 of Year 1, S sells the equipment to B at a gain. B uses the equipment in a passive activity and does not dispose of the equipment before it has been fully depreciated.

(ii) Under the matching rule of §1.1502-13(c), S's gain taken into account as a result of B's depreciation is treated as gain from a passive activity even though S used the equipment in a nonpassive activity.

(iii) The facts are the same as in paragraph (a) of this *Example*, except that B sells the equipment to X on December 1 of Year 3 at a further gain. Assume that if S and B were divisions of a single corporation, gain from the sale to X would be passive income attributable to a passive activity. To the extent of B's depreciation before the sale, the results are the same as in paragraph (ii) of this *Example*. B's gain and S's remaining gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iv) The facts are the same as in paragraph (iii) of this *Example*, except that B recognizes a loss on the sale to X. B's loss and S's gain taken into account as a result of B's sale are treated as attributable to a passive activity.

(iii) *Effective dates.* This paragraph (h)(6) applies with respect to transactions occurring in years beginning on or after July 12, 1995. For transactions occurring in years beginning before

July 12, 1995, see §1.469-1T(h)(6) (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(h)(7) through (k) [Reserved]

§1.469-1T [Amended]

Par. 12. Section 1.469-1T is amended by removing and reserving paragraphs (c)(8), (h)(1), (2), and (6).

Par. 13. Section 1.1502-13 is revised to read as follows:

§1.1502-13 Intercompany transactions.

(a) *In general—(1) Purpose.* This section provides rules for taking into account items of income, gain, deduction, and loss of members from intercompany transactions. The purpose of this section is to provide rules to clearly reflect the taxable income (and tax liability) of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income (or consolidated tax liability).

(2) *Separate entity and single entity treatment.* Under this section, the selling member (S) and the buying member (B) are treated as separate entities for some purposes but as divisions of a single corporation for other purposes. The amount and location of S's intercompany items and B's corresponding items are determined on a separate entity basis (separate entity treatment). For example, S determines its gain or loss from a sale of property to B on a separate entity basis, and B has a cost basis in the property. The timing, and the character, source, and other attributes of the intercompany items and corresponding items, although initially determined on a separate entity basis, are redetermined under this section to produce the effect of transactions between divisions of a single corporation (single entity treatment). For example, if S sells land to B at a gain and B sells the land to a nonmember, S does not take its gain into account until B's sale to the nonmember.

(3) *Timing rules as a method of accounting—(i) In general.* The timing rules of this section are a method of accounting for intercompany transactions, to be applied by each member in addition to the member's other methods of accounting. See §1.1502-17. To the extent the timing rules of this section are inconsistent with a member's other-

wise applicable methods of accounting, the timing rules of this section control. For example, if S sells property to B in exchange for B's note, the timing rules of this section apply instead of the installment sale rules of section 453. S's or B's application of the timing rules of this section to an intercompany transaction clearly reflects income only if the effect of that transaction as a whole (including, for example, related costs and expenses) on consolidated taxable income is clearly reflected.

(ii) *Automatic consent for joining and departing members*—(A) *Consent granted.* Section 446(e) consent is granted under this section to the extent a change in method of accounting is necessary solely by reason of the timing rules of this section—

(1) For each member, with respect to its intercompany transactions, in the first consolidated return year which follows a separate return year and in which the member engages in an intercompany transaction; and

(2) For each former member, with respect to its transactions with members that would otherwise be intercompany transactions if the former member were still a member, in the first separate return year in which the former member engages in such a transaction.

(B) *Cut-off basis.* Any change in method of accounting described in paragraph (a)(3)(ii)(A) of this section is to be effected on a cut-off basis for transactions entered into on or after the first day of the year for which consent is granted under paragraph (a)(3)(ii)(A) of this section.

(4) *Other law.* The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, this section applies in addition to sections 267(f) (additional rules for certain losses), 269 (acquisitions to evade or avoid income tax), and 482 (allocations among commonly controlled taxpayers). Thus, an item taken into account under this section can be deferred, disallowed, or eliminated under other applicable law, for example, section 1091 (losses from wash sales).

(5) *References.* References in other sections to this section include, as appropriate, references to prior law. For effective dates and prior law see paragraph (l) of this section.

(6) *Overview*—(i) *In general.* The principal rules of this section that

implement single entity treatment are the matching rule and the acceleration rule of paragraphs (c) and (d) of this section. Under the matching rule, S and B are generally treated as divisions of a single corporation for purposes of taking into account their items from intercompany transactions. The acceleration rule provides additional rules for taking the items into account if the effect of treating S and B as divisions cannot be achieved (for example, if S or B becomes a nonmember). Paragraph (b) of this section provides definitions. Paragraph (e) of this section provides simplifying rules for certain transactions. Paragraphs (f) and (g) of this section provide additional rules for stock and obligations of members. Paragraphs (h) and (j) of this section provide anti-avoidance rules and miscellaneous operating rules.

(ii) *Table of examples.* Set forth below is a table of the examples contained in this section.

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| <i>Matching rule.</i> | (§1.1502-13(c)(7)(ii)) |
| Example 1. | Intercompany sale of land. |
| Example 2. | Dealer activities. |
| Example 3. | Intercompany section 351 transfer. |
| Example 4. | Depreciable property. |
| Example 5. | Intercompany sale followed by installment sale. |
| Example 6. | Intercompany sale of installment obligation. |
| Example 7. | Performance of services. |
| Example 8. | Rental of property. |
| Example 9. | Intercompany sale of a partnership interest. |
| Example 10. | Net operating losses subject to section 382 or the SRLY rules. |
| Example 11. | Section 475. |
| Example 12. | Section 1092. |
| Example 13. | Manufacturer incentive payments. |
| Example 14. | Source of income under section 863. |
| Example 15. | Section 1248. |

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| <i>Acceleration rule.</i> | (§1.1502-13(d)(3)) |
| Example 1. | Becoming a nonmember—timing. |
| Example 2. | Becoming a nonmember—attributes. |
| Example 3. | Selling member's disposition of installment note. |

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| Example 4. | Cancellation of debt and attribute reduction under section 108(b). |
| Example 5. | Section 481. |

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| <i>Simplifying rules—inventory.</i> | (§1.1502-13(e)(1)(v)) |
| Example 1. | Increment averaging method. |
| Example 2. | Increment valuation method. |
| Example 3. | Other reasonable inventory methods. |

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| <i>Stock of members.</i> | (§1.1502-13(f)(7)) |
| Example 1. | Dividend exclusion and property distribution. |
| Example 2. | Excess loss accounts. |
| Example 3. | Intercompany reorganization. |
| Example 4. | Stock redemptions and distributions. |
| Example 5. | Intercompany stock sale followed by section 332 liquidation. |
| Example 6. | Intercompany stock sale followed by section 355 distribution. |

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| <i>Obligations of members.</i> | (§1.1502-13(g)(5)) |
| Example 1. | Interest on intercompany debt. |
| Example 2. | Intercompany debt becomes nonintercompany debt. |
| Example 3. | Loss or bad debt deduction with respect to intercompany debt. |
| Example 4. | Nonintercompany debt becomes intercompany debt. |
| Example 5. | Notional principal contracts. |

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| <i>Anti-avoidance rules.</i> | (§1.1502-13(h)(2)) |
| Example 1. | Sale of a partnership interest. |
| Example 2. | Transitory status as an intercompany obligation. |
| Example 3. | Corporate mixing bowl. |
| Example 4. | Partnership mixing bowl. |
| Example 5. | Sale and leaseback. |

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|---------------------------------------|--------------------|
| <i>Miscellaneous operating rules.</i> | (§1.1502-13(j)(9)) |
|---------------------------------------|--------------------|

- Example 1. Intercompany sale followed by section 351 transfer to member.
- Example 2. Intercompany sale of member stock followed by recapitalization.
- Example 3. Back-to-back intercompany transactions—matching.
- Example 4. Back-to-back intercompany transactions—acceleration.
- Example 5. Successor group.
- Example 6. Liquidation—80% distributee.
- Example 7. Liquidation—no 80% distributee.

(b) *Definitions.* For purposes of this section—

(1) *Intercompany transactions*—(i) *In general.* An intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction. S is the member transferring property or providing services, and B is the member receiving the property or services. Intercompany transactions include—

(A) S's sale of property (or other transfer, such as an exchange or contribution) to B, whether or not gain or loss is recognized;

(B) S's performance of services for B, and B's payment or accrual of its expenditure for S's performance;

(C) S's licensing of technology, rental of property, or loan of money to B, and B's payment or accrual of its expenditure; and

(D) S's distribution to B with respect to S stock.

(ii) *Time of transaction.* If a transaction occurs in part while S and B are members and in part while they are not members, the transaction is treated as occurring when performance by either S or B takes place, or when payment for performance would be taken into account under the rules of this section if it were an intercompany transaction, whichever is earliest. Appropriate adjustments must be made in such cases by, for example, dividing the transaction into two separate transactions reflecting the extent to which S or B has performed.

(iii) *Separate transactions.* Except as otherwise provided in this section, each transaction is analyzed separately. For

example, if S simultaneously sells two properties to B, one at a gain and the other at a loss, each property is treated as sold in a separate transaction. Thus, the gain and loss cannot be offset or netted against each other for purposes of this section. Similarly, each payment or accrual of interest on a loan is a separate transaction. In addition, an accrual of premium is treated as a separate transaction, or as an offset to interest that is not a separate transaction, to the extent required under separate entity treatment. If two members exchange property, each member is S with respect to the property it transfers and B with respect to the property it receives. If two members enter into a notional principal contract, each payment under the contract is a separate transaction and the member making the payment is B with respect to that payment and the member receiving the payment is S. See paragraph (j)(4) of this section for rules aggregating certain transactions.

(2) *Intercompany items*—(i) *In general.* S's income, gain, deduction, and loss from an intercompany transaction are its intercompany items. For example, S's gain from the sale of property to B is intercompany gain. An item is an intercompany item whether it is directly or indirectly from an intercompany transaction.

(ii) *Related costs or expenses.* S's costs or expenses related to an intercompany transaction are included in determining its intercompany items. For example, if S sells inventory to B, S's direct and indirect costs properly includible under section 263A are included in determining its intercompany income. Similarly, related costs or expenses that are not capitalized under S's separate entity method of accounting are included in determining its intercompany items. For example, deductions for employee wages, in addition to other related costs, are included in determining S's intercompany items from performing services for B, and depreciation deductions are included in determining S's intercompany items from renting property to B.

(iii) *Amounts not yet recognized or incurred.* S's intercompany items include amounts from an intercompany transaction that are not yet taken into account under its separate entity method of accounting. For example, if S is a cash method taxpayer, S's intercompany income might be taken into account under this section even if

the cash is not yet received. Similarly, an amount reflected in basis (or an amount equivalent to basis) under S's separate entity method of accounting that is a substitute for income, gain, deduction or loss from an intercompany transaction is an intercompany item.

(3) *Corresponding items*—(i) *In general.* B's income, gain, deduction, and loss from an intercompany transaction, or from property acquired in an intercompany transaction, are its corresponding items. For example, if B pays rent to S, B's deduction for the rent is a corresponding deduction. If B buys property from S and sells it to a nonmember, B's gain or loss from the sale to the nonmember is a corresponding gain or loss; alternatively, if B recovers the cost of the property through depreciation, B's depreciation deductions are corresponding deductions. An item is a corresponding item whether it is directly or indirectly from an intercompany transaction (or from property acquired in an intercompany transaction).

(ii) *Disallowed or eliminated amounts.* B's corresponding items include amounts that are permanently disallowed or permanently eliminated, whether directly or indirectly. Thus, corresponding items include amounts disallowed under section 265 (expenses relating to tax-exempt income), and amounts not recognized under section 311(a) (nonrecognition of loss on distributions), section 332 (nonrecognition on liquidating distributions), or section 355(c) (certain distributions of stock of a subsidiary). On the other hand, an amount is not permanently disallowed or permanently eliminated (and therefore is not a corresponding item) to the extent it is not recognized in a transaction in which B receives a successor asset within the meaning of paragraph (j)(1) of this section. For example, B's corresponding items do not include amounts not recognized from a transaction with a nonmember to which section 1031 applies or from another transaction in which B receives exchanged basis property.

(4) *Recomputed corresponding items.* The recomputed corresponding item is the corresponding item that B would take into account if S and B were divisions of a single corporation and the intercompany transaction were between those divisions. For example, if S sells property with a \$70 basis to B for \$100, and B later sells the property to a nonmember for \$90, B's

corresponding item is its \$10 loss, and the recomputed corresponding item is \$20 of gain (determined by comparing the \$90 sales price with the \$70 basis the property would have if S and B were divisions of a single corporation). Although neither S nor B actually takes the recomputed corresponding item into account, it is computed as if B did take it into account (based on reasonable and consistently applied assumptions, including any provision of the Internal Revenue Code or regulations that would affect its timing or attributes).

(5) *Treatment as a separate entity.* Treatment as a separate entity means treatment without application of the rules of this section, but with the application of the other consolidated return regulations. For example, if S sells the stock of another member to B, S's gain or loss on a separate entity basis is determined with the application of §1.1502-80(b) (non-applicability of section 304), but without redetermination under paragraph (c) or (d) of this section.

(6) *Attributes.* The attributes of an intercompany item or corresponding item are all of the item's characteristics, except *amount*, *location*, and *timing*, necessary to determine the item's effect on taxable income (and tax liability). For example, attributes include character, source, treatment as excluded from gross income or as a noncapital, nondeductible amount, and treatment as built-in gain or loss under section 382(h) or 384. In contrast, the characteristics of property, such as a member's holding period, or the fact that property is included in inventory, are not attributes of an item, but these characteristics might affect the determination of the attributes of items from the property.

(c) *Matching rule.* For each consolidated return year, B's corresponding items and S's intercompany items are taken into account under the following rules:

(1) *Attributes and holding periods—*(i) *Attributes.* The separate entity attributes of S's intercompany items and B's corresponding items are redetermined to the extent necessary to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation, and the intercompany transaction were a transaction between divisions. Thus, the activities of both S and B might affect the attributes of both intercompany

items and corresponding items. For example, if S holds property for sale to unrelated customers in the ordinary course of its trade or business, S sells the property to B at a gain and B sells the property to an unrelated person at a further gain, S's intercompany gain and B's corresponding gain might be ordinary because of S's activities with respect to the property. Similar principles apply if S performs services, rents property, or engages in any other intercompany transaction.

(ii) *Holding periods.* The holding period of property transferred in an intercompany transaction is the aggregate of the holding periods of S and B. However, if the basis of the property is determined by reference to the basis of other property, the property's holding period is determined by reference to the holding period of the other property. For example, if S distributes stock to B in a transaction to which section 355 applies, B's holding period in the distributed stock is determined by reference to B's holding period in the stock of S.

(2) *Timing—*(i) *B's items.* B takes its corresponding items into account under its accounting method, but the redetermination of the attributes of a corresponding item might affect its timing. For example, if B's sale of property acquired from S is treated as a dealer disposition because of S's activities, section 453(b) prevents any corresponding income of B from being taken into account under the installment method.

(ii) *S's items.* S takes its intercompany item into account to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item.

(3) *Divisions of a single corporation.* As divisions of a single corporation, S and B are treated as engaging in their actual transaction and owning any actual property involved in the transaction (rather than treating the transaction as not occurring). For example, S's sale of land held for investment to B for cash is not disregarded, but is treated as an exchange of land for cash between divisions (and B therefore succeeds to S's basis in the property). Similarly, S's issuance of its own stock to B in exchange for property is not disregarded, B is treated as owning the stock it receives in the exchange, and section 1032 does not apply to B on its subsequent sale of the S stock. Al-

though treated as divisions, S and B nevertheless are treated as:

(i) Operating separate trades or businesses. See, e.g., §1.446-1(d) (accounting methods for a taxpayer engaged in more than one business).

(ii) Having any special status that they have under the Internal Revenue Code or regulations. For example, a bank defined in section 581, a domestic building and loan association defined in section 7701(a)(19), and an insurance company to which section 801 or 831 applies are treated as divisions having separate special status. On the other hand, the fact that a member holds property for sale to customers in the ordinary course of its trade or business is not a special status.

(4) *Conflict or allocation of attributes.* This paragraph (c)(4) provides special rules for redetermining and allocating attributes under paragraph (c)(1)(i) of this section.

(i) *Offsetting amounts—*(A) *In general.* To the extent B's corresponding item offsets S's intercompany item in amount, the attributes of B's corresponding item, determined based on both S's and B's activities, control the attributes of S's offsetting intercompany item. For example, if S sells depreciable property to B at a gain and B depreciates the property, the attributes of B's depreciation deduction (ordinary deduction) control the attributes of S's offsetting intercompany gain. Accordingly, S's gain is ordinary.

(B) *B controls unreasonable.* To the extent the results under paragraph (c)(4)(i)(A) are inconsistent with treating S and B as divisions of a single corporation, the attributes of the offsetting items must be redetermined in a manner consistent with treating S and B as divisions of a single corporation. To the extent, however, that B's corresponding item on a separate entity basis is excluded from gross income, is a noncapital, nondeductible amount, or is otherwise permanently disallowed or eliminated, the attributes of B's corresponding item always control the attributes of S's offsetting intercompany item.

(ii) *Allocation.* To the extent S's intercompany item and B's corresponding item do not offset in amount, the attributes redetermined under paragraph (c)(1)(i) of this section must be allocated to S's intercompany item and B's corresponding item by using a method that is reasonable in light of all the

facts and circumstances, including the purposes of this section and any other rule affected by the attributes of S's intercompany item and B's corresponding item. A method of allocation or redetermination is unreasonable if it is not used consistently by all members of the group from year to year.

(5) *Special status.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, to the extent an item's attributes determined under this section are permitted or not permitted to a member under the Internal Revenue Code or regulations by reason of the member's special status, the attributes required under the Internal Revenue Code or regulations apply to that member's items (but not the other member). For example, if S is a bank to which section 582(c) applies, and sells debt securities at a gain to B, a nonbank, the character of S's intercompany gain is ordinary as required under section 582(c), but the character of B's corresponding item as capital or ordinary is determined under paragraph (c)(1)(i) of this section without the application of section 582(c). For other special status issues, see, for example, sections 595(b) (foreclosure on property securing loans), 818(b) (life insurance company treatment of capital gains and losses), and 1503(c) (limitation on absorption of certain losses).

(6) *Treatment of intercompany items if corresponding items are excluded or nondeductible—(i) In general.* Under paragraph (c)(1)(i) of this section, S's intercompany item might be redetermined to be excluded from gross income or treated as a noncapital, nondeductible amount. For example, S's intercompany loss from the sale of property to B is treated as a noncapital, nondeductible amount if B distributes the property to a nonmember shareholder at no further gain or loss (because, if S and B were divisions of a single corporation, the loss would not have been recognized under section 311(a)). Paragraph (c)(6)(ii) of this section, however, provides limitations on the application of this rule to intercompany income or gain. See also §§1.1502-32 and 1.1502-33 (adjustments to S's stock basis and earnings and profits to reflect amounts so treated).

(ii) *Limitation on treatment of intercompany items as excluded from gross income.* Notwithstanding the general rule of paragraph (c)(1)(i) of this section, S's intercompany income or

gain is redetermined to be excluded from gross income only to the extent one of the following applies:

(A) *Disallowed amounts.* B's corresponding item is a deduction or loss and, in the taxable year the item is taken into account under this section, it is permanently and explicitly disallowed under another provision of the Internal Revenue Code or regulations. For example, deductions that are disallowed under section 265 are permanently and explicitly disallowed. An amount is not permanently and explicitly disallowed, for example, to the extent that—

(1) The Internal Revenue Code or regulations provide that the amount is not recognized (for example, a loss that is realized but not recognized under section 332 or section 355(c) is not permanently and explicitly disallowed, notwithstanding that it is a corresponding item within the meaning of paragraph (b)(3)(ii) of this section (certain disallowed or eliminated amounts));

(2) A related amount might be taken into account by B with respect to successor property, such as under section 280B (demolition costs recoverable as capitalized amounts);

(3) A related amount might be taken into account by another taxpayer, such as under section 267(d) (disallowed loss under section 267(a) might result in nonrecognition of gain for a related person);

(4) A related amount might be taken into account as a deduction or loss, including as a carryforward to a later year, under any provision of the Internal Revenue Code or regulations (whether or not the carryforward expires in a later year); or

(5) The amount is reflected in the computation of any credit against (or other reduction of) Federal income tax (whether allowed for the taxable year or carried forward to a later year).

(B) *Section 311.* The corresponding item is a loss that is realized, but not recognized under section 311(a) on a distribution to a nonmember (even though the loss is not a permanently and explicitly disallowed amount within the meaning of paragraph (c)(6)(ii)(A) of this section).

(C) *Other amounts.* The Commissioner determines that treating S's intercompany item as excluded from gross income is consistent with the purposes of this section and other applicable provisions of the Internal Revenue Code and regulations.

(7) *Examples—(i) In general.* For purposes of the examples in this section, unless otherwise stated, P is the common parent of the P consolidated group, P owns all of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only corporate activity, no member has any special status, and the transaction is not otherwise subject to recharacterization. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred to as M, M1, or M2 (rather than as S or B).

(ii) *Matching rule.* The matching rule of this paragraph (c) is illustrated by the following examples.

Example 1. Intercompany sale of land followed by sale to a nonmember. (a) *Facts.* S holds land for investment with a basis of \$70. S has held the land for more than one year. On January 1 of Year 1, S sells the land to B for \$100. B also holds the land for investment. On July 1 of Year 3, B sells the land to X for \$110.

(b) *Definitions.* Under paragraph (b)(1) of this section, S's sale of the land to B is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraphs (b)(2) and (3) of this section, S's \$30 gain from the sale to B is its intercompany item, and B's \$10 gain from the sale to X is its corresponding item.

(c) *Attributes.* Under the matching rule of paragraph (c) of this section, S's \$30 intercompany gain and B's \$10 corresponding gain are taken into account to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. In addition, the holding periods of S and B for the land are aggregated. Thus, the group's entire \$40 of gain is long-term capital gain. Because both S's intercompany item and B's corresponding item on a separate entity basis are long-term capital gain, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(d) *Timing.* For each consolidated return year, S takes its intercompany item into account under the matching rule to reflect the difference for the year between B's corresponding item taken into account and the recomputed corresponding item. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$70 basis in the land and would have a \$40 gain from the sale to X in Year 3, instead of a \$10 gain. Consequently, S takes no gain into account in Years 1 and 2, and takes the entire \$30 gain into account in Year 3, to reflect the \$30 difference in that year between the \$10 gain B takes into account and the \$40 recomputed gain (the recomputed corresponding item). Under §§1.1502-32 and 1.1502-33, P's basis in its S stock and the earnings and profits of S and P do

not reflect S's \$30 gain until the gain is taken into account in Year 3. (Under paragraph (a)(3) of this section, the results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(e) *Intercompany loss followed by sale to a nonmember at a gain.* The facts are the same as in paragraph (a) of this *Example 1*, except that S's basis in the land is \$130 (rather than \$70). The attributes and timing of S's intercompany loss and B's corresponding gain are determined under the matching rule in the manner provided in paragraphs (c) and (d) of this *Example 1*. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$130 basis in the land and would have a \$20 loss from the sale to X instead of a \$10 gain. Thus, S takes its entire \$30 loss into account in Year 3 to reflect the \$30 difference between B's \$10 gain taken into account and the \$20 recomputed loss. (The results are the same under section 267(f).) S's \$30 loss is long-term capital loss, and B's \$10 gain is long-term capital gain.

(f) *Intercompany gain followed by sale to a nonmember at a loss.* The facts are the same as in paragraph (a) of this *Example 1*, except that B sells the land to X for \$90 (rather than \$110). The attributes and timing of S's intercompany gain and B's corresponding loss are determined under the matching rule. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$70 basis in the land and would have a \$20 gain from the sale to X instead of a \$10 loss. Thus, S takes its entire \$30 gain into account in Year 3 to reflect the \$30 difference between B's \$10 loss taken into account and the \$20 recomputed gain. S's \$30 gain is long-term capital gain, and B's \$10 loss is long-term capital loss.

(g) *Intercompany gain followed by distribution to a nonmember at a loss.* The facts are the same as in paragraph (a) of this *Example 1*, except that B distributes the land to X, a minority shareholder of B, and at the time of the distribution the land has a fair market value of \$90. The attributes and timing of S's intercompany gain and B's corresponding loss are determined under the matching rule. Under section 311(a), B does not recognize its \$10 loss on the distribution to X. If S and B were divisions of a single corporation and the intercompany sale were a transfer between divisions, B would succeed to S's \$70 basis in the land and would have a \$20 gain from the distribution to X instead of an unrecognized \$10 loss. Under paragraph (b)(3)-(ii) of this section, B's loss that is not recognized under section 311(a) is a corresponding item. Thus, S takes its \$30 gain into account under the matching rule in Year 3 to reflect the difference between B's \$10 corresponding unrecognized loss and the \$20 recomputed gain. B's \$10 corresponding loss offsets \$10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Paragraph (c)(6) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income. (See paragraph (c)(6)(ii)(B) of this section.) Thus, \$10 of S's \$30 gain is redetermined to be excluded from gross income.

(h) *Intercompany sale followed by section 1031 exchange with nonmember.* The facts are the same as in paragraph (a) of this *Example 1*,

except that, instead of selling the land to X, B exchanges the land for land owned by X in a transaction to which section 1031 applies. There is no difference in Year 3 between B's \$0 corresponding item taken into account and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 1031 exchange. Instead, B's gain is preserved in the land received from X and, under the successor asset rule of paragraph (j)(1) of this section, S's intercompany gain is taken into account by reference to the replacement property. (If B takes gain into account as a result of boot received in the exchange, S's intercompany gain is taken into account under the matching rule to the extent the boot causes a difference between B's gain taken into account and the recomputed gain.)

(i) *Intercompany sale followed by section 351 transfer to nonmember.* The facts are the same as in paragraph (a) of this *Example 1*, except that, instead of selling the land to X, B transfers the land to X in a transaction to which section 351(a) applies and X remains a nonmember. There is no difference in Year 3 between B's \$0 corresponding item taken into account and the \$0 recomputed corresponding item. Thus, none of S's intercompany gain is taken into account under the matching rule as a result of the section 351(a) transfer. However, S's entire gain is taken into account in Year 3 under the acceleration rule of paragraph (d) of this section (because X, a nonmember, reflects B's \$100 cost basis in the land under section 362).

Example 2. Dealer activities. (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to B for \$100. B develops the land as residential real estate, and sells developed lots to customers during Year 3 for an aggregate amount of \$110.

(b) *Attributes.* S and B are treated under the matching rule as divisions of a single corporation for purposes of determining the attributes of S's intercompany item and B's corresponding item. Thus, although S held the land for investment, whether the gain is treated as from the sale of property described in section 1221(1) is based on the activities of both S and B. If, based on both S's and B's activities, the land is described in section 1221(1), both S's gain and B's gain are ordinary income.

Example 3. Intercompany section 351 transfer. (a) *Facts.* S holds land with a \$70 basis and a \$100 fair market value for sale to customers in the ordinary course of business. On January 1 of Year 1, S transfers the land to B in exchange for all of the stock of B in a transaction to which section 351 applies. S has no gain or loss under section 351(a), and its basis in the B stock is \$70 under section 358. Under section 362, B's basis in the land is \$70. B holds the land for investment. On July 1 of Year 3, B sells the land to X for \$100. Assume that if S and B were divisions of a single corporation, B's gain from the sale would be ordinary income because of S's activities.

(b) *Timing and attributes.* Under paragraph (b)(1) of this section, S's transfer to B is an intercompany transaction. Under paragraph (c)(3) of this section, S is treated as transferring the land in exchange for B's stock even though, as divisions, S could not own stock of B. S has no intercompany item, but B's \$30 gain from its sale of the land to X is a corresponding item because the land was acquired in an intercompany transaction. B's \$30 gain is ordinary

income that is taken into account under B's method of accounting.

(c) *Intercompany section 351 transfer with boot.* The facts are the same as in paragraph (a) of this *Example 3*, except that S receives \$10 cash in addition to the B stock in the transfer. S recognizes \$10 of gain under section 351(b), and its basis in the B stock is \$70 under section 358. Under section 362, B's basis in the land is \$80. S takes its \$10 intercompany gain into account in Year 3 to reflect the \$10 difference between B's \$20 corresponding gain taken into account and the \$30 recomputed gain. Both S's \$10 gain and B's \$20 gain are ordinary income.

(d) *Partial disposition.* The facts are the same as in paragraph (c) of this *Example 3*, except B sells a only a one-half, undivided interest in the land to X for \$50. The timing and attributes are determined in the manner provided in paragraph (b) of this *Example 3*, except that S takes only \$5 of its gain into account in Year 3 to reflect the \$5 difference between B's \$10 gain taken into account and the \$15 recomputed gain.

Example 4. Depreciable property. (a) *Facts.* On January 1 of Year 1, S buys 10-year recovery property for \$100 and depreciates it under the straight-line method. On January 1 of Year 3, S sells the property to B for \$130. Under section 168(i)(7), B is treated as S for purposes of section 168 to the extent B's \$130 basis does not exceed S's adjusted basis at the time of the sale. B's additional basis is treated as new 10-year recovery property for which B elects the straight-line method of recovery. (To simplify the example, the half-year convention is disregarded.)

(b) *Depreciation through Year 3; intercompany gain.* S claims \$10 of depreciation for each of Years 1 and 2 and has an \$80 basis at the time of the sale to B. Thus, S has a \$50 intercompany gain from its sale to B. For Year 3, B has \$10 of depreciation with respect to \$80 of its basis (the portion of its \$130 basis not exceeding S's adjusted basis). In addition, B has \$5 of depreciation with respect to the \$50 of its additional basis that exceeds S's adjusted basis.

(c) *Timing.* S's \$50 gain is taken into account to reflect the difference for each consolidated return year between B's depreciation taken into account with respect to the property and the recomputed depreciation. For Year 3, B takes \$15 of depreciation into account. If the intercompany transaction were a transfer between divisions of a single corporation, B would succeed to S's adjusted basis in the property and take into account only \$10 of depreciation for Year 3. Thus, S takes \$5 of gain into account in Year 3. In each subsequent year that B takes into account \$15 of depreciation with respect to the property, S takes into account \$5 of gain.

(d) *Attributes.* Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's depreciation must be redetermined to the extent necessary to produce the same effect on consolidated taxable income as if the intercompany transaction were between divisions of a single corporation (the group must have a net depreciation deduction of \$10). In each year, \$5 of B's corresponding depreciation deduction offsets S's \$5 intercompany gain taken into account and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control the attributes of S's intercompany item. Accordingly, S's intercompany gain that is taken into account as a result of B's depreciation deduction is ordinary income.

(e) *Sale of property to a nonmember.* The facts are the same as in paragraph (a) of this

Example 4, except that B sells the property to X on January 1 of Year 5 for \$110. As set forth in paragraphs (c) and (d) of this *Example 4*, B has \$15 of depreciation with respect to the property in each of Years 3 and 4, causing S to take \$5 of intercompany gain into account in each year as ordinary income. The \$40 balance of S's intercompany gain is taken into account in Year 5 as a result of B's sale to X, to reflect the \$40 difference between B's \$10 gain taken into account and the \$50 of recomputed gain (\$110 of sale proceeds minus the \$60 basis B would have if the intercompany sale were a transfer between divisions of a single corporation). Treating S and B as divisions of a single corporation, \$40 of the gain is section 1245 gain and \$10 is section 1231 gain. On a separate entity basis, S would have more than \$10 treated as section 1231 gain, and B would have no amount treated as section 1231 gain. Under paragraph (c)(4)(ii) of this section, all \$10 of the section 1231 gain is allocated to S. S's remaining \$30 of gain, and all of B's \$10 gain, is treated as section 1245 gain.

Example 5. Intercompany sale followed by installment sale. (a) *Facts.* S holds land for investment with a basis of \$70x. On January 1 of Year 1, S sells the land to B for \$100x. B also holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's \$110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55x in Year 4 and \$55x in Year 5. The interest charge under section 453A(c) applies to X's note.

(b) *Timing and attributes.* S takes its \$30x gain into account to reflect the difference in each consolidated return year between B's gain taken into account for the year and the recomputed gain. Under section 453, B takes into account \$5x of gain in Year 4 and \$5x of gain in Year 5. Thus, S takes into account \$15x of gain in Year 4 and \$15x of gain in Year 5 to reflect the \$15x difference in each of those years between B's \$5x gain taken into account and the \$20x recomputed gain. Both S's \$30x gain and B's \$10x gain are subject to the section 453A(c) interest charge beginning in Year 3.

(c) *Election out under section 453(d).* If, under the facts in paragraph (a) of this *Example 5*, the P group wishes to elect not to apply section 453 with respect to S's gain, an election under section 453(d) must be made for Year 3 with respect to B's gain. This election will cause B's \$10x gain to be taken into account in Year 3. Under the matching rule, this will result in S's \$30x gain being taken into account in Year 3. (An election by the P group solely with respect to S's gain has no effect because the gain from S's sale to B is taken into account under the matching rule, and therefore must reflect the difference between B's gain taken into account and the recomputed gain.)

(d) *Sale to a nonmember at a loss, but overall gain.* The facts are the same as in paragraph (a) of this *Example 5*, except that B sells the land to X in exchange for X's \$90x note (rather than \$110x note). If S and B were divisions of a single corporation, B would succeed to S's basis in the land, and the sale to X would be eligible for installment reporting under section 453, because it resulted in an overall gain. However, because only gains may be reported on the installment method, B's \$10x corresponding loss is taken into account in Year 3. Under paragraph (b)(4) of this section the recomputed corresponding item is \$20x gain that would be taken into account under the installment method, \$0 in Year 3 and \$10x in each of Years 4 and 5. Thus, in

Year 3 S takes \$10x of gain into account to reflect the difference between B's \$10x loss taken into account and the \$0 recomputed gain for Year 3. Under paragraph (c)(4)(i) of this section, B's \$10x corresponding loss offsets \$10x of S's intercompany gain, and B's attributes control. S takes \$10x of gain into account in each of Years 4 and 5 to reflect the difference in those years between B's \$0 gain taken into account and the \$10x recomputed gain that would be taken into account under the installment method. Only the \$20x of S's gain taken into account in Years 4 and 5 is subject to the interest charge under section 453A(c) beginning in Year 3. (If P elects under section 453(d) for Year 3 not to apply section 453 with respect to the gain, all of S's \$30x gain will be taken into account in Year 3 to reflect the difference between B's \$10x loss taken into account and the \$20x recomputed gain.)

(e) *Intercompany loss, installment gain.* The facts are the same as in paragraph (a) of this *Example 5*, except that S has a \$130x (rather than \$70x) basis in the land. Under paragraph (c)(1)(i) of this section, the separate entity attributes of S's and B's items from the intercompany transaction must be redetermined to produce the same effect on consolidated taxable income (and tax liability) as if the transaction had been a transfer between divisions. If S and B were divisions of a single corporation, B would succeed to S's basis in the land and the group would have \$20x loss from the sale to X, installment reporting would be unavailable, and the interest charge under section 453A(c) would not apply. Accordingly, B's gain from the transaction is not eligible for installment treatment under section 453. B takes its \$10x gain into account in Year 3, and S takes its \$30x of loss into account in Year 3 to reflect the difference between B's \$10x gain and the \$20x recomputed loss.

(f) *Recapture income.* The facts are the same as in paragraph (a) of this *Example 5*, except that S bought depreciable property (rather than land) for \$100x, claimed depreciation deductions, and reduced the property's basis to \$70x before Year 1. (To simplify the example, B's depreciation is disregarded.) If the intercompany sale of property had been a transfer between divisions of a single corporation, \$30x of the \$40x gain from the sale to X would be section 1245 gain (which is ineligible for installment reporting) and \$10x would be section 1231 gain (which is eligible for installment reporting). On a separate entity basis, S would have \$30x of section 1245 gain and B would have \$10x of section 1231 gain. Accordingly, the attributes are not redetermined under paragraph (c)(1)(i) of this section. All of B's \$10x gain is eligible for installment reporting and is taken into account \$5x each in Years 4 and 5 (and is subject to the interest charge under section 453A(c)). S's \$30x gain is taken into account in Year 3 to reflect the difference between B's \$0 gain taken into account and the \$30x of recomputed gain. (If S had bought the depreciable property for \$110x and its recomputed basis under section 1245 had been \$110x (rather than \$100x), B's \$10x gain and S's \$30x gain would both be recapture income ineligible for installment reporting.)

Example 6. Intercompany sale of installment obligation. (a) *Facts.* S holds land for investment with a basis of \$70x. On January 1 of Year 1, S sells the land to X in exchange for X's \$100x note, and S reports its gain on the installment method under section 453. X's note bears interest at a market rate of interest in excess of the

applicable Federal rate, and provides for principal payments of \$50x in Year 5 and \$50x in Year 6. Section 453A applies to X's note. On July 1 of Year 3, S sells X's note to B for \$100x, resulting in \$30x gain from S's prior sale of the land to X under section 453B(a).

(b) *Timing and attributes.* S's sale of X's note to B is an intercompany transaction, and S's \$30x gain is intercompany gain. S takes \$15x of the gain into account in each of Years 5 and 6 to reflect the \$15x difference in each year between B's \$0 gain taken into account and the \$15x recomputed gain. S's gain continues to be treated as its gain from the sale to X, and the deferred tax liability remains subject to the interest charge under section 453A(c).

(c) *Worthlessness.* The facts are the same as in paragraph (a) of this *Example 6*, except that X's note becomes worthless on December 1 of Year 3 and B has a \$100x short-term capital loss under section 165(g) on a separate entity basis. Under paragraph (c)(1)(ii) of this section, B's holding period for X's note is aggregated with S's holding period. Thus, B's loss is a long-term capital loss. S takes its \$30x gain into account in Year 3 to reflect the \$30x difference between B's \$100x loss taken into account and the \$70x recomputed loss. Under paragraph (c)(1)(i) of this section, S's gain is long-term capital gain.

(d) *Pledge.* The facts are the same as in paragraph (a) of this *Example 6*, except that, on December 1 of Year 3, B borrows \$100x from an unrelated bank and secures the indebtedness with X's note. X's note remains subject to section 453A(d) following the sale to B. Under section 453A(d), B's \$100x of proceeds from the secured indebtedness is treated as an amount received on December 1 of Year 3 by B on X's note. Thus, S takes its entire \$30x gain into account in Year 3.

Example 7. Performance of services. (a) *Facts.* S is a driller of water wells. B operates a ranch in a remote location, and B's taxable income from the ranch is not subject to section 447. B's ranch requires water to maintain its cattle. During Year 1, S drills an artesian well on B's ranch in exchange for \$100 from B, and S incurs \$80 of expenses (e.g., for employees and equipment). B capitalizes its \$100 cost for the well under section 263, and takes into account \$10 of cost recovery deductions in each of Years 2 through 11. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. If S and B were divisions of a single corporation, the costs incurred in drilling the well would be capitalized.

(b) *Definitions.* Under paragraph (b)(1) of this section, the service transaction is an intercompany transaction, S is the selling member, and B is the buying member. Under paragraph (b)(2)(ii) of this section, S's \$100 of income and \$80 of related expenses are both included in determining its intercompany income of \$20.

(c) *Timing and attributes.* S's \$20 of intercompany income is taken into account under the matching rule to reflect the \$20 difference between B's corresponding items taken into account (based on its \$100 cost basis in the well) and the recomputed corresponding items (based on the \$80 basis that B would have if S and B were divisions of a single corporation and B's basis were determined by reference to S's \$80 of expenses). In Year 1, S takes into account \$80 of its income and the \$80 of expenses. In each of Years 2 through 11, S takes \$2 of its \$20 intercompany income into account to reflect the annual \$2 difference between B's \$10 of cost

recovery deductions taken into account and the \$8 of recomputed cost recovery deductions. S's \$100 income and \$80 expenses, and B's cost recovery deductions, are ordinary items (because S's and B's items would be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section). If S's offsetting \$80 of income and expense would not be taken into account in the same year under its separate entity method of accounting, they nevertheless must be taken into account under this section in a manner that clearly reflects consolidated taxable income. See paragraph (a)(3)(i) of this section.

(d) *Sale of capitalized services.* The facts are the same as in paragraph (a) of this *Example 7*, except that B sells the ranch before Year 11 and recognizes gain attributable to the well. To the extent of S's income taken into account as a result of B's cost recovery deductions, as well as S's offsetting \$80 of income and expense, the timing and attributes are determined in the manner provided in paragraph (c) of this *Example 7*. The attributes of the remainder of S's \$20 of income and B's gain from the sale are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation. Accordingly, S's remaining intercompany income is treated as recapture income or section 1231 gain, even though it is from S's performance of services.

Example 8. Rental of property. B operates a ranch that requires grazing land for its cattle. S owns undeveloped land adjoining B's ranch. On January 1 of Year 1, S leases grazing rights to B for Year 1. B's \$100 rent expense is deductible for Year 1 under its separate entity accounting method. Under paragraph (b)(1) of this section, the rental transaction is an intercompany transaction, S is the selling member, and B is the buying member. S takes its \$100 of income into account in Year 1 to reflect the \$100 difference between B's rental deduction taken into account and the \$0 recomputed rental deduction. S's income and B's deduction are ordinary items (because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section).

Example 9. Intercompany sale of a partnership interest. (a) *Facts.* S owns a 20% interest in the capital and profits of a general partnership. The partnership holds land for investment with a basis equal to its value, and operates depreciable assets which have value in excess of basis. S's basis in its partnership interest equals its share of the adjusted basis of the partnership's land and depreciable assets. The partnership has an election under section 754 in effect. On January 1 of Year 1, S sells its partnership interest to B at a gain. During Years 1 through 10, the partnership depreciates the operating assets, and B's depreciation deductions from the partnership reflect the increase in the basis of the depreciable assets under section 743(b).

(b) *Timing and attributes.* S's gain is taken into account during Years 1 through 10 to reflect the difference in each year between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions from the partnership. Under paragraphs (c)(1)(i) and (c)(4)(i) of this section, S's gain taken into account is ordinary income. (The acceleration rule does not apply to S's gain as a result of the section 743(b) adjustment, because the adjustment is solely with respect to B and therefore no nonmember reflects any part of the intercompany transaction.)

(c) *Partnership sale of assets.* The facts are the same as in paragraph (a) of this *Example 9*, and the partnership sells some of its depreciable assets to X at a gain on December 31 of Year 4. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, S takes intercompany gain into account in Year 4 to reflect the difference between B's partnership items taken into account from the sale (which reflect the basis increase under section 743(b)) and the recomputed partnership items. The attributes of S's additional gain are redetermined to produce the same effect on consolidated taxable income as if S and B were divisions of a single corporation (recapture income or section 1231 gain).

(d) *B's sale of partnership interest.* The facts are the same as in paragraph (a) of this *Example 9*, and on December 31 of Year 4, B sells its partnership interest to X at no gain or loss. In addition to the intercompany gain taken into account as a result of the partnership's depreciation, the remaining balance of S's intercompany gain is taken into account in Year 4 to reflect the difference between B's \$0 gain taken into account from the sale of the partnership interest and the recomputed gain. The character of S's remaining intercompany item and B's corresponding item are determined on a separate entity basis under section 751, and then redetermined to the extent necessary to produce the same effect as treating the intercompany transaction as occurring between divisions of a single corporation.

(e) *No section 754 election.* The facts are the same as in paragraph (d) of this *Example 9*, except that the partnership does not have a section 754 election in effect, and B recognizes a capital loss from its sale of the partnership interest to X on December 31 of Year 4. Because there is no difference between B's depreciation deductions from the partnership taken into account and the recomputed depreciation deductions, S does not take any of its gain into account during Years 1 through 4 as a result of B's partnership's items. Instead, S's entire intercompany gain is taken into account in Year 4 to reflect the difference between B's loss taken into account from the sale to X and the recomputed gain or loss.

Example 10. Net operating losses subject to section 382 or the SRLY rules. (a) *Facts.* On January 1 of Year 1, P buys all of S's stock. S has net operating loss carryovers from prior years. P's acquisition results in an ownership change under section 382 with respect to S's loss carryovers, and S has a net unrealized built-in gain (within the meaning of section 382(h)(3)). S owns nondepreciable property with a \$70 basis and \$100 value. On July 1 of Year 3, S sells the property to B for \$100, and its \$30 gain is recognized built-in gain (within the meaning of section 382(h)(2)) on a separate entity basis. On December 1 of Year 5, B sells the property to X for \$90.

(b) *Timing and attributes.* S's \$30 gain is taken into account in Year 5 to reflect the \$30 difference between B's \$10 loss taken into account and the recomputed \$20 gain. S and B are treated as divisions of a single corporation for purposes of applying section 382 in connection with the intercompany transaction. Under a single entity analysis, the single corporation has losses subject to limitation under section 382, and this limitation may be increased under section 382(h) if the single corporation has recognized built-in gain with respect to those losses. B's \$10 corresponding loss offsets \$10 of

S's intercompany gain, and thus, under paragraph (c)(4)(i) of this section, \$10 of S's intercompany gain is redetermined not to be recognized built-in gain. S's remaining \$20 intercompany gain continues to be treated as recognized built-in gain.

(c) *B's recognized built-in gain.* The facts are the same as in paragraph (a) of this *Example 10*, except that the property declines in value after S becomes a member of the P group, S sells the property to B for its \$70 basis, and B sells the property to X for \$90 during Year 5. Treating S and B as divisions of a single corporation, S's sale to B does not cause the property to cease to be built-in gain property. Thus, B's \$20 gain from its sale to X is recognized built-in gain that increases the section 382 limitation applicable to S's losses.

(d) *SRLY limitation.* The facts are the same as in paragraph (a) of this *Example 10*, except that S's net operating loss carryovers are subject to the separate return limitation year (SRLY) rules. See §1.1502-21(c). The application of the SRLY rules depends on S's status as a separate corporation having losses from separate return limitation years. Under paragraph (c)(5), the attribute of S's intercompany item as it relates to S's SRLY limitation is not redetermined, because the SRLY limitation depends on S's special status. Accordingly, S's \$30 intercompany gain is included in determining its SRLY limitation for Year 5.

Example 11. Section 475. (a) *Facts.* S, a dealer in securities within the meaning of section 475(c), owns a security with a basis of \$70. The security is held for sale to customers and is not identified under section 475(b) as within an exception to marking to market. On July 1 of Year 1, S sells the security to B for \$100. B is not a dealer and holds the security for investment. On December 31 of Year 1, the fair market value of the security is \$100. On July 1 of Year 2, B sells the security to X for \$110.

(b) *Attributes.* Under section 475, a dealer in securities can treat a security as within an exception to marking to market under section 475(b) only if it timely identifies the security as so described. Under the matching rule, attributes must be redetermined by treating S and B as divisions of a single corporation. As a result of S's activities, the single corporation is treated as a dealer with respect to securities, and B must continue to mark to market the security acquired from S. Thus, B's corresponding items and the recomputed corresponding items are determined by continuing to treat the security as not within an exception to marking to market. Under section 475(d)(3), it is possible for the character of S's intercompany items to differ from the character of B's corresponding items.

(c) *Timing and character.* S has a \$30 gain when it disposes of the security by selling it to B. This gain is intercompany gain that is taken into account in Year 1 to reflect the \$30 difference between B's \$0 gain taken into account from marking the security to market under section 475 and the recomputed \$30 gain that would be taken into account. The character of S's gain and B's gain are redetermined as if the security were transferred between divisions. Accordingly, S's gain is ordinary income under section 475(d)(3)(A)(i), but under section 475(d)-(3)(B)(ii) B's \$10 gain from its sale to X is capital gain that is taken into account in Year 2.

(d) *Nondealer to dealer.* The facts are the same as in paragraph (a) of this *Example 11*, except that S is not a dealer and holds the security for investment with a \$70 basis, B is a

dealer to which section 475 applies and, immediately after acquiring the security from S for \$100, B holds the security for sale to customers in the ordinary course of its trade or business. Because S is not a dealer and held the security for investment, the security is treated as properly identified as held for investment under section 475(b)(1) until it is sold to B. Under section 475(b)(3), the security thereafter ceases to be described in section 475(b)(1) because B holds the security for sale to customers. The mark-to-market requirement applies only to changes in the value of the security after B's acquisition. B's mark-to-market gain taken into account and the recomputed mark-to-market gain are both determined based on changes from the \$100 value of the security at the time of B's acquisition. There is no difference between B's \$0 mark-to-market gain taken into account in Year 1 and the \$0 recomputed mark-to-market gain. Therefore, none of S's gain is taken into account in Year 1 as a result of B's marking the security to market in Year 1. In Year 2, B has a \$10 gain when it disposes of the security by selling it to X, but would have had a \$40 gain if S and B were divisions of a single corporation. Thus, S takes its \$30 gain into account in Year 2 under the matching rule. Under section 475(d)(3), S's gain is capital gain even though B's subsequent gain or loss from marking to market or disposing of the security is ordinary gain or loss. If B disposes of the security at a \$10 loss in Year 2, S's gain taken into account in Year 2 is still capital because on a single entity basis section 475(d)(3) would provide for \$30 of capital gain and \$10 of ordinary loss. Because the attributes are not redetermined under paragraph (c)(1)(i) of this section, paragraph (c)(4)(i) of this section does not apply. Furthermore, if B held the security for investment, and so identified the security under section 475(b)(1), the security would continue to be excepted from marking to market.

Example 12. Section 1092. (a) *Facts.* On July 1 of Year 1, S enters into offsetting long and short positions with respect to actively traded personal property. The positions are not section 1256 contracts, and they are the only positions taken into account for purposes of applying section 1092. On August 1 of Year 1, S sells the long position to B at an \$11 loss, and there is \$11 of unrealized gain in the offsetting short position. On December 1 of Year 1, B sells the long position to X at no gain or loss. On December 31 of Year 1, there is still \$11 of unrealized gain in the short position. On February 1 of Year 2, S closes the short position at an \$11 gain.

(b) *Timing and attributes.* If the sale from S to B were a transfer between divisions of a single corporation, the \$11 loss on the sale to X would have been deferred under section 1092(a)(1)(A). Accordingly, there is no difference in Year 1 between B's corresponding item of \$0 and the recomputed corresponding item of \$0. S takes its \$11 loss into account in Year 2 to reflect the difference between B's corresponding item of \$0 taken into account in Year 2 and the recomputed loss of \$11 that would have been taken into account in Year 2 under section 1092(a)(1)(B) if S and B had been divisions of a single corporation. (The results are the same under section 267(f).)

Example 13. Manufacturer incentive payments. (a) *Facts.* B is a manufacturer that sells its products to independent dealers for resale. S is a credit company that offers financing, including financing to customers of the dealers. S also

purchases the product from the dealers for lease to customers of the dealers. During Year 1, B initiates a program of incentive payments to the dealers' customers. Under B's program, S buys a product from an independent dealer for \$100 and leases it to a nonmember. S pays \$90 to the dealer for the product, and assigns to the dealer its \$10 incentive payment from B. Under their separate entity accounting methods, B would deduct the \$10 incentive payment in Year 1 and S would take a \$90 basis in the product. Assume that if S and B were divisions of a single corporation, the \$10 payment would not be deductible and the basis of the property would be \$100.

(b) *Timing and attributes.* Under paragraph (b)(1) of this section, the incentive payment transaction is an intercompany transaction. Under paragraph (b)(2)(iii) of this section, S has a \$10 intercompany item not yet taken into account under its separate entity method of accounting. Under the matching rule, S takes its intercompany item into account to reflect the difference between B's corresponding item taken into account and the recomputed corresponding item. In Year 1 there is a \$10 difference between B's \$10 deduction taken into account and the \$0 recomputed deduction. Accordingly, under the matching rule S must take the \$10 incentive payment into account as intercompany income in Year 1. S's \$10 of income and B's \$10 deduction are ordinary items. S's basis in the product is \$100 rather than the \$90 it would be under S's separate entity method of accounting. S's additional \$10 of basis in the product is recovered based on subsequent events (e.g., S's cost recovery deductions or its sale of the product).

Example 14. Source of income under section 863. (a) *Intercompany sale with no independent factory price.* S manufactures inventory in the United States, and recognizes \$75 of income on sales to B in Year 1. B distributes the inventory in Country Y and recognizes \$25 of income on sales to X, also in Year 1. Title passes from S to B, and from B to X, in Country Y. There is no independent factory price (as defined in regulations under section 863) for the sale from S to B. Under the matching rule, S's \$75 intercompany income and B's \$25 corresponding income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 of income were recognized from producing in the United States and selling in Country Y. Assume that applying the section 863 regulations on a single entity basis, \$50 is treated as foreign source income and \$50 as U.S. source income. Assume further that on a separate entity basis, S would have \$37.50 of foreign source income and \$37.50 of U.S. source income, and that all of B's \$25 of income would be foreign source income. Thus, on a separate entity basis, S and B would have \$62.50 of combined foreign source income and \$37.50 of U.S. source income. Accordingly, under single entity treatment, \$12.50 that would be treated as foreign source income on a separate entity basis is redetermined to be U.S. source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$12.50 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. For example, it may be reasonable to recharacterize only S's foreign source income as U.S. source income because only S would have any U.S. source income on a separate entity

basis. However, it may also be reasonable to allocate the redetermined attribute between S and B in proportion to their separate entity amounts of foreign source income (in a 3:2 ratio, so that \$7.50 of S's foreign source income is redetermined to be U.S. source and \$5 of B's foreign source income is redetermined to be U.S. source), provided the same method is applied to all similar transactions within the group.

(b) *Intercompany sale with independent factory price.* The facts are the same as in paragraph (a) of this *Example 14*, except that an independent factory price exists for the sale by S to B such that \$70 of S's \$75 of income is attributable to the production function. Assume that on a single entity basis, \$70 is treated as U.S. source income (because of the existence of the independent factory price) and \$30 is treated as foreign source income. Assume that on a separate entity basis, \$70 of S's income would be treated as U.S. source, \$5 of S's income would be treated as foreign source income, and all of B's \$25 income would be treated as foreign source income. Because the results are the same on a single entity basis and a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.

(c) *Sale of property reflecting intercompany services or intangibles.* S earns \$10 of income performing services in the United States for B. B capitalizes S's fees into the basis of property that it manufactures in the United States and sells to an unrelated person in Year 1 at a \$90 profit, with title passing in Country Y. Under the matching rule, S's \$10 income and B's \$90 income are taken into account in Year 1. In determining the source of income, S and B are treated as divisions of a single corporation, and section 863 applies as if \$100 were earned from manufacturing in the United States and selling in Country Y. Assume that on a single entity basis \$50 is treated as foreign source income and \$50 is treated as U.S. source income. Assume that on a separate entity basis, S would have \$10 of U.S. source income, and B would have \$45 of foreign source income and \$45 of U.S. source income. Accordingly, under single entity treatment, \$5 of income that would be treated as U.S. source income on a separate entity basis is redetermined to be foreign source income. Under paragraph (c)(1)(i) of this section, attributes are redetermined only to the extent of the \$5 necessary to achieve the same effect as a single entity determination. Under paragraph (c)(4)(ii) of this section, the redetermined attribute must be allocated between S and B using a reasonable method. (If instead of performing services, S licensed an intangible to B and earned \$10 that would be treated as U.S. source income on a separate entity basis, the results would be the same.)

Example 15. Section 1248. (a) *Facts.* On January 1 of Year 1, S forms FT, a wholly owned foreign subsidiary, with a \$10 contribution. During Years 1 through 3, FT has earnings and profits of \$40. None of the earnings and profits is taxed as subpart F income under section 951, and FT distributes no dividends to S during this period. On January 1 of Year 4, S sells its FT stock to B for \$50. While B owns FT, FT has a deficit in earnings and profits of \$10. On July 1 of Year 6, B sells its FT stock for \$70 to X, an unrelated foreign corporation.

(b) *Timing.* S's \$40 of intercompany gain is taken into account in Year 6 to reflect the difference between B's \$20 of gain taken into account and the \$60 recomputed gain.

(c) *Attributes.* Under the matching rule, the attributes of S's intercompany gain and B's corresponding gain are redetermined to have the same effect on consolidated taxable income (and consolidated tax liability) as if S and B were divisions of a single corporation. On a single entity basis, there is \$60 of gain and the portion which is characterized as a dividend under section 1248 is determined on the basis of FT's \$30 of earnings and profits at the time of the sale of FT to X (the sum of FT's \$40 of earnings and profits while held by S and FT's \$10 deficit in earnings and profits while held by B). Therefore, \$30 of the \$60 gain is treated as a dividend under section 1248. The remaining \$30 is treated as capital gain. On a separate entity basis, all of S's \$40 gain would be treated as a dividend under section 1248 and all of B's \$20 gain would be treated as capital gain. Thus, as a result of the single entity determination, \$10 that would be treated as a dividend under section 1248 on a separate entity basis is redetermined to be capital gain. Under paragraph (c)(4)(ii) of this section, this redetermined attribute must be allocated between S's intercompany item and B's corresponding item by using a reasonable method. On a separate entity basis, only S would have any amount treated as a dividend under section 1248 available for redetermination. Accordingly, \$10 of S's income is redetermined to be not subject to section 1248, with the result that \$30 of S's intercompany gain is treated as a dividend and the remaining \$10 is treated as capital gain. All of B's corresponding gain is treated as capital gain, as it would be on a separate entity basis.

(d) *B has loss.* The facts are the same as in paragraph (a) of this *Example 15*, except that FT has no earnings and profits or deficit in earnings and profits while B owns FT, and B sells the FT stock to X for \$40. On a single entity basis, there is \$30 of gain, and section 1248 is applied on the basis of FT's \$40 earnings and profits at the time of the sale of FT to X. Under section 1248, the amount treated as a dividend is limited to \$30 (the amount of the gain). On a separate entity basis, S's entire \$40 gain would be treated as a dividend under section 1248, and B's \$10 loss would be a capital loss. B's \$10 corresponding loss offsets \$10 of S's intercompany gain and, under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item control. Accordingly, \$10 of S's gain must be redetermined to be capital gain. B's \$10 loss remains a capital loss. (If, however, S sold FT to B at a loss and B sold FT to X at a gain, it may be unreasonable for the attributes of B's corresponding gain to control S's offsetting intercompany loss. If B's attributes were to control, for example, the group could possibly claim a larger foreign tax credit than would be available if S and B were divisions of a single corporation.)

(d) *Acceleration rule.* S's intercompany items and B's corresponding items are taken into account under this paragraph (d) to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single corporation. For this purpose, the following rules apply:

(1) *S's items*—(i) *Timing.* S takes its intercompany items into account to the extent they cannot be taken into account to produce the effect of treating S and B as divisions of a single

corporation. The items are taken into account immediately before it first becomes impossible to achieve this effect. For this purpose, the effect cannot be achieved—

(A) To the extent an intercompany item or corresponding item will not be taken into account in determining the group's consolidated taxable income (or consolidated tax liability) under the matching rule (for example, if S or B becomes a nonmember, or if S's intercompany item is no longer reflected in the difference between B's basis (or an amount equivalent to basis) in property and the basis (or equivalent amount) the property would have if S and B were divisions of a single corporation); or

(B) To the extent a nonmember reflects, directly or indirectly, any aspect of the intercompany transaction (e.g., if B's cost basis in property purchased from S is reflected by a nonmember under section 362 following a section 351 transaction).

(ii) *Attributes.* The attributes of S's intercompany items taken into account under this paragraph (d)(1) are determined as follows:

(A) *Sale, exchange, or distribution.* If the item is from an intercompany sale, exchange, or distribution of property, its attributes are determined under the principles of the matching rule as if B sold the property, at the time the item is taken into account under paragraph (d)(1)(i) of this section, for a cash payment equal to B's adjusted basis in the property (i.e., at no net gain or loss), to the following person:

(1) *Property leaves the group.* If the property is owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to that nonmember. If the nonmember is related for purposes of any provision of the Internal Revenue Code or regulations to any party to the intercompany transaction (or any related transaction) or to the common parent, the nonmember is treated as related to B for purposes of that provision. For example, if the nonmember is related to P within the meaning of section 1239(b), the deemed sale is treated as being described in section 1239(a). See paragraph (j)(6) of this section, under which property is not treated as being owned by a nonmember if it is owned by the common parent after the common parent becomes the only remaining member.

(2) *Property does not leave the group.* If the property is not owned by a nonmember immediately after S's item is taken into account, B is treated as selling the property to an affiliated corporation that is not a member of the group.

(B) *Other transactions.* If the item is from an intercompany transaction other than a sale, exchange, or distribution of property (e.g., income from S's services capitalized by B), its attributes are determined on a separate entity basis.

(2) *B's items*—(i) *Attributes.* The attributes of B's corresponding items continue to be redetermined under the principles of the matching rule, with the following adjustments:

(A) If S and B continue to join with each other in the filing of consolidated returns, the attributes of B's corresponding items (and any applicable holding periods) are determined by continuing to treat S and B as divisions of a single corporation.

(B) Once S and B no longer join with each other in the filing of consolidated returns, the attributes of B's corresponding items are determined as if the S division (but not the B division) were transferred by the single corporation to an unrelated person. Thus, S's activities (and any applicable holding period) before the intercompany transaction continue to affect the attributes of the corresponding items (and any applicable holding period).

(ii) *Timing.* If paragraph (d)(1) of this section applies to S, B nevertheless continues to take its corresponding items into account under its accounting method. However, the redetermination of the attributes of a corresponding item under this paragraph (d)(2) might affect its timing.

(3) *Examples.* The acceleration rule of this paragraph (d) is illustrated by the following examples.

Example 1. Becoming a nonmember—timing.
(a) *Facts.* S owns land with a basis of \$70. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, P sells 60% of S's stock to X for \$60 and, as a result, S becomes a nonmember.

(b) *Matching rule.* Under the matching rule, none of S's \$30 gain is taken into account in Years 1 through 3 because there is no difference between B's \$0 gain or loss taken into account and the recomputed gain or loss.

(c) *Acceleration of S's intercompany items.* Under the acceleration rule of paragraph (d) of this section, S's \$30 gain is taken into account in computing consolidated taxable income (and consolidated tax liability) immediately before the effect of treating S and B as divisions of a single

corporation cannot be produced. Because the effect cannot be produced once S becomes a nonmember, S takes its \$30 gain into account in Year 3 immediately before becoming a nonmember. S's gain is reflected under §1.1502-32 in P's basis in the S stock immediately before P's sale of the stock. Under §1.1502-32, P's basis in the S stock is increased by \$30, and therefore P's gain is reduced (or loss is increased) by \$18 (60% of \$30). See also §§1.1502-33 and 1.1502-76(b). (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(d) *B's corresponding items.* Notwithstanding the acceleration of S's gain, B continues to take its corresponding items into account under its accounting method. Thus, B's items from the land are taken into account based on subsequent events (e.g., its sale of the land).

(e) *Sale of B's stock.* The facts are the same as in paragraph (a) of this *Example 1*, except that P sells 60% of B's stock (rather than S stock) to X for \$60 and, as a result, B becomes a nonmember. Because the effect of treating S and B as divisions of a single corporation cannot be produced once B becomes a nonmember, S takes its \$30 gain into account under the acceleration rule immediately before B becomes a nonmember. (The results would be the same if S sold the land to B in an installment sale to which section 453 would otherwise apply, because S must take its intercompany gain into account under this section.)

(f) *Discontinue filing consolidated returns.* The facts are the same as in paragraph (a) of this *Example 1*, except that the P group receives permission under §1.1502-75(c) to discontinue filing consolidated returns beginning in Year 3. Under the acceleration rule, S takes its \$30 gain into account on December 31 of Year 2.

(g) *No subgroups.* The facts are the same as in paragraph (a) of this *Example 1*, except that P simultaneously sells all of the stock of both S and B to X (rather than 60% of S's stock), and S and B become members of the X consolidated group. Because the effect of treating S and B as divisions of a single corporation in the P group cannot be produced once S and B become nonmembers, S takes its \$30 gain into account under the acceleration rule immediately before S and B become nonmembers. (Paragraph (j)(5) of this section does not apply to treat the X consolidated group as succeeding to the P group because the X group acquired only the stock of S and B.) However, so long as S and B continue to join with each other in the filing of consolidated returns, B continues to treat S and B as divisions of a single corporation for purposes of determining the attributes of B's corresponding items from the land.

Example 2. Becoming a nonmember—attributes. (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to B for \$100. B holds the land for sale to customers in the ordinary course of business, and expends substantial resources over a two-year period subdividing, developing, and marketing the land. On July 1 of Year 3, before B has sold any of the land, P sells 60% of S's stock to X for \$60 and, as a result, S becomes a nonmember.

(b) *Attributes.* Under the acceleration rule, the attributes of S's gain are redetermined under the principles of the matching rule as if B sold the land to an affiliated corporation that is not a

member of the group for a cash payment equal to B's adjusted basis in the land (because the land continues to be held within the group). Thus, whether S's gain is capital gain or ordinary income depends on the activities of both S and B. Because S and B no longer join with each other in the filing of consolidated returns, the attributes of B's corresponding items (e.g., from its subsequent sale of the land) are redetermined under the principles of the matching rule as if the S division (but not the B division) were transferred by the single corporation to an unrelated person at the time of P's sale of the S stock. Thus, B continues to take into account the activities of S with respect to the land before the intercompany transaction.

(c) *Depreciable property.* The facts are the same as in paragraph (a) of this *Example 2*, except that the property sold by S to B is depreciable property. Section 1239 applies to treat all of S's gain as ordinary income because it is taken into account as a result of B's deemed sale of the property to an affiliated corporation that is not a member of the group (a related person within the meaning of section 1239(b)).

Example 3. Selling member's disposition of installment note. (a) *Facts.* S owns land with a basis of \$70. On January 1 of Year 1, S sells the land to B in exchange for B's \$110 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55 in Year 4 and \$55 in Year 5. On July 1 of Year 3, S sells B's note to X for \$110.

(b) *Timing.* S's intercompany gain is taken into account under this section, and not under the rules of section 453. Consequently, S's sale of B's note does not result in its intercompany gain from the land being taken into account (e.g., under section 453B). The sale does not prevent S's intercompany items and B's corresponding items from being taken into account in determining the group's consolidated taxable income under the matching rule, and X does not reflect any aspect of the intercompany transaction (X has its own cost basis in the note). S will take the intercompany gain into account under the matching rule or acceleration rule based on subsequent events (e.g., B's sale of the land). See also paragraph (g) of this section for additional rules applicable to B's note as an intercompany obligation.

Example 4. Cancellation of debt and attribute reduction under section 108(b). (a) *Facts.* S holds land for investment with a basis of \$0. On January 1 of Year 1, S sells the land to B for \$100. B also holds the land for investment. During Year 3, B is insolvent and B's nonmember creditors discharge \$60 of B's indebtedness. Because of insolvency, B's \$60 discharge is excluded from B's gross income under section 108(a), and B reduces the basis of the land by \$60 under sections 108(b) and 1017.

(b) *Acceleration rule.* As a result of B's basis reduction under section 1017, \$60 of S's intercompany gain will not be taken into account under the matching rule (because there is only a \$40 difference between B's \$40 basis in the land and the \$0 basis the land would have if S and B were divisions of a single corporation). Accordingly, S takes \$60 of its gain into account under the acceleration rule in Year 3. S's gain is long-term capital gain, determined under paragraph (d)(1)(ii) of this section as if B sold the land to an affiliated corporation that is not a member of the group for \$100 immediately before the basis reduction.

(c) *Purchase price adjustment.* Assume instead that S sells the land to B in exchange for B's \$100 purchase money note, B remains solvent, and S subsequently agrees to discharge \$60 of the note as a purchase price adjustment to which section 108(e)(5) applies. Under applicable principles of tax law, \$60 of S's gain and \$60 of B's basis in the land are eliminated and never taken into account. Similarly, the note is not treated as satisfied and reissued under paragraph (g) of this section.

Example 5. Section 481. (a) *Facts.* S operates several trades or businesses, including a manufacturing business. S receives permission to change its method of accounting for valuing inventory for its manufacturing business. S increases the basis of its ending inventory by \$100, and the related \$100 positive section 481(a) adjustment is to be taken into account ratably over six taxable years, beginning in Year 1. During Year 3, S sells all of the assets used in its manufacturing business to B at a gain. Immediately after the transfer, B does not use the same inventory valuation method as S. On a separate entity basis, S's sale results in an acceleration of the balance of the section 481(a) adjustment to Year 3.

(b) *Timing and attributes.* Under paragraph (b)(2) of this section, the balance of S's section 481(a) adjustment accelerated to Year 3 is intercompany income. However, S's \$100 basis increase before the intercompany transaction eliminates the related difference for this amount between B's corresponding items taken into account and the recomputed corresponding items in subsequent periods. Because the accelerated section 481(a) adjustment will not be taken into account in determining the group's consolidated taxable income (and consolidated tax liability) under the matching rule, the balance of S's section 481 adjustment is taken into account under the acceleration rule as ordinary income at the time of the intercompany transaction. (If S's sale had not resulted in accelerating S's section 481(a) adjustment on a separate entity basis, S would have no intercompany income to be taken into account under this section.)

(e) *Simplifying rules—(1) Dollar-value LIFO inventory methods—(i) In general.* This paragraph (e)(1) applies if either S or B uses a dollar-value LIFO inventory method to account for intercompany transactions. Rather than applying the matching rule separately to each intercompany inventory transaction, this paragraph (e)(1) provides methods to apply an aggregate approach that is based on dollar-value LIFO inventory accounting. Any method selected under this paragraph (e)(1) must be applied consistently.

(ii) *B uses dollar-value LIFO—(A) In general.* If B uses a dollar-value LIFO inventory method to account for its intercompany inventory purchases, and includes all of its inventory costs incurred for a year in its cost of goods sold for the year (that is, B has no inventory increment for the year), S takes into account all of its intercom-

pany inventory items for the year. If B does not include all of its inventory costs incurred for the year in its cost of goods sold for the year (that is, B has an inventory increment for the year), S does not take all of its intercompany inventory income or loss into account. The amount not taken into account is determined under either the increment averaging method of paragraph (e)(1)(ii)(B) of this section or the increment valuation method of paragraph (e)(1)(ii)(C) of this section. Separate computations are made for each pool of B that receives intercompany purchases from S, and S's amount not taken into account is layered based on B's LIFO inventory layers.

(B) *Increment averaging method.* Under this paragraph (e)(1)(ii)(B), the amount not taken into account is the amount of S's intercompany inventory income or loss multiplied by the ratio of the LIFO value of B's current-year costs of its layer of increment to B's total inventory costs incurred for the year under its LIFO inventory method. If B includes more than its inventory costs incurred during any subsequent year in its cost of goods sold (a decrement), S takes into account the intercompany inventory income or loss layers in the same manner and proportion as B takes into account its inventory decrements.

(C) *Increment valuation method.* Under this paragraph (e)(1)(ii)(C), the amount not taken into account is the amount of S's intercompany inventory

income or loss for the appropriate period multiplied by the ratio of the LIFO value of B's current-year costs of its layer of increment to B's total inventory costs incurred in the appropriate period under its LIFO inventory method. The principles of paragraph (e)(1)(ii)(B) of this section otherwise apply. The appropriate period is the period of B's year used to determine its current-year costs.

(iii) *S uses dollar-value LIFO.* If S uses a dollar-value LIFO inventory method to account for its intercompany inventory sales, S may use any reasonable method of allocating its LIFO inventory costs to intercompany transactions. LIFO inventory costs include costs of prior layers if a decrement occurs. For example, a reasonable allocation of the most recent costs incurred during the consolidated return year can be used to compute S's intercompany inventory income or loss for the year if S has an inventory increment and uses the earliest acquisitions costs method, but S must apportion costs from the most recent appropriate layers of increment if an inventory decrement occurs for the year.

(iv) *Other reasonable methods.* S or B may use a method not specifically provided in this paragraph (e)(1) that is expected to reasonably take into account intercompany items and corresponding items from intercompany inventory transactions. However, if the method used results, for any year, in a cumulative amount of intercompany in-

ventory items not taken into account by S that significantly exceeds the cumulative amount that would not be taken into account under paragraph (e)(1)(ii) or (iii) of this section, S must take into account for that year the amount necessary to eliminate the excess. The method is thereafter applied with appropriate adjustments to reflect the amount taken into account.

(v) *Examples.* The inventory rules of this paragraph (e)(1) are illustrated by the following examples.

Example 1. Increment averaging method. (a) *Facts.* Both S and B use a double-extension, dollar-value LIFO inventory method, and both value inventory increments using the earliest acquisitions cost valuation method. During Year 2, S sells 25 units of product Q to B on January 15 at \$10/unit. S sells another 25 units on April 15, on July 15, and on September 15, at \$12/unit. S's earliest cost of product Q is \$7.50/unit and S's most recent cost of product Q is \$8.00/unit. Both S and B have an inventory increment for the year. B's total inventory costs incurred during Year 2 are \$6,000 and the LIFO value of B's Year 2 layer of increment is \$600.

(b) *Intercompany inventory income.* Under paragraph (e)(1)(iii) of this section, S must use a reasonable method of allocating its LIFO inventory costs to intercompany transactions. Because S has an inventory increment for Year 2 and uses the earliest acquisitions cost method, a reasonable method of determining its intercompany cost of goods sold for product Q is to use its most recent costs. Thus, its intercompany cost of goods sold is \$800 (\$8.00 most recent cost, multiplied by 100 units sold to B), and its intercompany inventory income is \$350 (\$1,150 sales proceeds from B minus \$800 cost).

(c) *Timing.* (i) Under the increment averaging method of paragraph (e)(1)(ii)(B) of this section, \$35 of S's \$350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

$$\frac{\text{LIFO value of B's Year 2 layer of increment}}{\text{B's total inventory costs for Year 2}} = \frac{\$600}{\$6,000} = 10\%$$

$$10\% \times \text{S's } \$350 \text{ intercompany inventory income} = \$35$$

(ii) Thus, \$315 of S's intercompany inventory income is taken into account in Year 2 (\$350 of total intercompany inventory income minus \$35 not taken into account).

(d) *S incurs a decrement.* The facts are the same as in paragraph (a) of this *Example 1*, except that in Year 2, S incurs a decrement equal to 50% of its Year 1 layer. Under paragraph (e)(1)(iii) of this section, S must reasonably allocate the LIFO cost of the decrement to the cost of goods sold to B to determine S's intercompany inventory income.

(e) *B incurs a decrement.* The facts are the same as in paragraph (a) of this *Example 1*, except that B incurs a decrement in Year 2. S must take into account the entire \$350 of Year 2 intercompany inventory income because all 100 units of product Q are deemed sold by B in Year 2.

Example 2. Increment valuation method. (a) The facts are the same as in *Example 1*. In addition, B's use of the earliest acquisition's cost method of valuing its increments results in B valuing its year-end inventory using costs in-

curred from January through March. B's costs incurred during the year are: \$1,428 in the period January through March; \$1,498 in the period April through June; \$1,524 in the period July through September; and \$1,550 in the period October through December. S's intercompany inventory income for these periods is: \$50 in the period January through March ((25 × \$10) - (25 × \$8)); \$100 in the period April through June ((25 × \$12) - (25 × \$8)); \$100 in the period July through September ((25 × \$12) - (25 ×

\$8); and \$100 in the period October through December $((25 \times \$12) - (25 \times \$8))$.

(b) *Timing.* (i) Under the increment valuation method of paragraph (e)(1)(ii)(C) of this section, \$21 of S's \$350 of intercompany inventory income is not taken into account in Year 2, computed as follows:

$$\begin{array}{rcl} \text{LIFO value of B's Year 2} & & \\ \text{layer of increment} & = & \frac{\$600}{\$1,428} = 42\% \\ \text{B's total inventory costs from} & & \\ \text{January through March of Year 2} & & \\ \\ 42\% \times \text{S's } \$50 \text{ intercompany inventory income for the period} & & \\ \text{from January through March} & = & \$21 \end{array}$$

(ii) Thus, \$329 of S's intercompany inventory income is taken into account in Year 2 (\$350 of total intercompany inventory income minus \$21 not taken into account).

(c) *B incurs a subsequent decrement.* The facts are the same as in paragraph (a) of this Example 2. In addition, assume that in Year 3, B experiences a decrement in its pool that receives intercompany purchases from S. B's decrement equals 20% of the base-year costs for its Year 2 layer. The fact that B has incurred a decrement means that all of its inventory costs incurred for Year 3 are included in cost of goods sold. As a result, S takes into account its entire amount of intercompany inventory income from its Year 3 sales. In addition, S takes into account \$4.20 of its Year 2 layer of intercompany inventory income not already taken into account (20% of \$21).

Example 3. Other reasonable inventory methods. (a) *Facts.* Both S and B use a dollar-value LIFO inventory method for their inventory transactions. During Year 1, S sells inventory to B and to X. Under paragraph (e)(1)(iv) of this section, to compute its intercompany inventory income and the amount of this income not taken into account, S computes its intercompany inventory income using the transfer price of the inventory items less a FIFO cost for the goods, takes into account these items based on a FIFO cost flow assumption for B's corresponding items, and the LIFO methods used by S and B are ignored for these computations. These computations are comparable to the methods used by S and B for financial reporting purposes, and the book methods and results are used for tax purposes. S adjusts the amount of intercompany inventory items not taken into account as required by section 263A.

(b) *Reasonable method.* The method used by S is a reasonable method under paragraph (e)(1)(iv) of this section if the cumulative amount of intercompany inventory items not taken into account by S is not significantly greater than the cumulative amount that would not be taken into account under the methods specifically described in paragraph (e)(1) of this section. If, for any year, the method results in a cumulative amount of intercompany inventory items not taken into account by S that significantly exceeds the cumulative amount that would not be taken into account under the methods specifically provided, S must take into account for that year the amount necessary to eliminate the excess. The method is thereafter applied with appropriate adjustments to reflect the amount taken into account (e.g., to prevent the amount from being taken into account more than once).

(2) *Reserve accounting—(i) Banks and thrifts.* Except as provided in

paragraph (g)(3)(iv) of this section (deferral of items from an intercompany obligation), a member's addition to, or reduction of, a reserve for bad debts that is maintained under section 585 or 593 is taken into account on a separate entity basis. For example, if S makes a loan to a nonmember and subsequently sells the loan to B, any deduction for an addition to a bad debt reserve under section 585 and any recapture income (or reduced bad debt deductions) are taken into account on a separate entity basis rather than as intercompany items or corresponding items taken into account under this section. Any gain or loss of S from its sale of the loan to B is taken into account under this section, however, to the extent it is not attributable to recapture of the reserve.

(ii) *Insurance companies—(A) Direct insurance.* If a member provides insurance to another member in an intercompany transaction, the transaction is taken into account by both members on a separate entity basis. For example, if one member provides life insurance coverage for another member with respect to its employees, the premiums, reserve increases and decreases, and death benefit payments are determined and taken into account by both members on a separate entity basis rather than taken into account under this section as intercompany items and corresponding items.

(B) *Reinsurance—(1) In general.* Paragraph (e)(2)(ii)(A) of this section does not apply to a reinsurance transaction that is an intercompany transaction. For example, if a member assumes all or a portion of the risk on an insurance contract written by another member, the amounts transferred as reinsurance premiums, expense allowances, benefit reimbursements, reimbursed policyholder dividends, experience rating adjustments, and other similar items are taken into account under the matching rule and

the acceleration rule. For purposes of this section, the assuming company is treated as B and the ceding company is treated as S.

(2) *Reserves determined on a separate entity basis.* For purposes of determining the amount of a member's increase or decrease in reserves, the amount of any reserve item listed in section 807(c) or 832(b)(5) resulting from a reinsurance transaction that is an intercompany transaction is determined on a separate entity basis. But see section 845, under which the Commissioner may allocate between or among the members any items, recharacterize any such items, or make any other adjustments necessary to reflect the proper source and character of the separate taxable income of a member.

(3) *Consent to treat intercompany transactions on a separate entity basis—(i) General rule.* The common parent may request consent to take into account on a separate entity basis items from intercompany transactions other than intercompany transactions with respect to stock or obligations of members. Consent may be granted for all items, or for items from a class or classes of transactions. The consent is effective only if granted in writing by the Internal Revenue Service. Unless revoked with the written consent of the Internal Revenue Service, the separate entity treatment applies to all affected intercompany transactions in the consolidated return year for which consent is granted and in all subsequent consolidated return years. Consent under this paragraph (e)(3) does not apply for purposes of taking into account losses and deductions deferred under section 267(f).

(ii) *Time and manner for requesting consent.* The request for consent described in paragraph (e)(3)(i) of this section must be made in the form of a ruling request. The request must be signed by the common parent, include

any information required by the Internal Revenue Service, and be filed on or before the due date of the consolidated return (not including extensions of time) for the first consolidated return year to which the consent is to apply. The Internal Revenue Service may impose terms and conditions for granting consent. A copy of the consent must be attached to the group's consolidated returns (or amended returns) as required by the terms of the consent.

(iii) *Effect of consent on methods of accounting.* A consent for separate entity accounting under this paragraph (e)(3), and a revocation of that consent, may require changes in members' methods of accounting for intercompany transactions. Because the consent, or a revocation of the consent, is effective for all intercompany transactions occurring in the consolidated return year for which the consent or revocation is first effective, any change in method is effected on a cut-off basis. Section 446(e) consent is granted for any changes in methods of accounting for intercompany transactions that are necessary solely to conform a member's methods to a binding consent with respect to the group under this paragraph (e)(3) or the revocation of that consent, provided the changes are made in the first consolidated return year for which the consent or revocation under this paragraph (e)(3) is effective. Therefore, section 446(e) consent must be separately requested under applicable administrative procedures if a member has failed to conform its practices to the separate entity accounting provided under this paragraph (e)(3) or the revocation of that treatment in the first consolidated return year for which the consent to use separate entity accounting or revocation of that consent is effective.

(iv) *Consent to treat intercompany transactions on a separate entity basis under prior law.* A group that has received consent that is in effect as of the first day of the first consolidated return year beginning on or after July 12, 1995, to treat certain intercompany transactions as provided in §1.1502-13(c)(3) of the regulations (as contained in the 26 CFR part 1 edition revised as of April 1, 1995) will be considered to have obtained the consent of the Commissioner to take items from intercompany transactions into account on a separate entity basis as provided in paragraph (e)(3)(i) of this section. This treatment is applicable only to the

items, class or classes of transactions for which consent was granted under prior law.

(f) *Stock of members*—(1) *In general.* In addition to the general rules of this section, the rules of this paragraph (f) apply to stock of members.

(2) *Intercompany distributions to which section 301 applies*—(i) *In general.* This paragraph (f)(2) provides rules for intercompany transactions to which section 301 applies (intercompany distributions). For purposes of determining whether a distribution is an intercompany distribution, it is treated as occurring under the principles of the entitlement rule of paragraph (f)(2)(iv) of this section. A distribution is not an intercompany distribution to the extent it is deducted by the distributing member. See, for example, section 1382(c)(1).

(ii) *Distributee member.* An intercompany distribution is not included in the gross income of the distributee member (B). However, this exclusion applies to a distribution only to the extent there is a corresponding negative adjustment reflected under §1.1502-32 in B's basis in the stock of the distributing member (S). For example, no amount is included in B's gross income under section 301(c)(3) from a distribution in excess of the basis of the stock of a subsidiary that results in an excess loss account under §1.1502-32(a) which is treated as negative basis under §1.1502-19. See §1.1502-26(b) (applicability of the dividends received deduction to distributions not excluded from gross income, such as a distribution from the common parent to a subsidiary owning stock of the common parent).

(iii) *Distributing member.* The principles of section 311(b) apply to S's loss, as well as gain, from an intercompany distribution of property. Thus, S's loss is taken into account under the matching rule if the property is subsequently sold to a nonmember. However, section 311(a) continues to apply to distributions to nonmembers (for example, loss is not recognized).

(iv) *Entitlement rule*—(A) *In general.* For all Federal income tax purposes, an intercompany distribution is treated as taken into account when the shareholding member becomes entitled to it (generally on the record date). For example, if B becomes entitled to a cash distribution before it is made, the distribution is treated as made when B

becomes entitled to it. For this purpose, B is treated as entitled to a distribution no later than the time the distribution is taken into account under the Internal Revenue Code (e.g., under section 305(c)). To the extent a distribution is not made, appropriate adjustments must be made as of the date it was taken into account.

(B) *Nonmember shareholders.* If nonmembers own stock of the distributing corporation at the time the distribution is treated as occurring under this paragraph (f)(2)(iv), appropriate adjustments must be made to prevent the acceleration of the distribution to members from affecting distributions to nonmembers.

(3) *Boot in an intercompany reorganization*—(i) *Scope.* This paragraph (f)(3) provides additional rules for an intercompany transaction in which the receipt of money or other property (nonqualifying property) results in the application of section 356. For example, the distribution of stock of a lower-tier member to a higher tier member in an intercompany transaction to which section 355 would apply but for the receipt of nonqualifying property is a transaction to which this paragraph (f)(3) applies. This paragraph (f)(3) does not apply if a party to the transaction becomes a member or nonmember as part of the same plan or arrangement. For example, if S merges into a nonmember in a transaction described in section 368(a)(1)(A), this paragraph (f)(3) does not apply.

(ii) *Treatment.* Nonqualifying property received as part of a transaction described in this paragraph (f)(3) is treated as received by the member shareholder in a separate transaction. See, for example, sections 302 and 311 (rather than sections 356 and 361). The nonqualifying property is treated as taken into account immediately after the transaction if section 354 would apply but for the fact that nonqualifying property is received. It is treated as taken into account immediately before the transaction if section 355 would apply but for the fact that nonqualifying property is received. The treatment under this paragraph (f)(3)(ii) applies for all Federal income tax purposes.

(4) *Acquisition by issuer of its own stock.* If a member acquires its own stock, or an option to buy or sell its own stock, in an intercompany transaction, the member's basis in that stock or option is treated as eliminated for all purposes. Accordingly, S's intercom-

pany items from the stock or options of B are taken into account under this section if B acquires the stock or options in an intercompany transaction (unless, for example, B acquires the stock in exchange for successor property within the meaning of paragraph (j)(1) of this section in a nonrecognition transaction). For example, if B redeems its stock from S in a transaction to which section 302(a) applies, S's gain from the transaction is taken into account immediately under the acceleration rule.

(5) *Certain liquidations and distributions*—(i) *Netting allowed.* S's intercompany item from a transfer to B of the stock of another corporation (T) is taken into account under this section in certain circumstances even though the T stock is never held by a nonmember after the intercompany transaction. For example, if S sells all of T's stock to B at a gain, and T subsequently liquidates into B in a separate transaction to which section 332 applies, S's gain is taken into account under the matching rule. Under paragraph (c)(6)(ii) of this section, S's intercompany gain taken into account as a result of a liquidation under section 332 or a comparable nonrecognition transaction is not re-determined to be excluded from gross income. Under this paragraph (f)(5)(i), if S has both intercompany income or gain and intercompany deduction or loss attributable to stock of the same corporation having the same material terms, only the income or gain in excess of the deduction or loss is subject to paragraph (c)(6)(ii) of this section. This paragraph (f)(5)(i) applies only to a transaction in which B's basis in its T stock is permanently eliminated in a liquidation under section 332 or any comparable nonrecognition transaction, including—

(A) A merger of B into T under section 368(a);

(B) A distribution by B of its T stock in a transaction described in section 355; or

(C) A deemed liquidation of T resulting from an election under section 338(h)(10).

(ii) *Elective relief*—(A) *In general.* If an election is made pursuant to this paragraph (f)(5)(ii), certain transactions are recharacterized to prevent S's items from being taken into account or to provide offsets to those items. This paragraph (f)(5)(ii) applies only if T is a member throughout the period begin-

ning with S's transfer and ending with the completion of the nonrecognition transaction.

(B) *Section 332*—(1) *In general.* If section 332 applies to T's liquidation into B, and B transfers T's assets to a new member (new T) in a transaction not otherwise pursuant to the same plan or arrangement as the liquidation, the transfer is nevertheless treated for all Federal income tax purposes as pursuant to the same plan or arrangement as the liquidation. For example, if T liquidates into B, but B forms new T by transferring substantially all of T's former assets to new T, S's intercompany gain or loss generally is not taken into account solely as a result of the liquidation if the liquidation and transfer would qualify as a reorganization described in section 368(a). (Under paragraph (j)(1) of this section, B's stock in new T would be a successor asset to B's stock in T, and S's gain would be taken into account based on the new T stock.)

(2) *Time limitation and adjustments.* The transfer of an asset to new T not otherwise pursuant to the same plan or arrangement as the liquidation is treated under this paragraph (f)(5)(ii)(B) as pursuant to the same plan or arrangement only if B transfers it to new T pursuant to a written plan, a copy of which is attached to a timely filed original return (including extensions) for the year of T's liquidation, and the transfer is completed within 12 months of the filing of that return. Appropriate adjustments are made to reflect any events occurring before the formation of new T and to reflect any assets not transferred to new T as part of the same plan or arrangement. For example, if B retains an asset in the reorganization, the asset is treated under paragraph (f)(3) of this section as acquired by new T but distributed to B immediately after the reorganization.

(3) *Downstream merger, etc.* The principles of this paragraph (f)(5)(ii)(B) apply, with appropriate adjustments, if B's basis in the T stock is eliminated in a transaction similar to a section 332 liquidation, such as a transaction described in section 368 in which B merges into T. For example, if S and B are subsidiaries, and S sells all of T's stock to B at a gain followed by B's merger into T in a separate transaction described in section 368(a), S's gain is not taken into account solely as a result of the merger if T (as successor to B) forms new T with substantially all of T's former assets.

(C) *Section 338(h)(10)*—(1) *In general.* This paragraph (f)(5)(ii)(C) applies to a deemed liquidation of T under section 332 as the result of an election under section 338(h)(10). This paragraph (f)(5)(ii)(C) does not apply if paragraph (f)(5)(ii)(B) of this section is applied to the deemed liquidation. Under this paragraph, B is treated with respect to each share of its T stock as recognizing as a corresponding item any loss or deduction it would recognize (determined after adjusting stock basis under §1.1502-32) if section 331 applied to the deemed liquidation. For all other Federal income tax purposes, the deemed liquidation remains subject to section 332.

(2) *Limitation on amount of loss.* The amount of B's loss or deduction under this paragraph (f)(5)(ii)(C) is limited as follows—

(i) The aggregate amount of loss recognized with respect to T stock cannot exceed the amount of S's intercompany income or gain that is in excess of S's intercompany deduction or loss with respect to shares of T stock having the same material terms as the shares giving rise to S's intercompany income or gain; and

(ii) The aggregate amount of loss recognized under this paragraph (f)(5)(ii)(C) from T's deemed liquidation cannot exceed the net amount of deduction or loss (if any) that would be taken into account from the deemed liquidation if section 331 applied with respect to all T shares.

(3) *Asset sale, etc.* The principles of this paragraph (f)(5)(ii)(C) apply, with appropriate adjustments, if T transfers all of its assets to a nonmember and completely liquidates in a transaction comparable to the section 338(h)(10) transaction described in paragraph (f)(5)(ii)(C)(1) of this section. For example, if S sells all of T's stock to B at a gain followed by T's merger into a nonmember in exchange for a cash payment to B in a transaction treated for Federal income tax purposes as T's sale of its assets to the nonmember and complete liquidation, the merger is ordinarily treated as a comparable transaction.

(D) *Section 355.* If B distributes the T stock in an intercompany transaction to which section 355 applies (including an intercompany transaction to which 355 applies because of the application of paragraph (f)(3) of this section), the redetermination of the basis of the T

stock under section 358 could cause S's gain or loss to be taken into account under this section. This paragraph (f)(5)(ii)(D) applies to treat B's distribution as subject to section 301 and 311 (as modified by this paragraph (f)), rather than section 355. The election will prevent S's gain or loss from being taken into account immediately to the extent matching remains possible, but B's gain or loss from the distribution will also be taken into account under this section.

(E) *Election.* An election to apply this paragraph (f)(5)(ii) is made in a separate statement entitled "[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF §1.1502-13(f)(5)(ii)." The election must include a description of S's intercompany transaction and T's liquidation (or other transaction). It must specify which provision of §1.1502-13(f)(5)(ii) applies and how it alters the otherwise applicable results under this section (including, for example, the amount of S's intercompany items and the amount deferred or offset as a result of this §1.1502-13(f)(5)(ii)). A separate election must be made for each application of this paragraph (f)(5)(ii). The election must be signed by the common parent and filed with the group's income tax return for the year of T's liquidation (or other transaction). The Commissioner may impose reasonable terms and conditions to the application of this paragraph (f)(5)(ii) that are consistent with the purposes of this section.

(6) [Reserved]

(7) *Examples.* The application of this section to intercompany transactions with respect to stock of members is illustrated by the following examples.

Example 1. Dividend exclusion and property distribution. (a) *Facts.* S owns land with a \$70 basis and \$100 value. On January 1 of Year 1, P's basis in S's stock is \$100. During Year 1, S declares and makes a dividend distribution of the land to P. Under section 311(b), S has a \$30 gain. Under section 301(d), P's basis in the land is \$100. On July 1 of Year 3, P sells the land to X for \$110.

(b) *Dividend elimination and stock basis adjustments.* Under paragraph (b)(1) of this section, S's distribution to P is an intercompany distribution. Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income is not included in gross income. Under §1.1502-32, P's basis in S's stock is reduced from \$100 to \$0 in Year 1.

(c) *Matching rule and stock basis adjustments.* Under the matching rule (treating P as the buying member and S as the selling member), S takes its \$30 gain into account in Year 3 to

reflect the \$30 difference between P's \$10 gain taken into account and the \$40 recomputed gain. Under §1.1502-32, P's basis in S's stock is increased from \$0 to \$30 in Year 3.

(d) *Loss property.* The facts are the same as in paragraph (a) of this *Example 1*, except that S has a \$130 (rather than \$70) basis in the land. Under paragraph (f)(2)(iii) of this section, the principles of section 311(b) apply to S's loss from the intercompany distribution. Thus, S has a \$30 loss that is taken into account under the matching rule in Year 3 to reflect the \$30 difference between P's \$10 gain taken into account and the \$20 recomputed loss. (The results are the same under section 267(f).) Under §1.1502-32, P's basis in S's stock is reduced from \$100 to \$0 in Year 1, and from \$0 to a \$30 excess loss account in Year 3. (If P had distributed the land to its shareholders, rather than selling the land to X, P would take its \$10 gain under section 311(b) into account, and S would take its \$30 loss into account under the matching rule with \$10 offset by P's gain and \$20 recharacterized as a noncapital, nondeductible amount.)

(e) *Entitlement rule.* The facts are the same as in paragraph (a) of this *Example 1*, except that, after P becomes entitled to the distribution but before the distribution is made, S issues additional stock to the public and becomes a nonmember. Under paragraph (f)(2)(i) of this section, the determination of whether a distribution is an intercompany distribution is made under the entitlement rule of paragraph (f)(2)(iv) of this section. Treating S's distribution as made when P becomes entitled to it results in the distribution being an intercompany distribution. Under paragraph (f)(2)(ii) of this section, the distribution is not included in P's gross income. S's \$30 gain from the distribution is intercompany gain that is taken into account under the acceleration rule immediately before S becomes a nonmember. Thus, there is a net \$70 decrease in P's basis in its S stock under §1.1502-32 (\$100 decrease for the distribution and a \$30 increase for S's \$30 gain). See also §1.1502-20(b) (additional stock basis reductions applicable to certain deconsolidations). Under paragraph (f)(2)(iv) of this section, P does not take the distribution into account again under separate return rules when received, and P is not entitled to a dividends received deduction.

Example 2. Excess loss accounts. (a) *Facts.* S owns all of T's only class of stock with a \$10 basis and \$100 value. S has substantial earnings and profits, and T has \$10 of earnings and profits. On January 1 of Year 1, S declares and distributes a dividend of all of the T stock to P. Under section 311(b), S has a \$90 gain. Under section 301(d), P's basis in the T stock is \$100. During Year 3, T borrows \$90 and declares and makes a \$90 distribution to P to which section 301 applies, and P's basis in the T stock is reduced under §1.1502-32 from \$100 to \$10. During Year 6, T has \$5 of earnings that increase P's basis in the T stock under §1.1502-32 from \$10 to \$15. On December 1 of Year 9, T issues additional stock to X and, as a result, T becomes a nonmember.

(b) *Dividend exclusion.* Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income from S's distribution of the T stock, and its \$10 of dividend income from T's \$90 distribution, are not included in gross income.

(c) *Matching and acceleration rules.* Under §1.1502-19(b)(1), when T becomes a nonmember P must include in income the amount of its excess loss account (if any) in T stock. P has no

excess loss account in the T stock. Therefore P's corresponding item from the deconsolidation of T is \$0. Treating S and P as divisions of a single corporation, the T stock would continue to have a \$10 basis after the distribution, and the adjustments under §1.1502-32 for T's \$90 distribution and \$5 of earnings would result in a \$75 excess loss account. Thus, the recomputed corresponding item from the deconsolidation is \$75. Under the matching rule, S takes \$75 of its \$90 gain into account in Year 9 as a result of T becoming a nonmember, to reflect the difference between P's \$0 gain taken into account and the \$75 recomputed gain. S's remaining \$15 of gain is taken into account under the matching and acceleration rules based on subsequent events (for example, under the matching rule if P subsequently sells its T stock, or under the acceleration rule if S becomes a nonmember).

(d) *Reverse sequence.* The facts are the same as in paragraph (a) of this *Example 2*, except that T borrows \$90 and makes its \$90 distribution to S before S distributes T's stock to P. Under paragraph (f)(2)(ii) of this section, T's \$90 distribution to S (\$10 of which is a dividend) is not included in S's gross income. The corresponding negative adjustment under §1.1502-32 reduces S's basis in the T stock from \$10 to an \$80 excess loss account. Under section 311(b), S has a \$90 gain from the distribution of T stock to P. Under section 301(d) P's initial basis in the T stock is \$10 (the stock's fair market value), and the basis increases to \$15 under §1.1502-32 as a result of T's earnings in Year 6. The timing and attributes of S's gain are determined in the manner provided in paragraph (c) of this *Example 2*. Thus, \$75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining \$15 is taken into account under the matching and acceleration rules based on subsequent events.

(e) *Partial stock sale.* The facts are the same as in paragraph (a) of this *Example 2*, except that P sells 10% of T's stock to X on December 1 of Year 9 for \$1.50 (rather than T's issuing additional stock and becoming a nonmember). Under the matching rule, S takes \$9 of its gain into account to reflect the difference between P's \$0 gain taken into account (\$1.50 sale proceeds minus \$1.50 basis) and the \$9 recomputed gain (\$1.50 sale proceeds plus \$7.50 excess loss account).

(f) *Loss, rather than cash distribution.* The facts are the same as in paragraph (a) of this *Example 2*, except that T retains the loan proceeds and incurs a \$90 loss in Year 3 that is absorbed by the group. The timing and attributes of S's gain are determined in the same manner provided in paragraph (c) of this *Example 2*. Under §1.1502-32, the loss in Year 3 reduces P's basis in the T stock from \$100 to \$10, and T's \$5 of earnings in Year 6 increase the basis to \$15. Thus, \$75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining \$15 is taken into account under the matching and acceleration rules based on subsequent events. (The timing and attributes of S's gain would be determined in the same manner provided in paragraph (d) of this *Example 2* if T incurred the \$90 loss before S's distribution of the T stock to P.)

(g) *Stock sale, rather than stock distribution.* The facts are the same as in paragraph (a) of this *Example 2*, except that S sells the T stock to P for \$100 (rather than distributing the stock). The timing and attributes of S's gain are determined in the same manner provided in paragraph (c) of

this *Example 2*. Thus, \$75 of S's gain is taken into account under the matching rule in Year 9 as a result of T becoming a nonmember, and the remaining \$15 is taken into account under the matching and acceleration rules based on subsequent events.

Example 3. Intercompany reorganization. (a) *Facts.* P forms S and B by contributing \$200 to the capital of each. During Years 1 through 4, S and B each earn \$50, and under §1.1502-32 P adjusts its basis in the stock of each to \$250. (See §1.1502-33 for adjustments to earnings and profits.) On January 1 of Year 5, the fair market value of S's assets and its stock is \$500, and S merges into B in a tax-free reorganization. Pursuant to the plan of reorganization, P receives B stock with a fair market value of \$350 and \$150 of cash.

(b) *Treatment as a section 301 distribution.* The merger of S into B is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving additional B stock with a fair market value of \$500 and, under section 358, a basis of \$250. Immediately after the merger, \$150 of the stock received is treated as redeemed, and the redemption is treated under section 302(d) as a distribution to which section 301 applies. Because the \$150 distribution is treated as not received as part of the merger, section 356 does not apply and no basis adjustments are required under section 358(a)-(1)(A) and (B). Because B is treated under section 381(c)(2) as receiving S's earnings and profits and the redemption is treated as occurring after the merger, \$100 of the distribution is treated as a dividend under section 301 and P's basis in the B stock is reduced correspondingly under §1.1502-32. The remaining \$50 of the distribution reduces P's basis in the B stock. Section 301(c)(2) and §1.1502-32. Under paragraph (f)(2)(ii) of this section, P's \$100 of dividend income is not included in gross income. Under §1.302-2(c), proper adjustments are made to P's basis in its B stock to reflect its basis in the B stock redeemed, with the result that P's basis in the B stock is reduced by the entire \$150 distribution.

(c) *Depreciated property.* The facts are the same as in paragraph (a) of this *Example 3*, except that property of S with a \$200 basis and \$150 fair market value is distributed to P (rather than cash of B). As in paragraph (b) of this *Example 3*, P is treated as receiving additional B stock in the merger and a \$150 distribution to which section 301 applies immediately after the merger. Under paragraph (f)(2)(iii) of this section, the principles of section 311(b) apply to B's \$50 loss and the loss is taken into account under the matching and acceleration rules based on subsequent events (e.g., under the matching rule if P subsequently sells the property, or under the acceleration rule if B becomes a nonmember). The results are the same under section 267(f).

(d) *Divisive transaction.* Assume instead that, pursuant to a plan, S distributes the stock of a lower-tier subsidiary in a spin-off transaction to which section 355 applies together with \$150 of cash. The distribution of stock is a transaction to which paragraph (f)(3) of this section applies. P is treated as receiving the \$150 of cash immediately before the section 355 distribution, as a distribution to which section 301 applies. Section 356(b) does not apply and no basis adjustments are required under section 358(a)(1)(A) and (B). Because the \$150 distribution is treated as made before the section 355 distribution, the distribution reduces P's basis in the S stock

under §1.1502-32, and the basis allocated under section 358(c) between the S stock and the lower-tier subsidiary stock received reflects this basis reduction.

Example 4. Stock redemptions and distributions. (a) *Facts.* Before becoming a member of the P group, S owns P stock with a \$30 basis. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, P redeems the P stock held by S for \$100 in a transaction to which section 302(a) applies.

(b) *Gain under section 302.* Under paragraph (f)(4) of this section, P's basis in the P stock acquired from S is treated as eliminated. As a result of this elimination, S's intercompany item will never be taken into account under the matching rule because P's basis in the stock does not reflect S's intercompany item. Therefore, S's \$70 gain is taken into account under the acceleration rule in Year 3. The attributes of S's item are determined under paragraph (d)(1)(ii) of this section by applying the matching rule as if P had sold the stock to an affiliated corporation that is not a member of the group at no gain or loss. Although P's corresponding item from a sale of its stock would have been excluded from gross income under section 1032, paragraph (c)(6)(ii) of this section prevents S's gain from being treated as excluded from gross income; instead S's gain is capital gain.

(c) *Gain under section 311.* The facts are the same as in paragraph (a) of this *Example 4*, except that S distributes the P stock to P in a transaction to which section 301 applies (rather than the stock being redeemed), and S has a \$70 gain under section 311(b). The timing and attributes of S's gain are determined in the manner provided in paragraph (b) of this *Example 4*.

(d) *Loss stock.* The facts are the same as in paragraph (a) of this *Example 4*, except that S has a \$130 (rather than \$30) basis in the P stock and has a \$30 loss under section 302(a). The limitation under paragraph (c)(6)(ii) of this section does not apply to intercompany losses. Thus, S's loss is taken into account in Year 3 as a noncapital, nondeductible amount.

Example 5. Intercompany stock sale followed by section 332 liquidation. (a) *Facts.* S owns all of the stock of T, with a \$70 basis and \$100 value, and T's assets have a \$10 basis and \$100 value. On January 1 of Year 1, S sells all of T's stock to B for \$100. On July 1 of Year 3, when T's assets are still worth \$100, T distributes all of its assets to B in an unrelated complete liquidation to which section 332 applies.

(b) *Timing and attributes.* Under paragraph (b)(3)(ii) of this section, B's unrecognized gain or loss under section 332 is a corresponding item for purposes of applying the matching rule. In Year 3 when T liquidates, B has \$0 of unrecognized gain or loss under section 332 because B has a \$100 basis in the T stock and receives a \$100 distribution with respect to its T stock. Treating S and B as divisions of a single corporation, the recomputed corresponding item would have been \$30 of unrecognized gain under section 332 because B would have succeeded to S's \$70 basis in the T stock. Thus, under the matching rule, S's \$30 intercompany gain is taken into account in Year 3 as a result of T's liquidation. Under paragraph (c)(1)(i) of this section, the attributes of S's gain and B's corresponding item are redetermined as if S and B were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross

income to reflect the nonrecognition of B's gain under section 332, S's gain remains capital gain because B's unrecognized gain under section 332 is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. However, relief may be elected under paragraph (f)(5)(ii) of this section.

(c) *Intercompany sale at a loss.* The facts are the same as in paragraph (a) of this *Example 5*, except that S has a \$130 (rather than \$70) basis in the T stock. The limitation under paragraph (c)(6)(ii) of this section does not apply to intercompany losses. Thus, S's intercompany loss is taken into account in Year 3 as a noncapital, nondeductible amount. However, relief may be elected under paragraph (f)(5)(ii) of this section.

Example 6. Intercompany stock sale followed by section 355 distribution. (a) *Facts.* S owns all of the stock of T with a \$70 basis and a \$100 value. On January 1 of Year 1, S sells all of T's stock to M for \$100. On June 1 of Year 6, M distributes all of its T stock to its nonmember shareholders in a transaction to which section 355 applies. At the time of the distribution, M has a basis in T stock of \$100 and T has a value of \$150.

(b) *Timing and attributes.* Under paragraph (b)(3)(ii) of this section, M's \$50 gain not recognized on the distribution under section 355 is a corresponding item. Treating S and M as divisions of a single corporation, the recomputed corresponding item would be \$80 of unrecognized gain under section 355 because M would have succeeded to S's \$70 basis in the T stock. Thus, under the matching rule, S's \$30 intercompany gain is taken into account in Year 6 as a result of the distribution. Under paragraph (c)(1)(i) of this section, the attributes of S's intercompany item and M's corresponding item are redetermined to produce the same effect on consolidated taxable income as if S and M were divisions of a single corporation. Although S's gain ordinarily would be redetermined to be treated as excluded from gross income to reflect the nonrecognition of M's gain under section 355(c), S's gain remains capital gain because M's unrecognized gain under section 355(c) is not permanently and explicitly disallowed under the Code. See paragraph (c)(6)(ii) of this section. Because M's distribution of the T stock is not an intercompany transaction, relief is not available under paragraph (f)(5)(ii) of this section.

(c) *Section 355 distribution within the group.* The facts are the same as under paragraph (a) of this *Example 6*, except that M distributes the T stock to B (another member of the group), and B takes a \$75 basis in the T stock under section 358. Under paragraph (j)(2) of this section, B is a successor to M for purposes of taking S's intercompany gain into account, and therefore both M and B might have corresponding items with respect to S's intercompany gain. To the extent it is possible, matching with respect to B's corresponding items produces the result most consistent with treating S, M, and B as divisions of a single corporation. See paragraphs (j)(3) and (j)(4) of this section. However, because there is only \$5 difference between B's \$75 basis in the T stock and the \$70 basis the stock would have if S, M, and B were divisions of a single corporation, only \$5 can be taken into account under the matching rule with respect to B's corresponding items. (This \$5 is taken into account with respect to B's corresponding items based on subsequent events.) The remaining \$25 of S's \$30 intercompany gain is taken into account in Year 6 under the matching rule with respect to M's corresponding item from its

distribution of the T stock. The attributes of S's remaining \$25 of gain are determined in the same manner as in paragraph (b) of this *Example 6*.

(d) *Relief elected.* The facts are the same as in paragraph (c) of this *Example 6* except that P elects relief pursuant to paragraph (f)(5)(ii)(D) of this section. As a result of the election, M's distribution of the T stock is treated as subject to sections 301 and 311 instead of section 355. Accordingly, M recognizes \$50 of intercompany gain from the distribution, B takes a basis in the stock equal to its fair market value of \$150, and S and M take their intercompany gains into account with respect to B's corresponding items based on subsequent events. (None of S's gain is taken into account in Year 6 as a result of M's distribution of the T stock.)

(g) *Obligations of members*—(1) *In general.* In addition to the general rules of this section, the rules of this paragraph (g) apply to intercompany obligations.

(2) *Definitions.* For purposes of this section—

(i) *Obligation of a member.* An obligation of a member is—

(A) Any obligation of the member constituting indebtedness under general principles of Federal income tax law (for example, under nonstatutory authorities, or under section 108, section 163, section 171, or section 1275), but not an executory obligation to purchase or provide goods or services; and

(B) Any security of the member described in section 475(c)(2)(D) or (E), and any comparable security with respect to commodities, but not if the security is a position with respect to the member's stock. See paragraph (f)(4) of this section and §1.1502-13T(f)(6) for special rules applicable to positions with respect to a member's stock.

(ii) *Intercompany obligations.* An intercompany obligation is an obligation between members, but only for the period during which both parties are members.

(3) *Deemed satisfaction and reissuance of intercompany obligations*—

(i) *Application*—(A) *In general.* If a member realizes an amount (other than zero) of income, gain, deduction, or loss, directly or indirectly, from the assignment or extinguishment of all or part of its remaining rights or obligations under an intercompany obligation, the intercompany obligation is treated for all Federal income tax purposes as satisfied under paragraph (g)(3)(ii) of this section and, if it remains outstanding, reissued under paragraph (g)(3)(iii) of this section. Similar principles apply

under this paragraph (g)(3) if a member realizes any such amount, directly or indirectly, from a comparable transaction (for example, a marking-to-market of an obligation or a bad debt deduction), or if an intercompany obligation becomes an obligation that is not an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(3) does not apply to an obligation if any of the following applies:

(1) The obligation became an intercompany obligation by reason of an event described in §1.108-2(e) (exceptions to the application of section 108(e)(4)).

(2) The amount realized is from reserve accounting under section 585 or section 593 (see paragraph (g)(3)(iv) of this section for special rules).

(3) The amount realized is from the conversion of an obligation into stock of the obligor.

(4) Treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year. For this purpose, obligations issued in connection with the same transaction or related transactions are treated as a single obligation. However, this paragraph (g)(3)(i)(B)(4) does not apply to any obligation if the aggregate effect of this treatment for all obligations in a year would be significant.

(ii) *Satisfaction*—(A) *General rule.* If a creditor member sells intercompany debt for cash, the debt is treated as satisfied by the debtor immediately before the sale for the amount of the cash. For other transactions, similar principles apply to treat the intercompany debt as satisfied immediately before the transaction. Thus, if the debt is transferred for property, it is treated as satisfied for an amount consistent with the amount for which the debt is deemed reissued under paragraph (g)(3)(iii) of this section, and the basis of the property is also adjusted to reflect that amount. If this paragraph (g)(3) applies because the debtor or creditor becomes a nonmember, the obligation is treated as satisfied for cash in an amount equal to its fair market value immediately before the debtor or creditor becomes a nonmember. Similar principles apply to intercompany obligations other than debt.

(B) *Timing and attributes.* For purposes of applying the matching rule and the acceleration rule—

(1) Paragraph (c)(6)(ii) of this section (limitation on treatment of inter-

company income or gain as excluded from gross income) does not apply to prevent any intercompany income or gain from being excluded from gross income; and

(2) Any gain or loss from an intercompany obligation is not subject to section 108(a), section 354 or section 1091.

(iii) *Reissuance.* If a creditor member sells intercompany debt for cash, the debt is treated as a new debt (with a new holding period) issued by the debtor immediately after the sale for the amount of cash. For other transactions, if the intercompany debt remains outstanding, similar principles apply to treat the debt as reissued immediately after the transaction. Thus, if the debt is transferred for property, it is treated as new debt issued for the property. See, for example, section 1273(b)(3) or section 1274. If this paragraph (g)(3) applies because the debtor or creditor becomes a nonmember, the debt is treated as new debt issued for an amount of cash equal to its fair market value immediately after the debtor or creditor becomes a nonmember. Similar principles apply to intercompany obligations other than debt.

(iv) *Bad debt reserve.* A member's deduction under section 585 or section 593 for an addition to its reserve for bad debts with respect to an intercompany obligation is not taken into account, and is not treated as realized under this paragraph (g)(3) until the intercompany obligation becomes an obligation that is not an intercompany obligation, or, if earlier, the redemption or cancellation of the intercompany obligation.

(4) *Deemed satisfaction and reissuance of obligations becoming intercompany obligations*—(i) *Application*—(A) *In general.* This paragraph (g)(4) applies if an obligation that is not an intercompany obligation becomes an intercompany obligation.

(B) *Exceptions.* This paragraph (g)(4) does not apply to an obligation if—

(1) The obligation becomes an intercompany obligation by reason of an event described in §1.108-2(e) (exceptions to the application of section 108(e)(4)); or

(2) Treating the obligation as satisfied and reissued will not have a significant effect on any person's Federal income tax liability for any year. For this purpose, obligations issued in

connection with the same transaction or related transactions are treated as a single obligation. However, this paragraph (g)(4)(i)(B)(2) does not apply to any obligation if the aggregate effect of this treatment for all obligations in a year would be significant.

(ii) *Intercompany debt.* If this paragraph (g)(4) applies to an intercompany debt—

(A) Section 108(e)(4) does not apply;

(B) The debt is treated for all Federal income tax purposes, immediately after it becomes an intercompany debt, as satisfied and a new debt issued to the holder (with a new holding period) in an amount determined under the principles of §1.108-2(f);

(C) The attributes of all items taken into account from the satisfaction are determined on a separate entity basis, rather than by treating S and B as divisions of a single corporation;

(D) Any intercompany gain or loss taken into account is treated as not subject to section 354 or section 1091; and

(E) Solely for purposes of §1.1502-32(b)(4) and the effect of any election under that provision, any loss taken into account under this paragraph (g)(4) by a corporation that becomes a member as a result of the transaction in which the obligation becomes an intercompany obligation is treated as a loss carryover from a separate return limitation year.

(iii) *Other intercompany obligations.* If this paragraph (g)(4) applies to an intercompany obligation other than debt, the principles of paragraph (g)(4)(ii) of this section apply to treat the intercompany obligation as satisfied and reissued for an amount of cash equal to its fair market value immediately after the obligation becomes an intercompany obligation.

(5) *Examples.* The application of this section to obligations of members is illustrated by the following examples.

Example 1. Interest on intercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 5. B fully performs its obligations. Under their separate entity methods of accounting, B accrues a \$10 interest deduction annually under section 163, and S accrues \$10 of interest income annually under section 61(a)(4).

(b) *Matching rule.* Under paragraph (b)(1) of this section, the accrual of interest on B's note is

an intercompany transaction. Under the matching rule, S takes its \$10 of income into account in each of Years 1 through 5 to reflect the \$10 difference between B's \$10 of interest expense taken into account and the \$0 recomputed expense. S's income and B's deduction are ordinary items. (Because S's intercompany item and B's corresponding item would both be ordinary on a separate entity basis, the attributes are not redetermined under paragraph (c)(1)(i) of this section.)

(c) *Original issue discount.* The facts are the same as in paragraph (a) of this *Example 1*, except that B borrows \$90 (rather than \$100) from S in return for B's note providing for \$10 of interest annually and repayment of \$100 at the end of Year 5. The principles described in paragraph (b) of this *Example 1* for stated interest also apply to the \$10 of original issue discount. Thus, as B takes into account its corresponding expense under section 163(e), S takes into account its intercompany income. S's income and B's deduction are ordinary items.

(d) *Tax-exempt income.* The facts are the same as in paragraph (a) of this *Example 1*, except that B's borrowing from S is allocable under section 265 to B's purchase of state and local bonds to which section 103 applies. The timing of S's income is the same as in paragraph (b) of this *Example 1*. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding item of disallowed interest expense control the attributes of S's offsetting intercompany interest income. Paragraph (c)(6)(ii) of this section does not prevent the redetermination of S's intercompany item as excluded from gross income, because section 265 permanently and explicitly disallows B's corresponding deduction. Accordingly, S's intercompany income is treated as excluded from gross income.

Example 2. Intercompany debt becomes nonintercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note and S sells B's note to X for \$70, reflecting a change in the value of the note as a result of increases in prevailing market interest rates. B is never insolvent within the meaning of section 108(d)(3).

(b) *Deemed satisfaction.* Under paragraph (g)(3) of this section, B's note is treated as satisfied for \$70 immediately before S's sale to X. As a result of the deemed satisfaction of the obligation for less than its adjusted issue price, B takes into account \$30 of discharge of indebtedness income under section 61(a)(12). On a separate entity basis, S's \$30 loss would be a capital loss under section 1271(a)(1). Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. B's corresponding item completely offsets S's intercompany item in amount. Accordingly, under paragraph (c)(4)(i) of this section, the attributes of B's \$30 of discharge of indebtedness income control the attributes of S's loss. Thus, S's loss is treated as ordinary loss.

(c) *Deemed reissuance.* Under paragraph (g)(3) of this section, B is also treated as reissuing, directly to X, a new note with a \$70 issue price and a \$100 stated redemption price at maturity. The new note is not an intercompany obligation, it has a \$70 issue price and \$100 stated redemption

price at maturity, and the \$30 of original issue discount will be taken into account by B and X under sections 163(e) and 1272.

(d) *Creditor deconsolidation.* The facts are the same as in paragraph (a) of this *Example 2*, except that P sells S's stock to X (rather than S's selling the note of B). Under paragraph (g)(3) of this section, the note is treated as satisfied by B for its \$70 fair market value immediately before S becomes a nonmember, and B is treated as reissuing a new note to S immediately after S becomes a nonmember. The results for S's \$30 of loss and B's discharge of indebtedness income are the same as in paragraph (b) of this *Example 2*. The new note is not an intercompany obligation, it has a \$70 issue price and \$100 stated redemption price at maturity, and the \$30 of original issue discount will be taken into account by B and S under sections 163(e) and 1272.

(e) *Debtor deconsolidation.* The facts are the same as in paragraph (a) of this *Example 2*, except that P sells B's stock to X (rather than S's selling the note of B). The results are the same as in paragraph (d) of this *Example 2*.

(f) *Appreciated note.* The facts are the same as in paragraph (a) of this *Example 2*, except that S sells B's note to X for \$130 (rather than \$70), reflecting a decline in prevailing market interest rates. Under paragraph (g)(3) of this section, B's note is treated as satisfied for \$130 immediately before S's sale of the note to X. Under §1.163-7(c), B takes into account \$30 of repurchase premium. On a separate entity basis, S's \$30 gain would be a capital gain under section 1271(a)(1), and B's \$30 premium deduction would be an ordinary deduction. Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of B's corresponding premium deduction control the attributes of S's intercompany gain. Accordingly, S's gain is treated as ordinary income. B is also treated as reissuing a new note directly to X which is not an intercompany obligation. The new note has a \$130 issue price and a \$100 stated redemption price at maturity. Under §1.61-12(c), B's \$30 premium income under the new note is taken into account over the life of the new note.

Example 3. Loss or bad debt deduction with respect to intercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 5. In Year 3, S sells B's note to P for \$60. B is never insolvent within the meaning of section 108(d)(3). Assume B's note is not a security within the meaning of section 165(g)(2).

(b) *Deemed satisfaction and reissuance.* Under paragraph (g)(3) of this section, B is treated as satisfying its note for \$60 immediately before the sale, and reissuing a new note directly to P with a \$60 issue price and a \$100 stated redemption price at maturity. On a separate entity basis, S's \$40 loss would be a capital loss, and B's \$40 income would be ordinary income. Under the matching rule, however, the attributes of S's intercompany item and B's corresponding item must be redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of

B's corresponding discharge of indebtedness income control the attributes of S's intercompany loss. Accordingly, S's loss is treated as ordinary loss.

(c) *Partial bad debt deduction.* The facts are the same as in paragraph (a) of this *Example 3*, except that S claims a \$40 partial bad debt deduction under section 166(a)(2) (rather than selling the note to P). The results are the same as in paragraph (b) of this *Example 3*. B's note is treated as satisfied and reissued with a \$60 issue price. S's \$40 intercompany deduction and B's \$40 corresponding income are both ordinary.

(d) *Insolvent debtor.* The facts are the same as in paragraph (a) of this *Example 3*, except that B is insolvent within the meaning of section 108(d)(3) at the time that S sells the note to P. On a separate entity basis, S's \$40 loss would be capital, B's \$40 income would be excluded from gross income under section 108(a), and B would reduce attributes under section 108(b) or section 1017. However, under paragraph (g)(3)(ii)(B) of this section, section 108(a) does not apply to B's income to characterize it as excluded from gross income. Accordingly, the attributes of S's intercompany loss and B's corresponding income are redetermined in the same manner as in paragraph (b) of this *Example 3*.

Example 4. Nonintercompany debt becomes intercompany debt. (a) *Facts.* On January 1 of Year 1, B borrows \$100 from X in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 5. As of January 1 of Year 3, B has fully performed its obligations, but the note's fair market value is \$70. On January 1 of Year 3, P buys all of X's stock. B is solvent within the meaning of section 108(d)(3).

(b) *Deemed satisfied and reissuance.* Under paragraph (g)(4) of this section, B is treated as satisfying its indebtedness for \$70 (determined under the principles of §1.108-2(f)(2)) immediately after X becomes a member. Both X's \$30 capital loss under section 1271(a)(1) and B's \$30 of discharge of indebtedness income under section 61(a)(12) are taken into account in determining consolidated taxable income for Year 3. Under paragraph (g)(4)(ii)(C) of this section, the attributes of items resulting from the satisfaction are determined on a separate entity basis. But see section 382 and §1.1502-15 (limitations on the absorption of built-in losses). B is also treated as reissuing a new note. The new note is an intercompany obligation, it has a \$70 issue price and \$100 stated redemption price at maturity, and the \$30 of original issue discount will be taken into account by B and X in the same manner as provided in paragraph (c) of *Example 1* of this paragraph (g)(5).

(c) *Election to file consolidated returns.* Assume instead that B borrows \$100 from S during Year 1, but the P group does not file consolidated returns until Year 3. Under paragraph (g)(4) of this section, B's indebtedness is treated as satisfied and a new note reissued immediately after the debt becomes intercompany debt. The satisfaction and reissuance are deemed to occur on January 1 of Year 3, for the fair market value of the note (determined under the principles of §1.108-2(f)(2)) at that time.

Example 5. Notional principal contracts. (a) *Facts.* On April 1 of Year 1, M1 enters into a contract with counterparty M2 under which, for a term of five years, M1 is obligated to make a payment to M2 each April 1, beginning in Year 2, in an amount equal to the London Interbank Offered Rate (LIBOR), as determined on the

immediately preceding April 1, multiplied by a \$1,000 notional principal amount. M2 is obligated to make a payment to M1 each April 1, beginning in Year 2, in an amount equal to 8% multiplied by the same notional principal amount. LIBOR is 7.80% on April 1 of Year 1. On April 1 of Year 2, M2 owes \$2 to M1.

(b) *Matching rule.* Under §1.446-3(d), the net income (or net deduction) from a notional principal contract for a taxable year is included in (or deducted from) gross income. Under §1.446-3(e), the ratable daily portion of M2's obligation to M1 as of December 31 of Year 1 is \$1.50 (\$2 multiplied by 275/365). Under the matching rule, M1's net income for Year 1 of \$1.50 is taken into account to reflect the difference between M2's net deduction of \$1.50 taken into account and the \$0 recomputed net deduction. Similarly, the \$.50 balance of the \$2 of net periodic payments made on April 1 of Year 2 is taken into account for Year 2 in M1's and M2's net income and net deduction from the contract. In addition, the attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. (Although M1 is the selling member with respect to the payment on April 1 of Year 2, it might be the buying member in a subsequent period if it owes the net payment.)

(c) *Dealer.* The facts are the same as in paragraph (a) of this *Example 5*, except that M2 is a dealer in securities, and the contract with M1 is not inventory in the hands of M2. Under section 475, M2 must mark its securities to market at year-end. Assume that under section 475, M2's loss from marking to market the contract with M1 is \$100. Under paragraph (g)(3) of this section, M2 is treated as making a \$100 payment to M1 to terminate the contract immediately before section 475 is applied. M1's \$100 of income from the termination payment is taken into account under the matching rule to reflect M2's deduction under §1.446-3(h). The attributes of M1's intercompany income and M2's corresponding deduction are redetermined to produce the same effect as if the transaction had occurred between divisions of a single corporation. Under paragraph (c)(4)(i) of this section, the attributes of M2's corresponding deduction control the attributes of M1's intercompany income. Accordingly, M1's income is treated as ordinary income. Paragraph (g)(3) of this section also provides that, immediately after section 475 would apply, a new contract is treated as reissued with an upfront payment of \$100. Under §1.446-3(f), the deemed \$100 payment by M2 to M1 is taken into account over the term of the new contract in a manner reflecting the economic substance of the contract (for example, allocating the payment in accordance with the forward rates of a series of cash-settled forward contracts that reflect the specified index and the \$1,000 notional principal amount). (The timing of taking items into account is the same if M1, rather than M2, is the dealer subject to the mark-to-market requirement of section 475 at year-end. However in this case, because the attributes of the corresponding deduction control the attributes of the intercompany income, M1's income from the deemed termination payment might be ordinary or capital.)

(h) *Anti-avoidance rules—(1) In general.* If a transaction is engaged in

or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany transaction), adjustments must be made to carry out the purposes of this section.

(2) *Examples.* The anti-avoidance rules of this paragraph (h) are illustrated by the following examples. The examples set forth below do not address common law doctrines or other authorities that might apply to recast a transaction or to otherwise affect the tax treatment of a transaction. Thus, in addition to adjustments under this paragraph (h), the Commissioner can, for example, apply the rules of section 269 or §1.701-2 to disallow a deduction or to recast a transaction.

Example 1. Sale of a partnership interest. (a) *Facts.* S owns land with a \$10 basis and \$100 value. B has net operating losses from separate return limitation years (SRLYs) subject to limitation under §1.1502-21(c). Pursuant to a plan to absorb the losses without limitation by the SRLY rules, S transfers the land to an unrelated, calendar-year partnership in exchange for a 10% interest in the capital and profits of the partnership in a transaction to which section 721 applies. The partnership does not have a section 754 election in effect. S later sells its partnership interest to B for \$100. In the following year, the partnership sells the land to X for \$100. Because the partnership does not have a section 754 election in effect, its \$10 basis in the land does not reflect B's \$100 basis in the partnership interest. Under section 704(c), the partnership's \$90 built-in gain is allocated to B, and B's basis in the partnership interest increases to \$190 under section 705. In a later year, B sells the partnership interest to a nonmember for \$100.

(b) *Adjustments.* Under §1.1502-21(c), the partnership's \$90 built-in gain allocated to B ordinarily increases the amount of B's SRLY limitation, and B's \$90 loss from its sale of the partnership interest ordinarily is not subject to limitation under the SRLY rules. Because the contribution of property to the partnership and the sale of the partnership interest were part of a plan a principal purpose of which was to achieve a reduction in consolidated tax liability by creating offsetting gain and loss for B while deferring S's intercompany gain, B's allocable share of the partnership's gain from its sale of the land is treated under paragraph (h)(1) of this section as not increasing the amount of B's SRLY limitation.

Example 2. Transitory status as an intercompany obligation. (a) *Facts.* P historically has owned 70% of X's stock and the remaining 30% is owned by unrelated shareholders. On January 1 of Year 1, S borrows \$100 from X in return for S's note requiring \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, the P group has substantial net operating loss carryovers, and the fair market value of S's note falls to \$70 due to an increase in prevailing market interest rates. X is not permitted under section 166(a)(2) to take into account a \$30 loss with respect to the note. Pursuant to a plan to

permit X to take into account its \$30 loss without disposing of the note, P acquires an additional 10% of X's stock, causing X to become a member, and P subsequently resells the 10% interest. X's \$30 loss with respect to the note is a net unrealized built-in loss within the meaning of §1.1502-15.

(b) *Adjustments.* Under paragraph (g)(4) of this section, X ordinarily would take into account its \$30 loss as a result of the note becoming an intercompany obligation, and S would take into account \$30 of discharge of indebtedness income. Under §1.1502-22(c), X's loss is not combined with items of the other members and the loss would be carried to X's separate return years as a result of X becoming a nonmember. However, the transitory status of S's indebtedness to X as an intercompany obligation is structured with a principal purpose to accelerate the recognition of X's loss. Thus, S's note is treated under paragraph (h)(1) of this section as not becoming an intercompany obligation.

Example 3. Corporate mixing bowl. (a) *Facts.* M1 and M2 are subsidiaries of P. M1 operates a manufacturing business on land it leases from M2. The land is the only asset held by M2. P intends to dispose of the M1 business, including the land owned by M2; P's basis in the M1 stock is equal to the stock's fair market value. M2's land has a value of \$20 and a basis of \$0 and P has a \$0 basis in the stock of M2. In Year 1, with a principal purpose of avoiding gain from the sale of the land (by transferring the land to M1 with a carry-over basis without affecting P's basis in the stock of M1 or M2), M1 and M2 form corporation T; M1 contributes cash in exchange for 80% of the T stock and M2 contributes the land in exchange for 20% of the stock. In Year 3, T liquidates, distributing \$20 cash to M2 and the land (plus \$60 cash) to M1. Under §1.1502-34, section 332 applies to both M1 and M2. Under section 337, T recognizes no gain or loss from its liquidating distribution of the land to M1. T has neither gain nor loss on its distribution of cash to M2. In Year 4, P sells all of the stock of M1 to X and liquidates M2.

(b) *Adjustments.* A principal purpose for the formation and liquidation of T was to avoid gain from the sale of M2's land. Thus, under paragraph (h)(1) of this section, M2 must take \$20 of gain into account when the stock of M1 is sold to X.

Example 4. Partnership mixing bowl. (a) *Facts.* M1 owns a self-created intangible asset with a \$0 basis and a fair market value of \$100. M2 owns land with a basis of \$100 and a fair market value of \$100. In Year 1, with a principal purpose of creating basis in the intangible asset (which would be eligible for amortization under section 197), M1 and M2 form partnership PRS; M1 contributes the intangible asset and M2 contributes the land. X, an unrelated person, contributes cash to PRS in exchange for a substantial interest in the partnership. PRS uses the contributed assets in legitimate business activities. Five years and six months later, PRS liquidates, distributing the land to M1, the intangible to M2, and cash to X. The group reports no gain under sections 707(a)(2)(B) and 737(a) and claims that M2's basis in the intangible asset is \$100 under section 732 and that the asset is eligible for amortization under section 197.

(b) *Adjustments.* A principal purpose of the formation and liquidation of PRS was to create additional amortization without an offsetting increase in consolidated taxable income by

avoiding treatment as an intercompany transaction. Thus, under paragraph (h)(1) of this section, appropriate adjustments must be made.

Example 5. Sale and leaseback. (a) *Facts.* S operates a factory with a \$70 basis and \$100 value, and has loss carryovers from SRLYs. Pursuant to a plan to take into account the \$30 unrealized gain while continuing to operate the factory, S sells the factory to X for \$100 and leases it back on a long-term basis. In the transaction, a substantial interest in the factory is transferred to X. The sale and leaseback are not recharacterized under general principles of Federal income tax law. As a result of S's sale to X, the \$30 gain is taken into account and increases S's SRLY limitation.

(b) *No adjustments.* Although S's sale was pursuant to a plan to accelerate the \$30 gain, it is not subject to adjustment under paragraph (h)(1) of this section. The sale is not treated as engaged in or structured with a principal purpose to avoid the purposes of this section.

(i) [Reserved]

(j) *Miscellaneous operating rules.* For purposes of this section:

(1) *Successor assets.* Any reference to an asset includes, as the context may require, a reference to any other asset the basis of which is determined, directly or indirectly, in whole or in part, by reference to the basis of the first asset.

(2) *Successor persons*—(i) *In general.* Any reference to a person includes, as the context may require, a reference to a predecessor or successor. For this purpose, a predecessor is a transferor of assets to a transferee (the successor) in a transaction—

(A) To which section 381(a) applies;

(B) In which substantially all of the assets of the transferor are transferred to members in a complete liquidation;

(C) In which the successor's basis in assets is determined (directly or indirectly, in whole or in part) by reference to the basis of the transferor, but the transferee is a successor only with respect to the assets the basis of which is so determined; or

(D) Which is an intercompany transaction, but only with respect to assets that are being accounted for by the transferor in a prior intercompany transaction.

(ii) *Intercompany items.* If the assets of a predecessor are acquired by a successor member, the successor succeeds to, and takes into account (under the rules of this section), the predecessor's intercompany items. If two or more successor members acquire assets of the predecessor, the successors take into account the predecessor's intercompany items in a manner that is consistently applied and reasonably

carries out the purposes of this section and applicable provisions of law.

(3) *Multiple triggers.* If more than one corresponding item can cause an intercompany item to be taken into account under the matching rule, the intercompany item is taken into account in connection with the corresponding item most consistent with the treatment of members as divisions of a single corporation. For example, if S sells a truck to B, its intercompany gain from the sale is not taken into account by reference to B's depreciation if the depreciation is capitalized under section 263A as part of B's cost for a building; instead, S's gain relating to the capitalized depreciation is taken into account when the building is sold or as it is depreciated. Similarly, if B purchases appreciated land from S and transfers the land to a lower-tier member in exchange for stock, thereby duplicating the basis of the land in the basis of the stock, items with respect to both the stock and the land can cause S's intercompany gain to be taken into account; if the lower-tier member becomes a nonmember as a result of the sale of its stock, the attributes of S's intercompany gain are determined with respect to the land rather than the stock.

(4) *Multiple or successive intercompany transactions.* If a member's intercompany item or corresponding item affects the accounting for more than one intercompany transaction, appropriate adjustments are made to treat all of the intercompany transactions as transactions between divisions of a single corporation. For example, if S sells property to M, and M sells the property to B, then S, M, and B are treated as divisions of a single corporation for purposes of applying the rules of this section. Similar principles apply with respect to intercompany transactions that are part of the same plan or arrangement. For example, if S sells separate properties to different members as part of the same plan or arrangement, all of the participating members are treated as divisions of a single corporation for purposes of determining the attributes (which might also affect timing) of the intercompany items and corresponding items from each of the properties.

(5) *Acquisition of group*—(i) *Scope.* This paragraph (j)(5) applies only if a consolidated group (the terminating group) ceases to exist as a result of—

(A) The acquisition by a member of another consolidated group of either the

assets of the common parent of the terminating group in a reorganization described in section 381(a)(2), or the stock of the common parent of the terminating group; or

(B) The application of the principles of §1.1502-75(d)(2) or (d)(3).

(ii) *Application.* If the terminating group ceases to exist under circumstances described in paragraph (j)(5)(i) of this section, the surviving group is treated as the terminating group for purposes of applying this section to the intercompany transactions of the terminating group. For example, intercompany items and corresponding items from intercompany transactions between members of the terminating group are taken into account under the rules of this section by the surviving group. This treatment does not apply, however, to members of the terminating group that are not members of the surviving group immediately after the terminating group ceases to exist (for example, under section 1504(a)(3) relating to reconsolidation, or section 1504(c) relating to includible insurance companies).

(6) *Former common parent treated as continuation of group.* If a group terminates because the common parent is the only remaining member, the common parent succeeds to the treatment of the terminating group for purposes of applying this section so long as it neither becomes a member of an affiliated group filing separate returns nor becomes a corporation described in section 1504(b). For example, if the only subsidiary of the group liquidates into the common parent in a complete liquidation to which section 332 applies, or the common parent merges into the subsidiary and the subsidiary is treated as the common parent's successor under paragraph (j)(2)(i) of this section, the taxable income of the surviving corporation is treated as the group's consolidated taxable income in which the intercompany and corresponding items must be included. See §1.267(f)-1 for additional rules applicable to intercompany losses or deductions.

(7) *Becoming a nonmember.* For purposes of this section, a member is treated as becoming a nonmember if it has a separate return year (including another group's consolidated return year). A member is not treated as having a separate return year if its items are treated as taken into account in computing the group's consolidated

taxable income under paragraph (j)(5) or (6) of this section.

(8) *Recordkeeping.* Intercompany and corresponding items must be reflected on permanent records (including work papers). See also section 6001, requiring records to be maintained. The group must be able to identify from these permanent records the amount, location, timing, and attributes of the items, so as to permit the application of the rules of this section for each year.

(9) *Examples.* The operating rules of this paragraph (j) are illustrated generally throughout this section, and by the following examples.

Example 1. Intercompany sale followed by section 351 transfer to member. (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to M for \$100. M also holds the land for investment. On July 1 of Year 3, M transfers the land to B in exchange for all of B's stock in a transaction to which section 351 applies. Under section 358, M's basis in the B stock is \$100. B holds the land for sale to customers in the ordinary course of business and, under section 362(b), B's basis in the land is \$100. On December 1 of Year 5, M sells 20% of the B stock to X for \$22. In an unrelated transaction on July 1 of Year 8, B sells 20% of the land for \$22.

(b) *Definitions.* Under paragraph (b)(1) of this section, S's sale of the land to M and M's transfer of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. M has no intercompany items under paragraph (b)(2) of this section. Because B acquired the land in an intercompany transaction, B's items from the land are corresponding items to be taken into account under this section. Under the successor asset rule of paragraph (j)(1) of this section, references to the land include references to M's B stock. Under the successor person rule of paragraph (j)(2) of this section, references to M include references to B with respect to the land.

(c) *Timing and attributes resulting from the stock sale.* Under paragraph (c)(3) of this section, M is treated as owning and selling B's stock for purposes of the matching rule even though, as divisions, M could not own and sell stock in B. Under paragraph (j)(3) of this section, both M's B stock and B's land can cause S's intercompany gain to be taken into account under the matching rule. Thus, S takes \$6 of its gain into account in Year 5 to reflect the \$6 difference between M's \$2 gain taken into account from its sale of B stock and the \$8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation. Under paragraph (c)(1) of this section, S's \$6 gain and M's \$2 gain are treated as long-term capital gain. The gain would be capital on a separate entity basis (assuming that section 341 does not apply), and this treatment is not inconsistent with treating S, M, and B as divisions of a single corporation because the stock sale and subsequent land sale are unrelated transactions and B remains a member following the sale.

(d) *Timing and attributes resulting from the land sale.* Under paragraph (j)(3) of this section, S takes \$6 of its gain into account in Year 8 under the matching rule to reflect the \$6 difference between B's \$2 gain taken into account from its sale of an interest in the land and the \$8 recomputed gain. Under paragraph (j)(4) of this section, the attributes of this gain are determined by treating S, M, and B as divisions of a single corporation and taking into account the activities of S, M, and B with respect to the land. Thus, both S's gain and B's gain might be ordinary income as a result of B's activities. (If B subsequently sells the balance of the land, S's gain taken into account is limited to its remaining \$18 of intercompany gain.)

(e) *Sale of successor stock resulting in deconsolidation.* The facts are the same as in paragraph (a) of this *Example 1*, except that M sells 60% of the B stock to X for \$66 on December 1 of Year 5 and B becomes a nonmember. Under the matching rule, M's sale of B stock results in \$18 of S's gain being taken into account (to reflect the difference between M's \$6 gain taken into account and the \$24 recomputed gain). Under the acceleration rule, however, the entire \$30 gain is taken into account (to reflect B becoming a nonmember, because its basis in the land reflects M's \$100 cost basis from the prior intercompany transaction). Under paragraph (j)(4) of this section, the attributes of S's gain are determined by treating S, M, and B as divisions of a single corporation. Because M's cost basis in the land will be reflected by B as a nonmember, all of S's gain is treated as from the land (rather than a portion being from B's stock), and B's activities with respect to the land might therefore result in S's gain being ordinary income.

Example 2. Intercompany sale of member stock followed by recapitalization. (a) *Facts.* Before becoming a member of the P group, S owns P stock with a basis of \$70. On January 1 of Year 1, P buys all of S's stock. On July 1 of Year 3, S sells the P stock to M for \$100. On December 1 of Year 5, P acquires M's original P stock in exchange for new P stock in a recapitalization described in section 368(a)(1)(E).

(b) *Timing and attributes.* Although P's basis in the stock acquired from M is eliminated under paragraph (f)(4) of this section, the new P stock received by M is exchanged basis property (within the meaning of section 7701(a)(44)) having a basis under section 358 equal to M's basis in the original P stock. Under the successor asset rule of paragraph (j)(1) of this section, references to M's original P stock include references to M's new P stock. Because it is still possible to take S's intercompany item into account under the matching rule with respect to the successor asset, S's gain is not taken into account under the acceleration rule as a result of the basis elimination under paragraph (f)(4) of this section. Instead, the gain is taken into account based on subsequent events with respect to M's new P stock (for example, a subsequent distribution or redemption of the new stock).

Example 3. Back-to-back intercompany transactions—matching. (a) *Facts.* S holds land for investment with a basis of \$70. On January 1 of Year 1, S sells the land to M for \$90. M also holds the land for investment. On July 1 of Year 3, M sells the land for \$100 to B, and B holds the land for sale to customers in the ordinary course of business. During Year 5, B sells all of the land to customers for \$105.

(b) *Timing.* Under paragraph (b)(1) of this section, S's sale of the land to M and M's sale

of the land to B are both intercompany transactions. S is the selling member and M is the buying member in the first intercompany transaction, and M is the selling member and B is the buying member in the second intercompany transaction. Under paragraph (j)(4) of this section, S, M and B are treated as divisions of a single corporation for purposes of determining the timing of their items from the intercompany transactions. See also paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany gain into account). Thus, S's \$20 gain and M's \$10 gain are both taken into account in Year 5 to reflect the difference between B's \$5 gain taken into account with respect to the land and the \$35 recomputed gain (the gain that B would have taken into account if the intercompany sales had been transfers between divisions of a single corporation, and B succeeded to S's \$70 basis).

(c) *Attributes.* Under paragraphs (j)(4) of this section, the attributes of the intercompany items and corresponding items of S, M, and B are also determined by treating S, M, and B as divisions of a single corporation. For example, the attributes of S's and M's intercompany items are determined by taking B's activities into account.

Example 4. Back-to-back intercompany transactions—acceleration. (a) *Facts.* During Year 1, S performs services for M in exchange for \$10 from M. S incurs \$8 of employee expenses. M capitalizes the \$10 cost of S's services under section 263 as part of M's cost to acquire real property from X. Under its separate entity method of accounting, S would take its income and expenses into account in Year 1. M holds the real property for investment and, on July 1 of Year 5, M sells it to B at a gain. B also holds the real property for investment. On December 1 of Year 8, while B still owns the real property, P sells all of M's stock to X and M becomes a nonmember.

(b) *M's items.* M takes its gain into account immediately before it becomes a nonmember. Because the real property stays in the group, the acceleration rule redetermines the attributes of M's gain under the principles of the matching rule as if B sold the real property to an affiliated corporation that is not a member of the group for a cash payment equal to B's adjusted basis in the real property, and S, M, and B were divisions of a single corporation. Thus, M's gain is capital gain.

(c) *S's items.* Under paragraph (b)(2)(ii) of this section, S includes the \$8 of expenses in determining its \$2 intercompany income. In Year 1, S takes into account \$8 of income and \$8 of expenses. Under paragraph (j)(4) of this section, appropriate adjustments must be made to treat both S's performance of services for M and M's sale to B as occurring between divisions of a single corporation. Thus, S's \$2 of intercompany income is not taken into account as a result of M becoming a nonmember, but instead will be taken into account based on subsequent events (e.g., under the matching rule based on B's sale of the real property to a nonmember, or under the acceleration rule based on P's sale of the stock of S or B to a nonmember). See the successor person rules of paragraph (j)(2) of this section (B is treated as a successor to M for purposes of taking S's intercompany income into account).

(d) *Sale of S's stock.* The facts are the same as in paragraph (a) of this *Example 4*, except that P sells all of S's stock (rather than M's stock) and S becomes a nonmember on July 1 of Year 5.

S's remaining \$2 of intercompany income is taken into account immediately before S becomes a nonmember. Because S's intercompany income is not from an intercompany sale, exchange, or distribution of property, the attributes of the intercompany income are determined on a separate entity basis. Thus, S's \$2 of intercompany income is ordinary income. M does not take any of its intercompany gain into account as a result of S becoming a nonmember.

(e) *Intercompany income followed by intercompany loss.* The facts are the same as in paragraph (a) of this *Example 4*, except that M sells the real property to B at a \$1 loss (rather than a gain). M takes its \$1 loss into account under the acceleration rule immediately before M becomes a nonmember. But see §1.267(f)-1 (which might further defer M's loss if M and B remain in a controlled group relationship after M becomes a nonmember). Under paragraph (j)(4) of this section appropriate adjustments must be made to treat the group as if both intercompany transactions occurred between divisions of a single corporation. Accordingly, P's sale of M stock also results in S taking into account \$1 of intercompany income as capital gain to offset M's \$1 of corresponding capital loss. The remaining \$1 of S's intercompany income is taken into account based on subsequent events.

Example 5. Successor group. (a) *Facts.* On January 1 of Year 1, B borrows \$100 from S in return for B's note providing for \$10 of interest annually at the end of each year, and repayment of \$100 at the end of Year 20. As of January 1 of Year 3, B has paid the interest accruing under the note. On that date, X acquires all of P's stock and the former P group members become members of the X consolidated group.

(b) *Successor.* Under paragraph (j)(5) of this section, although B's note ceases to be an intercompany obligation of the P group, the note is not treated as satisfied and reissued under paragraph (g) of this section as a result of X's acquisition of P stock. Instead, the X consolidated group succeeds to the treatment of the P group for purposes of paragraph (g) of this section, and B's note is treated as an intercompany obligation of the X consolidated group.

(c) *No subgroups.* The facts are the same as in paragraph (a) of this *Example 5*, except that X simultaneously acquires the stock of S and B from P (rather than X acquiring all of P's stock). Paragraph (j)(5) of this section does not apply to X's acquisitions. Unless an exception described in paragraph (g)(3)(i)(B) applies, B's note is treated as satisfied immediately before S and B become nonmembers, and reissued immediately after they become members of the X consolidated group. The amount at which the note is satisfied and reissued under paragraph (g)(3) of this section is based on the fair market value of the note at the time of P's sales to X. Paragraph (g)(4) of this section does not apply to the reissued B note in the X consolidated group, because the new note is always an intercompany obligation of the X consolidated group.

Example 6. Liquidation—80% distributee. (a) *Facts.* X has had preferred stock described in section 1504(a)(4) outstanding for several years. On January 1 of Year 1, S buys all of X's common stock for \$60, and B buys all of X's preferred stock for \$40. X's assets have a \$0 basis and \$100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under §1.1502-34, section 332 applies to both S and B. Under section 337, X has no gain or loss from its liquidating dis-

tribution to S. Under sections 336 and 337(c), X has a \$40 gain from its liquidating distribution to B. B has a \$40 basis under section 334(a) in the assets received from X, and S has a \$0 basis under section 334(b) in the assets received from X.

(b) *Intercompany items from the liquidation.* Under the matching rule, X's \$40 gain from its liquidating distribution to B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under section 337(c), X recognizes gain or loss only with respect to the assets distributed to B. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's \$40 intercompany gain. The gain will be taken into account by S under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain to S does not govern the allocation of any other attributes.)

Example 7. Liquidation—no 80% distributee. (a) *Facts.* X has only common stock outstanding. On January 1 of Year 1, S buys 60% of X's stock for \$60, and B buys 40% of X's stock for \$40. X's assets have a \$0 basis and \$100 value. On July 1 of Year 3, X distributes all of its assets to S and B in a complete liquidation. Under §1.1502-34, section 332 applies to both S and B. Under sections 336 and 337(c), X has a \$100 gain from its liquidating distributions to S and B. Under section 334(b), S has a \$60 basis in the assets received from X and B has a \$40 basis in the assets received from X.

(b) *Intercompany items from the liquidation.* Under the matching rule, X's \$100 intercompany gain from its liquidating distributions to S and B is not taken into account under this section as a result of the liquidation (and therefore is not yet reflected under §§1.1502-32 and 1.1502-33). Under the successor person rule of paragraph (j)(2)(i) of this section, S and B are both successors to X. Under paragraph (j)(2)(ii) of this section, to be consistent with the purposes of this section, S succeeds to X's \$40 intercompany gain with respect to the assets distributed to B, and B succeeds to X's \$60 intercompany gain with respect to the assets distributed to S. The gain will be taken into account by S and B under the matching and acceleration rules of this section based on subsequent events. (The allocation of the intercompany gain does not govern the allocation of any other attributes.)

(k) *Cross references—(1) Section 108.* See §1.108-3 for the treatment of intercompany deductions and losses as subject to attribute reduction under section 108(b).

(2) *Section 263A(f).* See section 263A(f) and §1.263A-9(g)(5) for special rules regarding interest from intercompany transactions.

(3) *Section 267(f).* See section 267(f) and §1.267(f)-1 for special rules applicable to certain losses and deductions from transactions between members of a controlled group.

(4) *Section 460.* See §1.460-4(j) for special rules regarding the application

of section 460 to intercompany transactions.

(5) *Section 469.* See §1.469-1(h) for special rules regarding the application of section 469 to intercompany transactions.

(6) *§1.1502-80.* See §1.1502-80 for the non-application of certain Internal Revenue Code rules.

(1) *Effective dates*—(1) *In general.* This section applies with respect to transactions occurring in years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items may be duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items may be treated inconsistently, prior law (and not this section) applies to the transaction. For example, S's and B's items from S's sale of property to B which occurs before July 12, 1995, are taken into account under prior law, even though B may dispose of the property after July 12, 1995. Similarly, an intercompany distribution to which a shareholder becomes entitled before July 12, 1995, but which is distributed after that date is taken into account under prior law (generally when distributed), because this section generally takes dividends into account when the shareholder becomes entitled to them but this section does not apply at that time. If application of prior law to S's deferred gain or loss from a deferred intercompany transaction (as defined under prior law) occurring prior to July 12, 1995, would be affected by an intercompany transaction (as defined under this section) occurring after July 12, 1995, S's deferred gain or loss continues to be taken into account as provided under prior law, and the items from the subsequent intercompany transaction are taken into account under this section. Appropriate adjustments must be made to prevent items from being duplicated, omitted, or eliminated in determining taxable income as a result of the application of both this section and prior law to the successive transactions, and to ensure the proper application of prior law.

(2) *Avoidance transactions.* This paragraph (1)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (1)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to

prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section. For example, if S is a dealer in real property and sells land to B on March 16, 1995 with a principal purpose of converting any future appreciation in the land to capital gain, B's gain from the sale of the land on May 11, 1997 might be characterized as ordinary income under this paragraph (1)(2).

(3) *Election for certain stock elimination transactions*—(i) *In general.* A group may elect pursuant to this paragraph (1)(3) to apply this section (including the elections available under paragraph (f)(5)(ii) of this section) to stock elimination transactions to which prior law would otherwise apply. If an election is made, this section, and not prior law, applies to determine the timing and attributes of S's and B's gain or loss from stock with respect to all stock elimination transactions.

(ii) *Stock elimination transactions.* For purposes of this paragraph (1)(3), a stock elimination transaction is a transaction in which stock transferred from S to B—

(A) Is cancelled or redeemed on or after July 12, 1995;

(B) Is treated as cancelled in a liquidation pursuant to an election under section 338(h)(10) with respect to a qualified stock purchase with an acquisition date on or after July 12, 1995;

(C) Is distributed on or after July 12, 1995; or

(D) Is exchanged on or after July 12, 1995, for stock of a member (determined immediately after the exchange) in a transaction that would cause S's gain or loss from the transfer to be taken into account under prior law.

(iii) *Time and manner of making election.* An election under this paragraph (1)(3) is made by attaching to a timely filed original return (including extensions) for the consolidated return year including July 12, 1995, a statement entitled “[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF §1.1502-13(1)-(3).” See paragraph (f)(5)(ii)(E) of this section for the manner of electing the relief provisions of paragraph (f)(5)(ii) of this section.

(4) *Prior law.* For transactions occurring in S's years beginning before

July 12, 1995, see the applicable regulations issued under section 1502. See §§1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, 1.1502-31, and 1.1502-32 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

(5) *Consent to adopt method of accounting.* For intercompany transactions occurring in a consolidated group's first taxable year beginning on or after July 12, 1995, the Commissioner's consent under section 446(e) is hereby granted for any changes in methods of accounting that are necessary solely by reason of the timing rules of this section. Changes in method of accounting for these transactions are to be effected on a cut-off basis.

§§1.1502-13T, 1.1502-14, and 1.1502-14T [Removed]

Par. 14. Sections 1.1502-13T, 1.1502-14, and 1.1502-14T are removed.

Par. 15. Section 1.1502-17 is amended as follows:

1. Paragraph (b) is revised.

2. Paragraph (c) is redesignated as paragraph (d).

3. New paragraphs (c) and (e) are added.

4. Newly designated paragraph (d) is amended by:

a. Revising the paragraph heading and the introductory text.

b. Designating the existing example as *Example 1* and adding a heading.

c. Adding *Examples 2* and *3*.

The added and revised provisions read as follows:

§1.1502-17 *Methods of accounting.*

* * * * *

(b) *Adjustments required if method of accounting changes*—(1) *General rule.* If a member of a group changes its method of accounting for a consolidated return year, the terms and conditions prescribed by the Commissioner under section 446(e), including section 481(a) where applicable, shall apply to the member. If the requirements of section 481(b) are met because applicable adjustments under section 481(a) are substantial, the increase in tax for any prior year shall be computed upon the basis of a consolidated return or a separate return, whichever was filed for such prior year.

(2) *Changes in method of accounting for intercompany transactions.* If a member changes its method of accounting for intercompany transactions for a consolidated return year, the change in method generally will be effected on a cut-off basis.

(c) *Anti-avoidance rules—(1) General rule.* If one member (B) directly or indirectly acquires an activity of another member (S), or undertakes S's activity, with the principal purpose to avail the group of an accounting method that would be unavailable (or would be unavailable without securing consent from the Commissioner) if S and B were treated as divisions of a single corporation, B must use the accounting method for the acquired or undertaken activity determined under paragraph (c)(2) of this section or must secure consent from the Commissioner under applicable administrative procedures to use a different method.

(2) *Treatment as divisions of a single corporation.* B must use the method of accounting that would be required if B acquired the activity from S in a transaction to which section 381 applied. Thus, the principles of section 381(c)(4) and (c)(5) apply to resolve any conflicts between the accounting methods of S and B, and the acquired or undertaken activity is treated as having the accounting method used by S. Appropriate adjustments are made to treat all acquisitions or undertakings that are part of the same plan or arrangement as a single acquisition or undertaking.

(d) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. Separate return treatment generally. * * *

Example 2. Adopting methods. Corporation P is a member of a consolidated group. P provides consulting services to customers under various agreements. For one type of customer, P's agreements require payment only when the contract is completed (payment-on-completion contracts). P uses an overall accrual method of accounting. Accordingly, P takes its income from consulting contracts into account when earned, received, or due, whichever is earlier. With the principal purpose to avoid seeking the consent of the Commissioner to change its method of accounting for the payment-on-completion contracts to the cash method, P forms corporation S, and S begins to render services to those customers subject to the payment-on-completion contracts. P continues to render services to those customers not subject to these contracts.

(b) Under paragraph (c) of this section, S must account for the consulting income under the payment-on-completion contracts on an accrual method rather than adopting the cash method contemplated by P.

Example 3. Changing inventory sub-method.

(a) Corporation P is a member of a consolidated group. P operates a manufacturing business that uses dollar-value LIFO, and has built up a substantial LIFO reserve. P has historically manufactured all its inventory and has used one natural business unit pool. P begins purchasing goods identical to its own finished goods from a foreign supplier, and is concerned that it must establish a separate resale pool under §1.472-8(c). P anticipates that it will begin to purchase, rather than manufacture, a substantial portion of its inventory, resulting in a recapture of most of its LIFO reserve because of decrements in its manufacturing pool. With the principal purpose to avoid the decrements, P forms corporation S in Year 1. S operates as a distributor to nonmembers, and P sells all of its existing inventories to S. S adopts LIFO, and elects dollar-value LIFO with one resale pool. Thereafter, P continues to manufacture and purchase inventory, and to sell it to S for resale to nonmembers. P's intercompany gain from sales to S is taken into account under §1.1502-13. S maintains its Year 1 base dollar value of inventory so that P will not be required to take its intercompany items (which include the effects of the LIFO reserve recapture) into account.

(b) Under paragraph (c) of this section, S must maintain two pools (manufacturing and resale) to the same extent that P would be required to maintain those pools under §1.472-8 if it had not formed S.

(e) *Effective dates.* Paragraph (b) of this section applies to changes in method of accounting effective for years beginning on or after July 12, 1995. For changes in method of accounting effective for years beginning before that date, see §1.1502-17 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995). Paragraphs (c) and (d) apply with respect to acquisitions occurring or activities undertaken in years beginning on or after July 12, 1995.

Par. 16. Section 1.1502-18 is amended by revising the heading for paragraph (f) and adding paragraph (g) to read as follows:

§1.1502-18 Inventory adjustment.

* * * * *

(f) *Transitional rules for years before 1966.* * * *

(g) *Transitional rules for years beginning on or after July 12, 1995.* Paragraphs (a) through (f) of this section do not apply for taxable years beginning on or after July 12, 1995. Any remaining unrecovered inventory amount of a member under paragraph (c) of this section is recovered in the first taxable year beginning on or after July 12, 1995, under the principles of paragraph (c)(3) of this section by

treating the first taxable year as the first separate return year of the member. The unrecovered inventory amount can be recovered only to the extent it was previously included in taxable income. The principles of this section apply, with appropriate adjustments, to comparable amounts under paragraph (f) of this section.

Par. 17. Section 1.1502-20 is amended as follows:

1. Paragraph (a)(5) *Example 6* is amended as follows:

a. The fifth sentence of paragraph (i) is revised.

b. Paragraph (ii) is revised.

c. Paragraphs (iii) and (iv) are added.

2. Paragraph (b)(6) *Example 5* is amended as follows:

a. The fifth sentence of paragraph (i) is revised.

b. A sentence is added at the beginning of paragraph (ii).

c. Paragraph (iii) is revised.

d. Paragraph (iv) is removed.

3. Paragraph (b)(6) *Example 7* is amended as follows:

a. The fourth sentence of paragraph (i) is revised.

b. The first sentence of paragraph (iii) is revised.

4. Paragraph (c)(4) is amended as follows:

a. *Example 3* is amended by removing paragraph (iii).

b. *Example 9* is added.

5. Paragraph (e)(3) is amended as follows:

a. *Examples 2* and *8* are removed.

b. *Example 3* through *Example 7* are redesignated as *Example 2* through *Example 6*.

c. Newly designated *Example 5* is revised.

6. In paragraph (h)(1), the second sentence is revised.

The revised and added provisions read as follows:

§1.1502-20 Disposition or deconsolidation of subsidiary stock.

(a) * * *

(5) * * *

Example 6. * * *

(i) * * * S sells its T stock to P for \$100 in an intercompany transaction, recognizing a \$60 intercompany loss that is deferred under section 267(f) and §1.1502-13. * * *

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's \$60 intercompany loss on the sale of its T stock to P is deferred, because S's intercompany loss is deferred under section 267(f) and §1.1502-13. P's sale of the T stock to X ordinarily would result in S's intercompany loss being taken into account under the matching rule of §1.1502-13(c). The deferred loss is not taken into account under §1.267(f)-1, however, because P's sale to X (a member of the same controlled group as P) is a second intercompany transaction for purposes of section 267(f). Nevertheless, paragraph (a)(3)(ii) of this section provides that paragraph (a)(1) of this section applies to the intercompany loss as a result of P's sale to X because the T stock ceases to be owned by a member of the P consolidated group. Thus, the loss is disallowed under paragraph (a)(1) of this section immediately before P's sale and is therefore never taken into account under section 267(f).

(iii) The facts are the same as in (i) of this Example, except that S is liquidated after its sale of the T stock to P, but before P's sale of the T stock to X, and P sells the T stock to X for \$110. Under §§1.1502-13(j) and 1.267(f)-1(b), P succeeds to S's intercompany loss as a result of S's liquidation. Thus, paragraph (a)(3)(i) of this section continues to defer the application of paragraph (a)(1) of this section until P's sale to X. Under paragraph (a)(4) of this section, the amount of S's \$60 intercompany loss disallowed under paragraph (a)(1) of this section is limited to \$50 because P's \$10 gain on the disposition of the T stock is taken into account as a consequence of the same plan or arrangement.

(iv) The facts are the same as in (i) of this Example, except that P sells the T stock to A, a person related to P within the meaning of section 267(b)(2). Although S's intercompany loss is ordinarily taken into account under the matching rule of §1.1502-13(c) as a result of P's sale, §1.267(f)-1(c)(2)(ii) provides that none of the intercompany loss is taken into account because A is a nonmember that is related to P under section 267(b). Under paragraph (a)(3)(i) of this section, paragraph (a)(1) of this section does not apply to loss that is disallowed under any other provision. Because §1.267(f)-1(c)(2)(ii) and section 267(d) provide that the benefit of the intercompany loss is retained by A if the property is later disposed of at a gain, the intercompany loss is not disallowed for purposes of paragraph (a)(3)(i) of this section. Thus, the intercompany loss is disallowed under paragraph (a)(1) of this section immediately before P's sale and is therefore never taken into account under section 267(d).

(b) * * *

(6) * * *

Example 5. * * *

(i) * * * S sells its T stock to P for \$100 in an intercompany transaction, recognizing a \$60 intercompany loss that is deferred under section 267(f) and §1.1502-13. * * *

(ii) Under paragraph (a)(3)(i) of this section, the application of paragraph (a)(1) of this section to S's intercompany loss on the sale of its T stock to P is deferred because S's loss is deferred under section 267(f) and §1.1502-13. * * *

(iii) T's issuance of the additional shares to the public does not result in S's intercompany loss being taken into account under the matching or acceleration rules of §1.1502-13(c) and (d), or under the application of the principles of those

rules in section 267(f). However, the deconsolidation of T is an overriding event under paragraph (a)(3)(ii) of this section, and paragraph (a)(1) of this section disallows the intercompany loss immediately before the deconsolidation even though the intercompany loss is not taken into account at that time.

Example 7. * * *

(i) * * * S recently purchased its T stock from S1, a lower tier subsidiary, in an intercompany transaction in which S1 recognized a \$30 intercompany gain that was deferred under §1.1502-13. * * *

* * * * *

(iii) Under the matching rule of §1.1502-13, S's sale of its T stock results in S1's \$30 intercompany gain being taken into account. * * *

* * * * *

(c) * * *

(4) * * *

Example 9. Intercompany stock sales.

(i) P is the common parent of a consolidated group, S is a wholly owned subsidiary of P, and T is a wholly owned recently purchased subsidiary of S. S has a \$100 basis in the T stock, and T has a capital asset with a basis of \$0 and a value of \$100. T's asset declines in value to \$60. Before T has any positive investment adjustments or extraordinary gain dispositions, S sells its T stock to P for \$60. T's asset reappreciates and is sold for \$100, and T recognizes \$100 of gain. Under the investment adjustment system, P's basis in the T stock increases to \$160. P then sells all of the T stock for \$100 and recognizes a loss of \$60.

(ii) S's sale of the T stock to P is an intercompany transaction. Thus, S's \$40 loss is deferred under section 267(f) and §1.1502-13. Under paragraph (a)(3) of this section, the application of paragraph (a)(1) of this section to S's \$40 loss is deferred until the loss is taken into account. Under the matching rule of §1.1502-13(c), the loss is taken into account to reflect the difference for each year between P's corresponding items taken into account and P's recomputed corresponding items (the corresponding items that P would take into account for the year if S and P were divisions of a single corporation). If S and P were divisions of a single corporation and the intercompany sale were a transfer between the divisions, P would succeed to S's \$100 basis and would have a \$200 basis in the T stock at the time it sells the T stock (\$100 of initial basis plus \$100 under the investment adjustment system). S's \$40 loss is taken into account at the time of P's sale of the T stock to reflect the \$40 difference between the \$60 loss P takes into account and P's recomputed \$100 loss.

(iii) Under the matching rule of §1.1502-13(c), the attributes of S's \$40 loss and P's \$60 loss are redetermined to produce the same effect on consolidated taxable income (and consolidated tax liability) as if S and P were divisions of a single corporation. Under §1.1502-13(b)(6), attributes of the losses include whether they are disallowed under this section. Because the amount described in paragraph (c)(1) of this section is \$100, both S's \$40 loss and P's \$60 loss are disallowed.

* * * * *

(e) * * *

(3) * * *

Example 5. Absence of a view.

(i) In Year 1, P buys all the stock of T for \$100, and T becomes a member of the P group. T has 2 historic assets, asset 1 with a basis of \$40 and value of \$90, and asset 2 with a basis of \$60 and value of \$10. In Year 2, T sells asset 1 for \$90. Under the investment adjustment system, P's basis in the T stock increases from \$100 to \$150. Asset 2 is not essential to the operation of T's business, and T distributes asset 2 to P in Year 5 with a view to having the group retain its \$50 loss inherent in the asset. Under §1.1502-13(f)(2), and the application of the principles of this rule in section 267(f), T has a \$50 intercompany loss that is deferred. Under §1.1502-32(b)(3)(iv), the distribution reduces P's basis in the T stock by \$10 to \$140 in Year 5. In Year 6, P sells all the T stock for \$90. Under the acceleration rule of §1.1502-13(d), and the application of the principles of this rule in section 267(f), T's intercompany loss is ordinarily taken into account immediately before P's sale of the T stock. Assuming that the loss is absorbed by the group, P's basis in T's stock would be reduced from \$140 to \$90 under §1.1502-32(b)(3)(i), and there would be no gain or loss from the stock disposition. (Alternatively, if the loss is not absorbed and the loss is reattributed to P under paragraph (g) of this section, the retribution would reduce P's basis in T's stock from \$140 to \$90.)

(ii) A \$50 loss is reflected both in T's basis in asset 2 and in P's basis in the T stock. Because the distribution results in the loss with respect to asset 2 being taken into account before the corresponding loss reflected in the T stock, and asset 2 is an historic asset of T, the distribution is not with the view described in paragraph (e)(2) of this section.

* * * * *

(h) * * *

(1) * * * For this purpose, dispositions deferred under §1.1502-13 are deemed to occur at the time the deferred gain or loss is taken into account unless the stock was deconsolidated before February 1, 1991. * * *

* * * * *

Par. 18. Section 1.1502-26 is amended by revising paragraph (b) to read as follows:

§1.1502-26 Consolidated dividends received deduction.

* * * * *

(b) *Intercompany dividends.* The deduction determined under paragraph (a) of this section is determined without taking into account intercompany dividends to the extent that, under §1.1502-13(f)(2), they are not included in gross income. See §1.1502-13 for additional rules relating to intercompany dividends.

* * * * *

Par. 19. Section 1.1502-33 is amended by revising paragraph (c)(2) to read as follows:

§1.1502-33 Earnings and profits.

* * * * *

(c) * * *

(2) *Intercompany transactions.* Intercompany items and corresponding items are not reflected in earnings and profits before they are taken into account under §1.1502-13. See §1.1502-13 for the applicable rules and definitions.

* * * * *

§1.1502-79 [Amended]

Par. 20. Section 1.1502-79 is amended by removing paragraph (f).

Par. 21. Section 1.1502-80 is amended by adding paragraphs (e) and (f) to read as follows:

§1.1502-80 Applicability of other provisions of law.

* * * * *

(e) *Non-applicability of section 163(e)(5).* Section 163(e)(5) does not apply to any intercompany obligation (within the meaning of §1.1502-13(g)) issued in a consolidated return year beginning on or after July 12, 1995.

(f) *Non-applicability of section 1031.* Section 1031 does not apply to any intercompany transaction occurring in consolidated return years beginning on or after July 12, 1995.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 22. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 23. In §602.101, paragraph (c) is amended as follows:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

| CFR part or section where identified and described | Current OMB control number |
|--|----------------------------|
| 1.267(f)-1T | 1545-0885 |
| 1.469-1T | 1545-1008 |
| 1.1502-14 | 1545-0123 |
| 1.1502-14T | 1545-1161 |

2. Adding entries in numerical order to the table for §§267(f)-1 and 1.469-1 and revising the entry for §1.1502-13 to read as follows:

§602.101 OMB Control numbers.

* * * * *

| CFR part or section where identified and described | Current OMB control number |
|--|--|
| 1.267(f)-1 | 1545-0885 |
| 1.469-1 | 1545-1008 |
| 1.1502-13 | 1545-0123
1545-0885
1545-1161
1545-1433 |

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved June 29, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on July 12, 1995, 12:56 p.m. and published in the issue of the Federal Register for July 18, 1995, 60 F.R. 36671)

T.D. 8598

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Consolidated Groups—Intercompany Transactions and Related Rules

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide rules for disallowing loss and excluding gain for certain dispositions and other transactions involving stock of the common parent of a consolidated group. These temporary regulations are necessary to prevent taxpayers from recognizing certain gains and losses on common parent stock that would not be recognized if a consolidated group were treated as a single entity. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [CO-24-95, page 466, this Bulletin].

DATES: These regulations are effective July 12, 1995.

For dates of applicability, see the effective date provision of the temporary regulations.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 1502. These temporary regulations provide rules for disallowing loss and excluding gain for certain dispositions and other transactions involving stock of the common parent of a consolidated group.

Final regulations published in *** [T.D. 8597, page 147, this Bulletin] provide rules for the treatment of intercompany transactions. The regulations generally provide greater single entity treatment of intercompany transactions than prior regulations under §1.1502-13 and -14.

For intercompany transactions with respect to stock of a member, however,

the final regulations generally adopt separate entity treatment, similar to the treatment under prior §1.1502-14. For example, stock is generally treated as an asset separate from the member's underlying assets and, if a member's stock is sold in an intercompany transaction, gain or loss from the stock sale is taken into account under the matching and acceleration rules that apply to other assets. The regulations adopt this approach in part because greater single entity treatment would significantly increase the complexity of the regulations. See Notice 94-49, 1994-1 C.B. 358, for a discussion of issues relating to the single entity treatment of stock.

The Treasury and the IRS are continuing to study whether greater single entity treatment of stock is appropriate or possible. While finalizing the intercompany transaction regulations, however, the Treasury and the IRS have become aware that consolidated groups are relying on the separate entity treatment of stock to claim losses on capital raising and other transactions. For example, taxpayers might seek to take advantage of separate entity treatment by having a subsidiary (S) purchase the stock of the common parent (P) from P. If the value of the P stock has gone down at a time when the group wants to issue P stock, S will sell its P stock at a loss and claim the losses, even though in a sale of the stock by P, no gain or loss would be recognized under section 1032.

Although the circular ownership described in this structure could result in the recognition of gains as well as losses on the sale of P stock, taxpayers can easily avoid most gains. For example, if the P stock held by S appreciates, P can issue P stock and avoid recognizing gain under section 1032. Other transactions involving circular ownership are subject to specific relief. See, for example, Rev. Rul. 80-76, 1980-1 C.B. 15 (no gain on S's use of P stock to compensate S's employee); Prop. Reg. §1.1032-2(b) (no gain or loss on S's use of certain P stock in triangular reorganizations).

Through planning techniques and relief provisions, taxpayers may use circular ownership structures to claim artificial losses and to avoid reporting of gains. As a result, taxpayers frequently have the benefit of single entity treatment for gains but separate entity treatment for losses. The Treasury and the IRS have concluded, therefore, that

pending further study of single entity treatment of stock generally, temporary regulations are necessary to provide greater single entity treatment for losses by preventing groups from inappropriately claiming losses on the sale of stock of the common parent.

As mentioned above, in transactions where S intends to use P stock for a legitimate business purpose, S can generally avoid the recognition of gain. Nonetheless, structuring transactions to avoid the gain adds additional costs and uncertainties to these transactions. Therefore, these temporary regulations also include provisions to prevent taxpayers from being subject to inappropriate taxation on gains in certain transactions.

Explanation of Provisions

These temporary regulations are limited to transactions involving P stock. While similar artificial losses or gains may arise in transactions involving circular ownership with respect to the stock of a subsidiary, existing regulations address many issues with respect to losses in S stock. See §1.1502-20. For purposes of these temporary regulations, P stock is any stock of the common parent held by another member, or any stock of a member (the issuer) that was the common parent if the stock was held by another member while the issuer was the common parent.

These temporary regulations provide that losses recognized with respect to P stock held by a member are permanently disallowed. Similarly, if a member, M, owns P stock, the stock is subsequently owned by a nonmember, and immediately before the stock is owned by the nonmember M's basis in the share exceeds its fair market value, then (unless the loss is disallowed under the general rule) M's basis in the share is reduced immediately before the share is held by the nonmember. For example, if M owns shares of P stock with a basis in excess of their fair market value and M becomes a nonmember, M's basis in the P shares is reduced to fair market value immediately before M becomes a nonmember. Similar principles apply to options and other positions with respect to P stock.

To qualify for the relief from gain, the member must acquire P stock directly from P through a contribution

to capital or a transaction qualifying under section 351(a), and must, pursuant to a plan, transfer the stock immediately to an unrelated nonmember in a taxable transaction (other than in exchange for P stock). In addition, the common parent must remain the common parent and the member must remain a member.

These temporary regulations provide relief from gain by providing S with a fair market value basis in the P stock. To properly reflect the transaction in the basis of other members, (including P's basis in its S stock) these regulations treat S as if it purchased the stock from P with cash contributed by P. No inference is intended whether circular cash flows would be respected apart from this regulation. Similarly, no inference is intended with respect to other methods of avoiding gain on S's use of P stock.

The Treasury and the IRS request comments as to transactions outside the scope of the regulations. In particular, comments are requested as to whether any such transactions should be given relief from gain recognition. In addition, comments are requested on whether greater single entity treatment of stock should be adopted more generally.

These temporary regulations are effective for transactions on or after the date they are filed with the Federal Register.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that these regulations only affect affiliated groups of corporations that have elected to file consolidated returns, which tend to be larger businesses. The rules do not significantly alter the reporting or recordkeeping duties of small entities. Accordingly, a regulatory flexibility analysis is not required. It has also been determined that under section 553(d) of the Administrative Procedure Act (5 U.S.C. chapter 5) there is good cause for these regulations to be effective immediately to insure transactions in P stock are

appropriately reflected. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * * Section 1.1502-13T also issued under 26 U.S.C. 1502 * * *

Par. 2. Section 1.1502-13T is added to read as follows:

§1.1502-13T Intercompany transactions temporary.

(a) through (f)(5) [Reserved] For further guidance, see 1.1502-13.

(f)(6) *Stock of common parent.* In addition to the general rules of this section, this paragraph (f)(6) applies to parent stock (P stock) and positions in parent stock held by another member. For this purpose, P stock is any stock of the common parent held by another member or any stock of a member (the issuer) that was the common parent if the stock was held by another member while the issuer was the common parent.

(i) *Loss stock*—(A) *Recognized loss.* Any loss recognized, directly or indirectly, by a member with respect to P stock is permanently disallowed and does not reduce earnings and profits. See §1.1502-32(b)(3)(iii)(A) for a corresponding reduction in the basis of the member's stock.

(B) *Other cases.* If a member, M, owns P stock, the stock is subsequently owned by a nonmember, and immediately before the stock is owned by the nonmember, M's basis in the share exceeds its fair market value, then to the extent paragraph (f)(6)(i)(A) of this section does not apply, M's basis in the share is reduced to the share's fair market value immediately before the share is held by the nonmember. For

example, if M owns shares of P stock with a \$100x basis and M becomes a nonmember at a time when the P shares have a value of \$60x, M's basis in the P shares is reduced to \$60x immediately before M becomes a nonmember. Similarly, if M contributes the P stock to a nonmember in a transaction subject to section 351, M's basis in the shares is reduced to \$60x immediately before the contribution. See §1.1502-32(b)(3)(iii)(B) for a corresponding reduction in the basis of M's stock.

(ii) *Gain stock.* If a member, M, would otherwise recognize gain on a qualified disposition of P stock, then immediately before the qualified disposition, M is treated as purchasing the P stock from P for fair market value with cash contributed to M by P (or, if necessary, through any intermediate members). A disposition is a qualified disposition only if—

(A) The member acquires the P stock directly from the common parent (P) through a contribution to capital or a transaction qualifying under section 351(a) (or, if necessary, through a series of such transactions involving only members);

(B) Pursuant to a plan, the member transfers the stock immediately to a nonmember that is not related, within the meaning of section 267(b) or 707(b), to any member of the group;

(C) No nonmember receives a substituted basis in the stock within the meaning of section 7701(a)(42);

(D) The P stock is not exchanged for P stock;

(E) P neither becomes nor ceases to be the common parent as part of, or in contemplation of, the plan or disposition; and

(F) M neither becomes nor ceases to be a member as part of, or in contemplation of, the plan or disposition.

(iii) *Options, warrants and other rights.* Paragraph (f)(6)(i) of this section applies to options, warrants, forward contracts, or other positions with respect to P stock (including, for example, cash-settled positions). For example, if S purchases (from any party) a warrant on P stock and the warrant lapses, any loss recognized by S is permanently disallowed. Similarly, if S purchases a warrant on P stock and S becomes a nonmember at a time when the value of the warrant is less than S's basis in the warrant, S's basis

in the warrant is reduced to its fair market value immediately before S becomes a nonmember.

(iv) *Effective date.* This paragraph (f)(6) applies to transactions on or after July 12, 1995 (notwithstanding whether the intercompany transaction, if any, occurred prior to that date).

Michael P. Dolan,
*Acting Commissioner of
Internal Revenue.*

Approved June 29, 1995.

Leslie Samuels,
*Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on July 12, 1995, 12:56 p.m., and published in the issue of the Federal Register for July 18, 1995, 60 F.R. 36669)

26 CFR 1.1502-75: *Filing of consolidated returns.*

This procedure sets forth the requirements for consolidated groups requesting permission to discontinue filing consolidated returns as a result of T.D. 8597 for the first taxable year that begins on or after July 12, 1995. See Rev. Proc. 95-39, page 399.

Section 1504.—Definitions

What procedures apply, in post-1993 tax years, for electing the § 936(a)(4)(B) percentage limitation, electing to compute the § 936(a)(4)(A) economic activity limitation on a consolidated basis, revoking a § 936(a) election, or changing a § 936(h) intangible property income allocation method. See Rev. Proc. 95-37, page 393.

26 CFR 1.1504-1: *Definitions.*

This procedure sets forth the requirements for consolidated groups requesting permission to discontinue filing consolidated returns as a result of T.D. 8597 for the first taxable year that begins on or after July 12, 1995. See Rev. Proc. 95-39, page 399.

Subchapter B.—Related Rules
Part II.—Certain Controlled Corporations

Section 1563.—Definitions and Special Rules

What procedures apply, in post-1993 tax years, for electing the § 936(a)(4)(B) percentage limitation, electing to compute the § 936(a)(4)(A) economic activity limitation on a consolidated basis, revoking a § 936(a) election, or changing a § 936(h) intangible property income allocation method. See Rev. Proc. 95-37, page 393.

Section 2036.—Transfers With Retained Life Estate

26 CFR 20.2036-1: *Transfers with retained life estate.*
(Also §§ 672, 2038, 2511; 20.2038-1; 25.2511-2.)

Transfers; trust; power to appoint successor trustee. A decedent-grantor's reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent (within the meaning of section 672(c) of the Code) is not considered a reservation of the trustee's discretionary powers of distribution over the property transferred by the decedent-grantor to the trust. Rev. Ruls. 79-353 and 81-51 revoked; Rev. Rul. 77-182 modified.

Rev. Rul. 95-58

The Internal Revenue Service has reconsidered whether a grantor's reservation of an unqualified power to remove a trustee and appoint a new trustee (other than the grantor) is tantamount to a reservation by the grantor of the trustee's discretionary powers of distribution. This issue is presented in Rev. Rul. 79-353, 1979-2 C.B. 325, as modified by Rev. Rul. 81-51, 1981-1 C.B. 458. An analogous issue is presented in Rev. Rul. 77-182, 1977-1 C.B. 273. The reconsideration is caused by the recent court decisions in *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993), and *Estate of Vak v. Commissioner*, 973 F.2d 1409 (8th Cir. 1992), *rev'g* T.C. Memo 1991-503.

Section 2036(a) of the Internal Revenue Code, in general, provides that the value of the gross estate includes the value of all property to the extent of any interest in the property that was transferred by the decedent (for less than adequate consideration) if the decedent has retained for life the right, alone or in conjunction with any person, to designate the person who shall possess or enjoy the property or the income therefrom.

Section 2038(a)(1), in general, provides that the value of the gross estate

includes the value of all property to the extent of any interest in the property that was transferred by the decedent (for less than adequate consideration) if the decedent held a power, exercisable alone or in conjunction with any person, to change the enjoyment of the property through the exercise of a power to alter, amend, revoke, or terminate.

Section 25.2511-2(c) of the Gift Tax Regulations provides that a gift of property is incomplete to the extent that the donor reserves the power to revest the beneficial title to the property in himself or herself or the power (other than a fiduciary power limited by a fixed or ascertainable standard) to name new beneficiaries or to change the interest of the beneficiaries among themselves. *See also* § 25.2511-2(f).

For purposes of §§ 2036 and 2038, it is immaterial in what capacity the power was exercisable by the decedent. Thus, if a decedent transferred property in trust while retaining, as trustee, the discretionary power to distribute the principal and income, the trust property will be includible in the decedent's gross estate under §§ 2036 and 2038. The regulations under §§ 2036 and 2038 explain that a decedent is regarded as having possessed the powers of a trustee if the decedent possessed an unrestricted power to remove the trustee and appoint anyone (including the decedent) as trustee. Sections 20.2036-1(b)(3) and 20.2038-1(a) of the Estate Tax Regulations.

Rev. Rul. 79-353 concludes that, for purposes of §§ 2036(a)(2) and 2038(a)(1), the reservation by a decedent-settlor of the unrestricted power to remove a corporate trustee and appoint a successor corporate trustee is equivalent to the decedent-settlor's reservation of the trustee's discretionary powers.

Rev. Rul. 81-51 modifies Rev. Rul. 79-353 so that it does not apply to a transfer or addition to a trust made before October 29, 1979, the publication date of Rev. Rul. 79-353, if the trust was irrevocable on October 28, 1979.

Rev. Rul. 77-182 concludes that a decedent's power to appoint a successor corporate trustee only in the event of the resignation or removal by judicial process of the original trustee did not amount to a power to remove the original trustee that would have endowed the decedent with the

trustee's discretionary control over trust income.

In *Estate of Wall*, the decedent had created a trust for the benefit of others and designated an independent corporate fiduciary as trustee. The trustee possessed broad discretionary powers of distribution. The decedent reserved the right to remove and replace the corporate trustee with another independent corporate trustee. The court concluded that the decedent's retained power was not equivalent to a power to affect the beneficial enjoyment of the trust property as contemplated by §§ 2036 and 2038. *See also Estate of Headrick v. Commissioner*, 93 T.C. 171 (1989), *aff'd* 918 F.2d 1263 (6th Cir. 1990).

In *Estate of Vak*, the decedent had created a trust and appointed family members as the trustees with discretionary powers of distribution. The decedent reserved the right to remove and replace the trustees with successor trustees who were not related or subordinate to the decedent. The decedent was also a discretionary distributee. Three years later, the trust was amended to eliminate both the decedent's power to remove and replace the trustees and the decedent's eligibility to receive discretionary distributions.

The issue considered in *Estate of Vak* was whether the decedent's gift in trust was complete when the decedent created the trust and transferred the property to it or, instead, when the decedent relinquished the removal and replacement power and his eligibility to receive discretionary distributions. The Eighth Circuit concluded that the decedent had not retained dominion and control over the transferred assets by reason of his removal and replacement power. Accordingly, the court held that under § 25.2511-2(c) the gift was complete when the decedent created the trust and transferred the assets to it.

In view of the decisions in the above cases, Rev. Rul. 79-353 and Rev. Rul. 81-51 are revoked. Rev. Rul. 77-182 is modified to hold that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent would not have retained a trustee's discretionary control over trust income.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 79-353 and Rev. Rul. 81-51 are revoked. Rev. Rul. 77-182 is modified.

Section 2038.—Revocable Transfers

26 CFR 20.2038-1: Revocable transfers.

If a decedent-grantor makes a transfer to a trust and reserves an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent-grantor (within the meaning of § 672(c) of the Code), is the reservation of the power tantamount to a reservation by the decedent-grantor of the trustee's discretionary powers of distribution? See Rev. Rul. 95-58, page 191.

Part IV.—Taxable Estate

Section 2056.—Bequests, etc., to Surviving Spouse

26 CFR 20.2056-0: Table of contents.

T.D. 8612

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 20, 25 and 602

Income, Gift and Estate Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the income tax imposed under chapter 1, the estate tax imposed under chapter 11, and the gift tax imposed under chapters 12 and 14 of the Internal Revenue Code of 1986. Changes to the marital deduction provisions of the estate and gift tax chapters were made by the Technical and Miscellaneous Revenue Act of 1988. Further amendments were made by the Revenue Reconciliation Act of 1989, and the Revenue Reconciliation Act of 1990. These final regulations will provide guidance needed to comply with the changes to the marital deduction provisions of the estate and gift tax chapters.

DATES: These regulations are effective August 22, 1995.

These regulations apply to decedents dying and to gifts made after August 22, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1360. The estimated annual burden per respondent/recordkeeper varies from 30 minutes to 3 hours, depending on individual circumstances, with an estimated average of 2 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

A notice of proposed rulemaking was published in the Federal Register (58 FR 305 [PS-102-88, 1993-1 C.B. 885]), on January 5, 1993, reflecting amendments made to the Code by the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647 [1988-3 C.B. 1]) (the 1988 Act), the Revenue Reconciliation Act of 1989 (Pub. L. 101-239 [1990-1 C.B. 210]) (the 1989 Act), and the Revenue Reconciliation Act of 1990 (Pub. L. 101-508 [1991-2 C.B. 481]) (the 1990 Act). The 1988, 1989, and 1990 Acts impose restrictions on the allowance of the estate and gift tax marital deduction where the surviving spouse (in the case of a transfer at death) or the donee spouse (in the case of a lifetime transfer) is not a citizen of the United States. In addition, the gift tax annual exclusion allowable in the case of a transfer to a noncitizen spouse was increased to \$100,000. The statutory amendments also changed the tax rate and the amount of the unified credit applicable in the case of the estate of a decedent nonresident not a citizen of the United States (nonresident alien). The IRS

received written comments on the proposed regulations and, on April 2, 1993, held a public hearing on the regulations.

After consideration of the written and oral comments received, §20.2056A-2(d) of the proposed regulations, which provides additional requirements for qualification as a qualified domestic trust to ensure the collection of the section 2056A estate tax, was substantially modified. In view of these substantial modifications, §20.2056A-2(d) has been reissued as proposed and temporary regulations in order to afford the public a further opportunity to comment on these security arrangements. See the proposed rules and the rules portion *** [PS-25-94 and T.D. 8613, pages 502 & 216], respectively. The balance of the proposed regulations are revised and adopted as final regulations by this Treasury decision.

The following is a discussion of the more significant comments received (other than those comments pertaining to §20.2056A-2(d) of the proposed regulations) and the reasons for accepting or rejecting those comments in the final regulations.

A. §1.1015-5 Increased basis for gift tax paid in the case of gifts made after December 31, 1976.

This section of the proposed regulations has been revised to better conform to the existing regulations and to clarify the determination of the amount of the gift tax paid in situations where the donor's unified credit is applied against the gift tax liability.

B. §20.2056A-1 Restrictions on allowance of marital deduction if surviving spouse is not a United States citizen.

Under section 2056(d)(4), if the surviving spouse becomes a citizen of the United States before the day on which the estate tax return is filed, property passing from the decedent to the surviving spouse either outright or in trust need not be transferred to a qualified domestic trust (QDOT) (or the trust need not be reformed to qualify as a QDOT) in order to qualify for the estate tax marital deduction. It is possible that the naturalization process may not be completed before the due date, including extensions, for

filing the estate tax return. Comments suggested that if the surviving spouse has filed an application for naturalization within a reasonable time after the decedent's death, then any late filing of the return pending the outcome of the citizenship process should be treated as due to reasonable cause for purposes of section 6651 (imposing penalties for failure to file returns and failure to pay tax). This suggestion was not adopted because the existence of reasonable cause for late-filing and late-payment should be determined on a case by case basis applying well-established standards as prescribed under current law.

In response to comments, the discussion in §20.2056A-1(c) of the proposed regulations, regarding the special rule for estate and gift tax treaties, was expanded. Section 7815(d)(14) of the 1989 Act added a special rule under which the statutory amendments affecting the estate and gift tax marital deduction do not apply when the decedent or donor is not a United States citizen or resident and is a resident of a country with which the United States has an estate, gift or inheritance tax treaty, to the extent such statutory amendments would be inconsistent with the treaty provisions. The final regulations provide that under this special rule, the estate may choose either the statutory deduction under section 2056A or the marital deduction, exemption, or credit allowed under the treaty. See H. Rep. No. 247, 101 Cong. 1st Sess. 1435, n. 99 (September 20, 1989). Thus, the estate may not avail itself of both the marital benefit under the treaty and the marital deduction under the QDOT provisions of the Code with respect to the remainder of the marital property that is not otherwise deductible under the treaty. These regulations do not conflict with existing treaties.

C. §20.2056A-2 Requirements for Qualified Domestic Trust.

Under §20.2056A-2(a) of the proposed regulations, in order to qualify as a QDOT, a trust must be created and maintained under the laws of the United States or any state or the District of Columbia. Several commentators suggested that this requirement should be deleted because it places an additional burden on nonresident aliens with only limited contacts with the United States. This comment was not adopted. The ability of the Internal

Revenue Service to collect the section 2056A estate tax is adequately protected only if the trust has a sufficient nexus with the United States. However, the final regulations delete the requirement that the trust be created under the laws of the United States. In lieu of that requirement, the final regulations provide that the trust may be established by a document executed under the laws of either the United States or a foreign jurisdiction, such as under a foreign will or trust, provided that the document directs that the laws of a particular state of the United States or the District of Columbia govern the administration of the trust, and that direction is effective under the applicable local law. The final regulations also clarify that a trust is "maintained" in the United States for purposes of this provision if the records of the trust (or copies thereof) are kept in the United States.

Section 20.2056A-2(a) of the proposed regulations also provided that in order to qualify as a QDOT, a trust must constitute an "explicit trust" as defined in §301.7701-4(a) of the regulations. The final regulations change this reference to an "ordinary trust", since that is the term referred to in §301.7701-4(a). Some commentators raised the concern that if property transferred to a QDOT includes an active trade or business, the trust may be classified as an association taxable as a corporation under §301.7701-2 and, therefore, will not qualify as a QDOT. In response to those comments, the final regulations provide that a trust will not fail to be treated as an ordinary trust under §301.7701-4(a) for purposes of section 2056A solely because of the nature of the assets transferred to that trust.

D. §20.2056A-3 QDOT election.

Comments were received recommending that the protective election rules contained in §20.2056A-3(c) of the proposed regulations be expanded to permit protective elections with respect to a broader range of controversies affecting the availability of the marital deduction for property passing to or for the benefit of a noncitizen spouse and the time period during which such controversies must arise. In response to these comments, the availability of a protective election has been revised to cover additional situations. The final regulations provide that a

protective election may be made only if a bona fide issue is presented, the resolution of which is uncertain at the time the federal estate tax return is filed. The bona fide issue must concern the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. Conforming changes have been made to the protective assignment rules of the proposed regulations to reflect these amendments.

Under §20.2056A-3(b) of the proposed regulations, partial QDOT elections were not permitted. However, the proposed regulations provide that if a trust is severed in accordance with the rules under section 2056(b)(7), a QDOT election may be made for each separate trust. A comment was received stating that the phrase "for each separate trust" implies that if there are two or more trusts after division, an election must be made for each trust. The final regulations clarify that upon severance of a trust, a QDOT election may be made for any one or more of the severed trusts.

E. §20.2056A-4 Procedures for conforming marital trusts and nonmarital transfers to the requirements of a qualified domestic trust.

A comment was received pointing out that the proposed regulations did not specify the time by which a nonjudicial reformation must be completed. Accordingly, the final regulations provide that a nonjudicial reformation must be completed by the time prescribed (including extensions) for filing the decedent's estate tax return. This result is consistent with section 2056(d)(5)(A), which provides that absent a judicial reformation the determination of the qualification of a trust as a QDOT is made as of the date the return is filed.

Section 20.2056A-4(a)(2) of the proposed regulations provide that a trust, as reformed, must be effective under local law and irrevocable. A trust in which the surviving spouse has an income interest and an *inter vivos* general power of appointment is, in effect, revocable and could, therefore, fail to qualify under the proposed regulations. Accordingly, the final regulations have been amended to provide

that the trust as reformed may be revocable by the spouse, or otherwise be subject to the spouse's general power of appointment, provided that there is no power exercisable by any person to amend the trust during the continued period of its existence such that it would no longer qualify as a QDOT. Thus, for example, any distributions made pursuant to the spouse's exercise of a power to appoint must be subject to the requirement that the U.S. Trustee withhold the section 2056A estate tax.

The final regulations provide that prior to the time a judicial reformation of the trust is completed, the trustee is responsible for filing the Form 706-QDT, paying any section 2056A estate tax that becomes due, and filing the annual report if such a report is required. In addition, failure to comply with these requirements may cause the trust to be subject to the anti-abuse rule under §20.2056A-2T(d)(1)(iv). A claim for refund may be filed to recover any section 2056A estate tax paid by the trust if the judicial reformation is terminated prior to completion. In addition, if the judicial reformation is terminated prior to completion, the trustee of the trust is liable for the additional estate tax on the decedent's estate that becomes due at the time of the termination due to the trust's failure to comply with section 2056A.

Comments were received criticizing the rule contained in §20.2056A-4(b)(5) of the proposed regulations, that a transfer of property by the surviving spouse or the decedent's executor to a QDOT created by the spouse pursuant to section 2056(d)(2)(B) is treated as a transfer from the decedent *solely* for purposes of section 2056(d)(2)(A). For all other purposes, *e.g.*, income, gift, estate, generation-skipping transfer tax and section 1491, the proposed regulations provide that the property is treated as passing from the surviving spouse to the trust. The comments suggested that although section 2056A(b)(15) provides for tax exempt reimbursement to the spouse of income taxes paid by the spouse with respect to trust items, that provision should not be interpreted as acknowledging that all QDOTs created by the surviving spouse or by the decedent's executor are grantor trusts for income tax purposes.

The final regulations retain the rule that the surviving spouse is treated as the transferor of the property trans-

ferred to a QDOT pursuant to section 2056(d)(2)(B). It is believed that this treatment is consistent with Congressional intent, as evidenced by section 2056A(b)(15). However, because of the potentially unanticipated result in the case of completed transfers to trusts by the surviving spouse where the spouse retains an income interest, §25.2702-1(c) of the regulations is amended by this document to provide that property assigned or transferred to a QDOT by the surviving spouse, where the surviving spouse retains an income interest in the transferred property, is not subject to the special valuation rules of section 2702. See §25.2702-1(c)(8). The final regulations also provide that the surviving spouse is not considered the transferor of property to a QDOT if the transfer by the spouse constitutes a transfer that satisfies the requirements of section 2518(c)(3).

Section 20.2056A-4(b) of the proposed regulations provide that if property is transferred or assigned to a QDOT by the surviving spouse pursuant to section 2056(d)(2)(B), the QDOT need not be a trust that would otherwise qualify for a marital deduction under section 2056(a). A question has been raised whether this rule applies regardless of whether the trust was created by the decedent during life or by will, by the surviving spouse, or by the decedent's executor. Accordingly, the final regulations clarify that if the spouse transfers property to a QDOT pursuant to section 2056(d)(2)(B), the transferee trust need not (with one exception) be in a form necessary to qualify for a marital deduction under section 2056(a) regardless of whether the trust is created by the decedent, the surviving spouse or the decedent's executor. However, the final regulations provide that, once funded, 100 percent of the transferee trust must consist of assets that qualify for the marital deduction under the Code. This rule is necessary to avoid complicated tracing issues under section 2056A(b)(1). Therefore, if the decedent also bequeaths property to the trust under his will, the trust will need to conform to the marital trust requirements in order that all of the trust property qualifies for the marital deduction under section 2056(a).

Section 20.2056A-4(b)(3) of the proposed regulations provide that only assets passing from the decedent to the spouse that are included in the decedent's gross estate may be transferred

or assigned to a QDOT. The language of the proposed regulations could be viewed as providing that assets originally owned at any time by the surviving spouse cannot be assigned to the QDOT, even if those assets in fact are included in the decedent's gross estate. For example, a question has been raised whether property owned by the surviving spouse that was transferred to the decedent and then subsequently bequeathed to the surviving spouse could be transferred or assigned to a QDOT. In order to address this concern, the final regulations have been clarified to provide that the surviving spouse may transfer or assign to the QDOT any property included in the decedent's gross estate and passing to the spouse at death. However, the spouse may not transfer property owned by the spouse at the time of the decedent's death, in lieu of property passing from the decedent.

In response to comments, the final regulations specifically address the transfer or assignment of property to a QDOT in the case of the death or incompetency of the surviving spouse. The final regulations provide that the transfer or assignment of property to a QDOT may be made by either the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is incompetent), or by the surviving spouse's executor (if the surviving spouse subsequently dies).

Comments were received suggesting that the method adopted in §20.2056A-4(c)(4) of the proposed regulations for computing the "corpus portion" of a nonassignable annuity payment be revised. The comments suggested that the corpus portion of each payment should be computed based on that portion of each payment excluded from the spouse's income under section 72. Alternatively, it was suggested that the determination of the corpus portion should be keyed to the threshold for imposition of the section 4980A excise tax on excess distributions (generally amounts distributed in excess of \$150,000). Both of these suggestions were rejected. The methodology in the regulations is designed to realistically approximate the portion of each payment representing income and corpus based on the present value of the benefit, the expected term of the annuity, and the assumed rate of return. On the other hand, basing the determination on the extent to which each payment is included in the spouse's

income would produce arbitrary and unrealistic results. For example, in the case of a noncontributory qualified plan, the entire payment will be includible in gross income and thus no portion would be allocated to corpus. Similarly, under the section 4980A approach, the first \$150,000 of payments will be arbitrarily allocated to income regardless of the amount of the total annual payment. It is believed that neither of these methods provides an accurate or realistic measure of the income or corpus portion of each payment.

Guidance was requested regarding whether an individual retirement account (IRA) described in section 408(a) is a nonassignable annuity or other arrangement eligible for the procedures contained in §20.2056A-4(c). In general, individual retirement accounts under section 408(a) are assignable but individual retirement annuities under section 408(b) are not assignable (and thus, are eligible for the special procedures described in §20.2056A-4(c)). However, if an individual retirement account is assigned to a trust with respect to which the surviving spouse is not treated as the owner under section 671 *et seq.* (providing rules for the treatment of grantor trusts), then the entire account balance is treated as a distribution to the spouse includible in the spouse's gross income under section 408(d) in the taxable year in which the assignment is made.

In view of this significant tax burden attendant to the assignment of an individual retirement account to a nongrantor trust, the final regulations allow the spouse to treat the individual retirement account as nonassignable for purposes of §20.2056A-4(c) and thus, eligible for the procedures contained in that section. However, if the spouse does assign the individual retirement account to a trust pursuant to §§20.2056A-2(b)(2) and 20.2056A-4(b) (either a grantor trust or a nongrantor trust), then §20.2056A-4(b)(7) (providing that an assignment of an assignable annuity or other arrangement to a trust is treated as a transfer of the property to a QDOT regardless of the method of payment actually elected) will apply. Thus, under the final regulations, if the individual retirement account is assignable, the spouse has the option of either assigning the individual retirement account to a QDOT, or using the procedures contained in §20.2056A-4(c).

In response to comments, §20.2056A-4(c) of the proposed regulations has been modified to provide that if the financial circumstances of the spouse are such that an amount equal to all or a part of the corpus portion of a nonassignable annuity payment received by the spouse would be eligible for a hardship exemption (as defined in §20.2056A-5(c)), if paid from a QDOT, then all or a corresponding part of the payment will be exempt from the rollover or the tax payment requirements, depending upon which option is selected by the spouse.

In response to comments, the agreements required under §20.2056A-4(c) of the proposed regulations (pertaining to the spouse's undertaking to roll over nonassignable annuity payments to a QDOT or pay a section 2056A estate tax on each payment) have been revised. In the final regulations, both forms of agreements provide that in the event of a failure to timely file the Form 706-QDT or a failure to either (1) timely pay the section 2056A estate tax on the corpus portion of the annuity payment, or (2) timely roll over the corpus portion to a QDOT, the surviving spouse may make an application for relief under §301.9100-1 of the Procedure and Administration Regulations, from the consequences of the failures. This is in lieu of the automatic acceleration of the balance of the section 2056A estate tax as provided in the proposed regulations.

Under the proposed regulations, both forms of agreements provided that the surviving spouse must agree, at the request of the District Director (or the Assistant Commissioner (International) in the case of a surviving spouse of a nonresident alien decedent or a surviving spouse of a United States citizen who died domiciled outside the United States) to enter into a security agreement to secure the spouse's undertakings under the agreement. Comments were received objecting to the open-ended nature of this security requirement. In response to these comments, the final regulations have been amended so that this provision applies only in those cases in which the plan or arrangement from which the annuity will be paid is established and administered by a person or entity that is located outside of the United States. In the case of these foreign plans, additional security requirements may be necessary to assure collectibility of the section 2056A estate tax.

F. §20.2056A-5 Imposition of the section 2056A estate tax.

Comments were received regarding §20.2056A-5(c)(2) of the proposed regulations which provides that items will be characterized as "income" for purposes of section 2056A(b)(3)(A) and section 2056A(c)(2) based on applicable state law, regardless of the terms of the instrument. Commentators maintained that this provision created unnecessary complexity in the administration of QDOTs in jurisdictions with no statutes governing allocation of receipts between principal and income. The commentators suggested that if local law or statutory law is silent regarding treatment of an item, the allocation of the item should be based on the terms of the governing instrument with certain specified exclusions (such as capital gains). This suggestion was not adopted, in part, because the grant of this broad discretion would not be consistent with the legislative history underlying section 2056A(b)(1). Instead, the final regulations provide that when local law is silent, reference will be made to general principles of law (such as, for example, the Uniform Principal and Income Act) and that these principles will override any provisions to the contrary in the governing instrument. In addition, the final regulations provide that for purposes of section 2056A(b)(3)(A), "income" does not include (in addition to the exclusion for capital gains) items constituting income in respect of a decedent under section 691, regardless of the characterization thereof under local law, except to the extent provided in administrative guidance published by the Service. The IRS added this exclusion because it is believed that local law may inappropriately characterize certain items of IRD (income in respect of a decedent) as income, contrary to the purposes of section 2056A, and it was determined that exceptions to this rule of exclusion should be made on a case by case basis. However, in cases where a QDOT is designated by the decedent as a beneficiary of a pension or profit sharing plan described in section 401(a), or an individual retirement account or annuity described in section 408, the proceeds of which are payable to the QDOT in the form of an annuity, the final regulations provide that any payments received by the QDOT may be allocated between income and corpus using the method

prescribed under §20.2056A-4(c) for determining the corpus and income portion of an annuity payment.

A comment was received recommending revision of §20.2056A-5(c)(3) of the proposed regulations to specifically authorize nontaxable reimbursement to the spouse for income taxes for which the spouse is liable if the spouse receives a lump sum distribution from a qualified plan and assigns the distribution to the QDOT. In response to this comment, the final regulations have been modified to provide that amounts paid from the QDOT to reimburse the spouse for such income taxes are not subject to the section 2056A estate tax. In addition, the provisions for nontaxable distributions to the spouse contained in section 2056A(b)(15) (regarding reimbursement for certain income taxes paid by the spouse) have been incorporated into §20.2056A-5(c)(3) of the final regulations to ensure completeness. With respect to the amount of the reimbursement, the final regulations provide that the amount of tax eligible for reimbursement is the difference between the income tax liability of the spouse (as reported on the spouse's income tax return) and the spouse's income tax liability determined as if the item had not been included in the spouse's gross income in the applicable taxable year.

In response to comments, the definition of a hardship distribution has been expanded. Under the final regulations, a distribution to the spouse is deemed made on account of hardship if the distribution is made to the spouse from the QDOT in response to an immediate and substantial financial need relating to the spouse's health, maintenance, education or support, or the health, education, maintenance or support of any person that the surviving spouse is legally obligated to support.

One comment suggested modifying the regulations to provide that in making a distribution, the trustee may rely upon a statement by the surviving spouse claiming hardship under the regulations. It was decided that this change not be made. Trustees must frequently make decisions concerning whether a distribution is warranted under a particular standard under the trust document. It is believed that a QDOT presents no special circumstances that would justify a deviation from normal fiduciary practices under these circumstances.

Language has been added to the final regulations to further clarify what

assets are considered "reasonably available" to the surviving spouse for purposes of determining whether the assets must be liquidated before a hardship distribution may be made. The final regulations provide that assets such as closely held business interests, real estate and tangible personalty are not considered assets that are reasonably available.

G. §20.2056A-6 Amount of tax.

Under the proposed regulations, in computing the estate tax imposed under section 2056A(b)(1)(B) on the death of the surviving spouse, a credit for state or foreign death taxes under sections 2011 or 2014, respectively, is allowable only if the state or foreign jurisdiction actually imposed additional tax on the QDOT at the time of the taxable event (*i.e.*, only if the jurisdiction had a statutory provision similar in effect to section 2056A). A comment was received that this limitation was inappropriate and was not consistent with the legislative history underlying section 2056A(b)(10). See 136 Cong. Rec. H7147 (daily ed. Aug. 3, 1990). In response to this comment, the final regulations provide that if state or foreign death taxes are paid by the surviving spouse's estate with respect to the QDOT (because the QDOT is included in the surviving spouse's gross estate for state or foreign tax purposes), the taxes are creditable to the extent provided in sections 2011 or 2014 in computing the section 2056A estate tax. In addition, the final regulations provide that state or foreign death taxes previously paid by the decedent/transferor's estate are also creditable within the section 2011 or 2014 framework. A new example has been added to the final regulations to illustrate this application of the state death tax credit.

H. §20.2056A-7 Allowance of prior transfer credit under section 2013.

The proposed regulations provided that the "first limitation" in determining the allowable section 2013 credit with respect to the section 2056A estate tax imposed on the spouse's death is deemed to be the section 2056A estate tax imposed. This approach was adopted to avoid certain computational and interpretative problems that would be presented if the methodology described in section 2013(b) and §20.2013-2 was used. The final regulations retain this approach.

In order to ensure consistency, the final regulations adopt two additional modifications to the section 2013 regime in computing the allowable credit with respect to the section 2056A estate tax. Under §20.2013-4(a), the amount of the transfer, based on which the "first limitation" and "second limitation" are determined, is the value at which the property was included in the transferor's gross estate. Further, under §20.2013-4(b), the amount of the transfer is reduced by any estate and inheritance taxes payable out of the property transferred to the transferee decedent. However, under §20.2056A-7, the "first limitation" is the amount of the section 2056A estate tax determined based on the value of the QDOT on the death of the transferee spouse and any corpus distributions made prior to that time that were subject to tax under section 2056A(b)(1)(A). This same value should be used in determining the "second limitation." Further, since the entire value of the QDOT, unreduced by the amount of the section 2056A estate tax, is included in the transferee spouse's gross estate (see section 2053(c)(1)(B)), this amount (unreduced by the section 2056A estate tax) should be used in determining the "second limitation". Otherwise, the credit mechanism will not adequately avoid the double taxation the credit was intended to alleviate in the case of property which has appreciated since the death of the first decedent, and would confer an unintended windfall in the case of property which has declined in value. Accordingly, the final regulations provide that, for purposes of the "second limitation" as described in section 2013(c), the value of the property transferred to the decedent is the value of the QDOT on the date of death of the surviving spouse. This value is not reduced by the section 2056A estate tax imposed at the time of the spouse's death. An example has been added illustrating the computation of the prior transfer credit.

I. §20.2056A-8 Special rules for joint property.

Several comments were received concerning the proper interpretation of sections 2056(d)(1) and 2056(d)(2) where joint property passing to a spouse is transferred by the spouse to a QDOT. Section 2056(d)(1) provides that if the surviving spouse is not a citizen then, except as provided in

section 2056(d)(2), no marital deduction is allowed and section 2040(a), rather than section 2040(b), applies in determining the extent to which the joint property is included in the decedent's gross estate. Section 2056(d)(2) provides, *inter alia*, that section 2056(d)(1) does not apply to any property passing to a QDOT. Comments have been received suggesting that under a literal interpretation of these provisions, if joint property includible in the decedent's gross estate is transferred by the surviving spouse to a QDOT, the provisions of section 2056(d)(1)(B) do not apply and, therefore, section 2040(b) (and not section 2040(a)) would apply to determine the extent to which the joint property is included in the gross estate. The final regulations do not adopt this comment. The statutory provisions should be interpreted as providing that section 2040(a) applies in all events in determining the extent to which spousal joint property is includible in the gross estate, regardless of whether the spouse transfers the property to a QDOT. Under section 2056(d)(2), any property so includible will qualify for the marital deduction if it is timely transferred to a QDOT. The result of the suggested interpretation would be circular in effect: the gross estate would be continually reduced by transfers of property to the QDOT and the size of the gross estate would affect the amount that would need to be transferred to the QDOT so that no net estate tax would be due.

Commentators requested clarification of the "consideration furnished" rule contained in §20.2056A-8(a)(2) of the proposed regulations has been clarified. This rule provided that for purposes of applying section 2040(a), in determining the amount of consideration furnished by the surviving spouse, any consideration furnished by the decedent with respect to the acquisition of the property before July 14, 1988, is treated as consideration furnished by the surviving spouse to the extent that the consideration was treated as a gift to the spouse under section 2511, or to the extent that the decedent elected to treat the transfer as a gift to the spouse under section 2515 (prior to repeal by the Economic Recovery Tax Act of 1981). Under the proposed regulations, this special rule was applicable only if the donor spouse predeceased the donee spouse. The final regulations clarify that in cases where the donee

spouse predeceases the donor spouse, the amount treated as a gift to the decedent/donee spouse on the creation of the tenancy is *not* treated as the donee spouse's contribution towards the acquisition of the property for purposes of section 2040(a). Thus, if the donee spouse provided no other consideration towards the acquisition of the property, no part of the property would be includible in the decedent/donee's gross estate under section 2040(a). No inference is intended as to the applicable rules in effect prior to the effective date of these regulations. Two additional examples have been added to further illustrate the application of the joint property rules.

J. §20.2056A-9 Designated Filer.

In response to comments, the time period accorded the U.S. Trustee for submitting Schedule B, Form 706-QDT, to the Designated Filer has been increased from thirty to sixty days prior to the due date for filing the return. Also, in response to comments, the rule in the proposed regulations that the Designated Filer may allocate the section 2056A estate tax among the various QDOTs in the Designated Filer's discretion has been modified. The final regulations provide that the tax due from each QDOT is allocated on a pro rata basis (based on the ratio of the amount of the respective taxable events in each QDOT to the amount of all such taxable events), unless a different allocation is required in the governing instrument or under local law.

In response to comments suggesting that the regulations provide guidance in the event that the Designated Filer ceases to qualify as a U.S. Trustee, the final regulations provide that unless the decedent has provided for a successor Designated Filer, if the Designated Filer ceases to qualify as a U.S. Trustee or otherwise becomes unable to serve as the Designated Filer, the remaining trustees are required to select a qualifying successor Designated Filer (who is also a U.S. Trustee) prior to the due date for the filing of the next Form 706-QDT. Failure to select a successor Designated Filer will result in the application of section 2056A(b)(2)(C).

K. §20.2056A-11 Filing requirements and payment of section 2056A estate tax.

Comments were received suggesting that in the case of multiple QDOTs

with respect to the same decedent, the extent of the trustees' liability for the amount of the section 2056A estate tax should be clarified. It was suggested that a trustee should be personally liable for the amount of any section 2056A estate tax imposed on any taxable event with respect to that trustee's trust, but should not be personally liable for tax imposed on the other trusts with respect to that decedent. In response to this comment, the trustee liability provisions of §20.2056A-11(d) of the proposed regulations have been modified. In the case of multiple QDOTs with respect to the same decedent, each trustee of a QDOT is personally liable for the amount of the tax imposed on any taxable event with respect to that trustee's QDOT and a trustee is not personally liable for tax imposed with respect to taxable events involving QDOTs of which that person is not a trustee. However, the assets of a trust would be subject to collection for the section 2056A estate tax due with respect to any other trust with respect to that decedent.

L. §25.2523(i)-1 Disallowance of gift tax marital deduction when spouse is not a United States citizen.

Comments were received concerning the conclusion in example 4 under §25.2523(i)-1(d) of the proposed regulations. This example involves the transfer in trust to a noncitizen spouse with income payable to the spouse for life and remainder to the children of the donor. As proposed, the example concludes that the transfer is eligible for the \$100,000 annual exclusion based on the rationale that if the donee were a citizen, the gift would qualify for a marital deduction if a qualified terminable interest property election were made. In response to the comments on this issue, the IRS has concluded that this result is not consistent with the statute because the gift does not qualify for the marital deduction "but for" the application of section 2523(i)(1). See section 2523(i)(2). The gift only qualifies for the marital deduction if an election is made under section 2523(f)(4) to treat the trust as qualified terminable interest property. This election is not available if the donee spouse is not a United States citizen. The statutory requirement that only gifts that would have qualified for the marital deduction but for section

2523(i) are eligible for the increased annual exclusion is intended to ensure that only gifts that would be includible in the spouse's gross estate at death (if the spouse were a United States citizen) qualify for the increased exclusion. This was not the case in the example as proposed and, as a result, the conclusion in the example has been changed.

M. §25.2523(i)-2 *Treatment of spousal joint tenancy property where one spouse is not a United States citizen.*

Section 2523(i)(3) provides that the rules of section 2515 prior to repeal by the Economic Recovery Tax Act of 1981 shall generally apply if the donee spouse is not a United States citizen. The provision is effective for gifts made after July 14, 1988.

In response to comments, the final regulations under §25.2523(i)-2(b) have been expanded to more fully describe the consequences of terminations of tenancies by the entirety and joint tenancies after July 13, 1988, where the donee spouse is not a United States citizen. As prescribed by statute, the gift tax consequences of the termination are governed by the principles of section 2515 (prior to repeal) and the regulations thereunder. Generally, under these rules, the gift tax consequences were dependent on whether or not the creation of the tenancy was initially treated as a gift under section 2515(a). Questions have been raised regarding the gift tax treatment for terminations of tenancies that were created after 1981 and before July 14, 1988. During this time period, section 2515 was not applicable and the generic principles of section 2511 governed the gift tax treatment of the creation of a joint tenancy or tenancy by the entirety. Accordingly, in response to these comments, the final regulations provide that, in the case of a termination on or after July 14, 1988, of a tenancy by the entirety or a joint tenancy that was created after 1981 and before July 14, 1988, if the creation of the tenancy was treated as a gift to the noncitizen donee spouse under section 2511 then, upon termination of the tenancy, the value of the property treated as a gift upon creation of the tenancy is treated as consideration originally belonging to the noncitizen spouse and never acquired by the non-

citizen spouse from the donor spouse. With respect to the termination on or after July 14, 1988, of a tenancy by the entirety or joint tenancy created after 1954 and before 1982 (during which period section 2515 applied), the consequences of termination are determined under the rules of section 2515 and the regulations thereunder.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

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Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR parts 1, 20, 25, and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. §1.1015-5 is amended as follows:

- a. The headings for paragraphs (a) and (b) are revised.
- b. Paragraph (c) is redesignated as paragraph (d).
- c. A new paragraph (c) is added.

The revisions and additions read as follows:

§1.1015-5 *Increased basis for gift tax paid.*

- (a) *General rule in the case of gifts*

made on or before December 31, 1976.
* * *

* * * * *

(b) *Amount of gift tax paid with respect to gifts made on or before December 31, 1976.* * * *

* * * * *

(c) *Special rule for increased basis for gift tax paid in the case of gifts made after December 31, 1976—(1) In general.* With respect to gifts made after December 31, 1976 (other than gifts between spouses described in section 1015(e)), the increase in basis for gift tax paid is determined under section 1015(d)(6). Under section 1015(d)(6)(A), the increase in basis with respect to gift tax paid is limited to the amount (not in excess of the amount of gift tax paid) that bears the same ratio to the amount of gift tax paid as the net appreciation in value of the gift bears to the amount of the gift.

(2) *Amount of gift.* In general, for purposes of section 1015(d)(6)(A)(ii), the amount of the gift is determined in conformance with the provisions of paragraph (b) of this section. Thus, the amount of the gift is the amount included with respect to the gift in determining (for purposes of section 2503(a)) the total amount of gifts made during the calendar year (or calendar quarter in the case of a gift made on or before December 31, 1981), reduced by the amount of any annual exclusion allowable with respect to the gift under section 2503(b), and any deductions allowed with respect to the gift under section 2522 (relating to the charitable deduction) and section 2523 (relating to the marital deduction). Where more than one gift of a present interest in property is made to the same donee during a calendar year, the annual exclusion shall apply to the earliest of such gifts in point of time.

(3) *Amount of gift tax paid with respect to the gift.* In general, for purposes of section 1015(d)(6), the amount of gift tax paid with respect to the gift is determined in conformance with the provisions of paragraph (b) of this section. Where more than one gift

is made by the donor in a calendar year (or quarter in the case of gifts made on or before December 31, 1981), the amount of gift tax paid with respect to any specific gift made during that period is the amount which bears the same ratio to the total gift tax paid for that period (determined after reduction for any gift tax unified credit available under section 2505) as the amount of the gift (computed as described in paragraph (c)(2) of this section) bears to the total taxable gifts for the period.

(4) *Qualified domestic trusts.* For purposes of section 1015(d)(6), in the case of a qualified domestic trust (QDOT) described in section 2056A(a), any distribution during the noncitizen surviving spouse's lifetime with respect to which a tax is imposed under section 2056A(b)(1)(A) is treated as a transfer by gift, and any estate tax paid on the distribution under section 2056A(b)(1)(A) is treated as a gift tax. The rules under this paragraph apply in determining the extent to which the basis in the assets distributed is increased by the tax imposed under section 2056A(b)(1)(A).

(5) *Examples.* Application of the provisions of this paragraph (c) may be illustrated by the following examples:

Example 1. (i) Prior to 1995, X exhausts X's gift tax unified credit available under section 2505. In 1995, X makes a gift to X's child Y, of a parcel of real estate having a fair market value of \$100,000. X's adjusted basis in the real estate immediately before making the gift was \$70,000. Also in 1995, X makes a gift to X's child Z, of a painting having a fair market value of \$70,000. X timely files a gift tax return for 1995 and pays gift tax in the amount of \$55,500, computed as follows:

| | |
|---|---------------|
| Value of real estate transferred to Y | \$100,000 |
| Less: Annual exclusion | <u>10,000</u> |
| Included amount of gift (C) | \$90,000 |
| Value of painting transferred to Z | \$70,000 |
| Less: annual exclusion | <u>10,000</u> |
| Included amount of gift | <u>60,000</u> |
| Total included gifts (D) | \$150,000 |
| Total gift tax liability for 1995 gifts (B) | \$ 55,500 |

(ii) The gift tax paid with respect to the real estate transferred to Y, is determined as follows:

$$\frac{\$90,000 \text{ (C)}}{\$150,000 \text{ (D)}} \times \$55,500 \text{ (B)} = \$33,300$$

(iii) (A) The amount by which Y's basis in the real property is increased is determined as follows:

$$\frac{\$30,000 \text{ (net appreciation)}}{\$90,000 \text{ (amount of gift)}} \times \$33,300 = \$11,100$$

(B) Y's basis in the real property is \$70,000 plus \$11,100, or \$81,100. If X had not exhausted any of X's unified credit, no gift tax would have been paid and, as a result, Y's basis would not be increased.

Example 2. (i) X dies in 1995. X's spouse, Y, is not a United States citizen. In order to obtain the marital deduction for property passing to X's spouse, X established a QDOT in X's will. In 1996, the trustee of the QDOT makes a distribution of principal from the QDOT in the form of shares of stock having a fair market value of \$70,000 on the date of distribution. The trustee's basis in the stock (determined under section 1014) is \$50,000. An estate tax is imposed on the distribution under section 2056A(b)(1)(A) in the amount \$38,500, and is paid. Y's basis in the shares of stock is increased by a portion of the section 2056A estate tax paid determined as follows:

$$\frac{\$20,000 \text{ (net appreciation)}}{\$70,000 \text{ (distribution)}} \times \$38,500 \text{ (section 2056A estate tax)} = \$11,000$$

(ii) Y's basis in the stock is \$50,000 plus \$11,000, or \$61,000.

(6) *Effective date.* The provisions of this paragraph (c) are effective for gifts made after August 22, 1995.

* * * * *

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 3. The authority citation for part 20 continues to read in part as follows:

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

Par. 4. In §20.2056-0, the table of contents is amended by:

a. Redesignating the entries for §§20.2056(d)-1 and 20.2056(d)-2 as §§20.2056(d)-2 and 20.2056(d)-3, respectively.

b. Adding a new entry for §20.2056(d)-1 to read as follows:

§20.2056-0 Table of contents

* * * * *

§20.2056(d)-1 Marital deduction; special rules for marital deduction if surviving spouse is not a United States citizen.

* * * * *

Par. 5. Sections 20.2056(d)-1 and 20.2056(d)-2 are redesignated as §§20.2056(d)-2 and 20.2056(d)-3, respectively, and new §20.2056(d)-1 is added to read as follows:

§20.2056(d)-1 Marital deduction; special rules for marital deduction if surviving spouse is not a United States citizen.

Rules pertaining to the application of section 2056(d), including certain transition rules, are contained in §§20.2056A-1 through 20.2056A-13.

Par. 6. Sections 20.2056A-0 through 20.2056A-13 are added to read as follows:

§20.2056A-0 Table of contents.

This section lists the captions that appear in the final regulations under §§20.2056A-1 through 20.2056A-13.

§20.2056A-1 Restrictions on allowance of marital deduction if surviving spouse is not a United States citizen.

- (a) General rule.
- (b) Marital deduction allowed if resident spouse becomes citizen.
- (c) Special rules in the case of certain transfers subject to estate and gift tax treaties.

§20.2056A-2 Requirements for qualified domestic trust.

- (a) In general.
- (b) Qualified marital interest requirements.
 - (1) Property passing to QDOT.
 - (2) Property passing outright to spouse.
 - (3) Property passing under a non-transferable plan or arrangement.
- (c) Statutory requirements.
- (d) [Reserved]

§20.2056A-3 QDOT election.

- (a) General rule.
- (b) No partial elections.
- (c) Protective elections.
- (d) Manner of election.

§20.2056A-4 Procedures for conforming marital trusts and nontrust marital transfers to the requirements of a qualified domestic trust.

- (a) Marital trusts.
 - (1) In general.
 - (2) Judicial reformations.
 - (3) Tolling of statutory assessment period.

- (b) Nontrust marital transfers.
- (1) In general.
- (2) Form of transfer or assignment.
- (3) Assets eligible for transfer or assignment.
- (4) Pecuniary assignment—special rules.
- (5) Transfer tax treatment of transfer or assignment.
- (6) Period for completion of transfer.
- (7) Retirement accounts and annuities.
- (8) Protective assignment.
- (c) Nonassignable annuities and other arrangements.

- (1) Definition and general rule.
- (2) Agreement to remit section 2056A estate tax on corpus portion of each annuity payment.
- (3) Agreement to roll over corpus portion of annuity payment to QDOT.
- (4) Determination of corpus portion.
- (5) Information Statement.
- (6) Agreement to pay section 2056A estate tax.
- (7) Agreement to roll over annuity payments.
- (d) Examples.

§20.2056A-5 Imposition of section 2056A estate tax.

- (a) In general.
- (b) Amounts subject to tax.
- (1) Distribution of principal during the spouse's lifetime.
- (2) Death of surviving spouse.
- (3) Trust ceases to qualify as QDOT.
- (c) Distributions and dispositions not subject to tax.
- (1) Distributions of principal on account of hardship.
- (2) Distributions of income to the surviving spouse.
- (3) Certain miscellaneous distributions and dispositions.

§20.2056A-6 Amount of tax.

- (a) Definition of tax.
- (b) Benefits allowed in determining amount of section 2056A estate tax.
- (1) General rule.
- (2) Treatment as resident.
- (3) Special rule in the case of trusts described in section 2056(b)(8).
- (4) Credit for state and foreign death taxes.
- (5) Alternate valuation and special use valuation.
- (c) Miscellaneous rules.
- (d) Examples.

§20.2056A-7 Allowance of prior transfer credit under section 2013.

- (a) Property subject to QDOT election.
- (b) Property not subject to QDOT election.
- (c) Example.

§20.2056A-8 Special rules for joint property.

- (a) Inclusion in gross estate.
- (1) General rule.
- (2) Consideration furnished by surviving spouse.
- (3) Amount allowed to be transferred to QDOT.
- (b) Surviving spouse becomes citizen.
- (c) Examples.

§20.2056A-9 Designated Filer.

§20.2056A-10 Surviving spouse becomes citizen after QDOT established.

- (a) Section 2056A estate tax no longer imposed under certain circumstances.
- (b) Special election by spouse.

§20.2056A-11 Filing requirements and payment of the section 2056A estate tax.

- (a) Distributions during surviving spouse's life.
- (b) Tax at death of surviving spouse.
- (c) Extension of time for paying section 2056A estate tax.
- (1) Extension of time for paying tax under section 6161(a)(2).
- (2) Extension of time for paying tax under section 6161(a)(1).
- (d) Liability for tax.

§20.2056A-12 Increased basis for section 2056A estate tax paid with respect to distribution from a QDOT.

§20.2056A-13 Effective date.

§20.2056A-1 Restrictions on allowance of marital deduction if surviving spouse is not a United States citizen.

- (a) *General rule.* Subject to the special rules provided in section 7815(d)(14) of the Omnibus Budget

Reconciliation Act of 1989 (Pub. L. 101-239; 103 Stat. 2106), in the case of a decedent dying after November 10, 1988, the federal estate tax marital deduction is not allowed for property passing to or for the benefit of a surviving spouse who is not a United States citizen at the date of the decedent's death (whether or not the surviving spouse is a resident of the United States) unless—

(1) The property passes from the decedent to (or pursuant to)—

(i) A qualified domestic trust (QDOT) described in section 2056A and §20.2056A-2;

(ii) A trust that, although not meeting all of the requirements for a QDOT, is reformed after the decedent's death to meet the requirements of a QDOT (see §20.2056A-4(a));

(iii) The surviving spouse not in trust (e.g., by outright bequest or devise, by operation of law, or pursuant to the terms of an annuity or other similar plan or arrangement) and, prior to the date that the estate tax return is filed and on or before the last date prescribed by law that the QDOT election may be made (no more than one year after the time prescribed by law, including extensions, for filing the return), the surviving spouse either actually transfers the property to a QDOT or irrevocably assigns the property to a QDOT (see §20.2056A-4(b)); or

(iv) A plan or other arrangement that would have qualified for the marital deduction but for section 2056(d)-(1)(A), and whose payments are not assignable or transferable to a QDOT, if the requirements of §20.2056A-4(c) are met; and

(2) The executor makes a timely QDOT election under §20.2056A-3.

(b) *Marital deduction allowed if resident spouse becomes citizen.* For purposes of section 2056(d)(1) and paragraph (a) of this section, the surviving spouse is treated as a citizen of the United States at the date of the decedent's death if the requirements of section 2056(d)(4) are satisfied. For purposes of section 2056(d)(4)(A) and notwithstanding §20.2056A-3(a), a return filed prior to the due date (including extensions) is considered filed on the last date that the return is required to be filed (including extensions), and a late return filed at any time after the due date is considered filed on the date that it is actually filed. A surviving

spouse is a resident only if the spouse is a resident under chapter 11 of the Internal Revenue Code. See §20.0–1(b)(1). The status of the spouse as a resident under section 7701(b) is not relevant to this determination except to the extent that the income tax residency of the spouse is pertinent in applying §20.0–1(b)(1).

(c) *Special rules in the case of certain transfers subject to estate and gift tax treaties.* Under section 7815(d)(14) of the Omnibus Budget Reconciliation Act of 1989 (Pub. L. 101–239, 103 Stat. 2106) certain special rules apply in the case of transfers governed by certain estate and gift tax treaties to which the United States is a party. In the case of the estate of, or gift by, an individual who was not a citizen or resident of the United States but was a resident of a foreign country with which the United States has a tax treaty with respect to estate, inheritance, or gift taxes, the amendments made by section 5033 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100–647, 102 Stat. 3342) do not apply to the extent such amendments would be inconsistent with the provisions of such treaty relating to estate, inheritance, or gift tax marital deductions. Under this rule, the estate may choose either the statutory deduction under section 2056A or the marital deduction allowed under the treaty. Thus, the estate may not avail itself of both the marital deduction under the treaty and the marital deduction under the QDOT provisions of section 2056A and chapter 11 of the Internal Revenue Code with respect to the remainder of the marital property that is not deductible under the treaty.

§20.2056A–2 Requirements for qualified domestic trust.

(a) *In general.* In order to qualify as a qualified domestic trust (QDOT), the requirements of paragraphs (b) and (c) of this section, and the requirements of §20.2056A–2T(d), must be satisfied. The executor of the decedent’s estate and the U.S. Trustee shall establish in such manner as may be prescribed by the Commissioner on the estate tax return and applicable instructions that these requirements have been satisfied or are being complied with. In order to constitute a QDOT, the trust must be maintained under the laws of a state of the United States or the District of Columbia, and the administration of the

trust must be governed by the laws of a particular state of the United States or the District of Columbia. For purposes of this paragraph, a trust is maintained under the laws of a state of the United States or the District of Columbia if the records of the trust (or copies thereof) are kept in that state (or the District of Columbia). The trust may be established pursuant to an instrument executed under either the laws of a state of the United States or the District of Columbia or pursuant to an instrument executed under the laws of a foreign jurisdiction, such as a foreign will or trust, provided that such foreign instrument designates the law of a particular state of the United States or the District of Columbia as governing the administration of the trust, and such designation is effective under the law of the designated jurisdiction. In addition, the trust must constitute an ordinary trust, as defined in §301.7701–4(a) of this chapter, and not any other type of entity. For purposes of this paragraph (a), a trust will not fail to constitute an ordinary trust solely because of the nature of the assets transferred to that trust, regardless of its classification under §§301.7701–2 through 301.7701–4 of this chapter.

(b) *Qualified marital interest requirements—(1) Property passing to QDOT.* If property passes from a decedent to a QDOT, the trust must qualify for the federal estate tax marital deduction under section 2056(b)(5) (life estate with power of appointment), section 2056(b)(7) (qualified terminable interest property, including joint and survivor annuities under section 2056(b)(7)(C)), or section 2056(b)(8) (surviving spouse is the only noncharitable beneficiary of a charitable remainder trust), or meet the requirements of an estate trust as defined in §20.2056(c)–2(b)(1)(i) through (iii).

(2) *Property passing outright to spouse.* If property does not pass from a decedent to a QDOT, but passes to a noncitizen surviving spouse in a form that meets the requirements for a marital deduction without regard to section 2056(d)(1)(A), and that is not described in paragraph (b)(1) of this section, the surviving spouse must either actually transfer the property, or irrevocably assign the property, to a trust (whether created by the decedent, the decedent’s executor or by the surviving spouse) that meets the requirements of paragraph (c) of this section and the requirements of

§20.2056A–2T(d) (pertaining, respectively, to statutory requirements and regulatory requirements imposed to ensure collection of tax) prior to the filing of the estate tax return for the decedent’s estate and on or before the last date prescribed by law that the QDOT election may be made (see §20.2056A–3(a)).

(3) *Property passing under a non-transferable plan or arrangement.* If property does not pass from a decedent to a QDOT, but passes under a plan or other arrangement that meets the requirements for a marital deduction without regard to section 2056(d)(1)(A) and whose payments are not assignable or transferable (see §20.2056A–4(c)), the property is treated as meeting the requirements of this section, and the requirements of §20.2056A–2T(d), if the requirements of §20.2056A–4(c) are satisfied. In addition, where an annuity or similar arrangement is described above except that it is assignable or transferable, see §20.2056A–4(b)(7).

(c) *Statutory requirements.* The requirements of section 2056A(a)(1)(A) and (B) must be satisfied. For purposes of that section, a domestic corporation is a corporation that is created or organized under the laws of the United States or under the laws of any state of the United States or the District of Columbia. The trustee required under that section is referred to herein as the “U.S. Trustee”.

(d) [Reserved]

§20.2056A–3 QDOT election.

(a) *General rule.* Subject to the time period prescribed in section 2056A(d), the election to treat a trust as a QDOT must be made on the last federal estate tax return filed before the due date (including extensions of time to file actually granted) or, if a timely return is not filed, on the first federal estate tax return filed after the due date. The election, once made, is irrevocable.

(b) *No partial elections.* An election to treat a trust as a QDOT may not be made with respect to a specific portion of an entire trust that would otherwise qualify for the marital deduction but for the application of section 2056(d). However, if the trust is actually severed in accordance with the applicable requirements of §20.2056(b)–7(b)(2)(ii) prior to the due date for the election, a QDOT election may be made for any one or more of the severed trusts.

(c) *Protective elections.* A protective election may be made to treat a trust as a QDOT only if at the time the federal estate tax return is filed, the executor of the decedent's estate reasonably believes that there is a bona fide issue that concerns either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. For example, if at the time the federal estate tax return is filed either the estate is involved in a bona fide will contest, there is uncertainty regarding the inclusion in the gross estate of an asset which, if includible, would be eligible for the QDOT election, or there is uncertainty regarding the status of the decedent as a resident alien or a nonresident alien for estate tax purposes, or a similar uncertainty regarding the citizenship status of the surviving spouse, a protective QDOT election may be made. The protective election is in addition to, and is not in lieu of, the requirements set forth in §20.2056A-4. The protective QDOT election must be made on a written statement signed by the executor under penalties of perjury and must be attached to the return described in paragraph (a) of this section, and must identify the specific assets to which the protective election refers and the specific basis for the protective election. However, the protective election may otherwise be defined by means of a formula (such as the minimum amount necessary to reduce the estate tax to zero). Once made, the protective election is irrevocable. For example, if a protective election is made because a bona fide question exists as to the includibility of an asset in the decedent's gross estate and it is later finally determined that the asset is so includible, the protective election becomes effective with respect to the asset and cannot thereafter be revoked.

(d) *Manner of election.* The QDOT election under paragraph (a) of this section is made in the form and manner set forth in the decedent's estate tax return, including applicable instructions.

§20.2056A-4 Procedures for conforming marital trusts and nontrust marital transfers to the requirements of a qualified domestic trust.

(a) *Marital trusts—(1) In general.* If an interest in property passes from the

decedent to a trust for the benefit of a noncitizen surviving spouse and if the trust otherwise qualifies for a marital deduction but for the provisions of section 2056(d)(1)(A), the property interest is treated as passing to the surviving spouse in a QDOT if the trust is reformed, either in accordance with the terms of the decedent's will or trust agreement or pursuant to a judicial proceeding, to meet the requirements of a QDOT. For this purpose, the requirements of a QDOT include all of the applicable requirements set forth in §20.2056A-2, and the requirements of §20.2056A-2T(d). A reformation pursuant to the terms of the decedent's will or trust instrument must be completed by the time prescribed (including extensions) for filing the decedent's estate tax return. For purposes of this paragraph (a), a return filed prior to the due date (including extensions) is considered filed on the last date that the return is required to be filed (including extensions), and a late return filed at any time after the due date is considered filed on the date that it is actually filed.

(2) *Judicial reformations.* In general, a reformation pursuant to a judicial proceeding is permitted under this section if the reformation is commenced on or before the due date (determined with regard to extensions actually granted) for filing the return of tax imposed by chapter 11 of the Internal Revenue Code, regardless of the date that the return is actually filed. The reformation (either pursuant to a judicial proceeding or otherwise) must result in a trust that is effective under local law. The reformed trust may be revocable by the spouse, or otherwise be subject to the spouse's general power of appointment, provided that no person (including the spouse) has the power to amend the trust during the continued existence of the trust such that it would no longer qualify as a QDOT. Prior to the time that the judicial reformation is completed, the trust must be treated as a QDOT. Thus, the trustee of the trust is responsible for filing the Form 706-QDT, paying any section 2056A estate tax that becomes due, and filing the annual statement required under §20.2056A-2T(d)(3), if applicable. Failure to comply with these requirements may cause the trust to be subject to the anti-abuse rule under §20.2056A-2T(d)(1)(iv). In addition, if the judicial reformation is terminated prior to the time that the

reformation is completed, the estate of the decedent is required to pay the increased estate tax imposed on the decedent's estate (plus interest and any applicable penalties) that becomes due at the time of such termination as a result of the failure of the trust to comply with section 2056(d). See section 6511 as to applicable time periods for credit or refund of tax.

(3) *Tolling of statutory assessment period.* For the tolling of the statute of limitations in the case of a judicial reformation, see section 2056(d)(5)(B).

(b) *Nontrust marital transfers—(1) In general.* Under section 2056(d)(2)-(B), if an interest in property passes outright from a decedent to a non-citizen surviving spouse either by testamentary bequest or devise, by operation of law, or pursuant to an annuity or other similar plan or arrangement, and such property interest otherwise qualifies for a marital deduction except that it does not pass in a QDOT, solely for purposes of section 2056(d)(2)(A), the property is treated as passing to the surviving spouse in a QDOT if the property interest is either actually transferred to a QDOT before the estate tax return is filed and on or before the last date prescribed by law that the QDOT election may be made, or is assigned to a QDOT under an enforceable and irrevocable written assignment made on or before the date on which the return is filed and on or before the last date prescribed by law that the QDOT election may be made. The transfer or assignment of property to a QDOT may be made by the surviving spouse, the surviving spouse's legal representative (if the surviving spouse is incompetent), or the personal representative of the surviving spouse's estate (if the surviving spouse has died). The QDOT to which the property is transferred may be created by the decedent (during life or by will), by the surviving spouse, or by the executor. For purposes of section 2056(d)(2)(B), if no property other than the property passing to the surviving spouse from the decedent is transferred to the QDOT, the transferee QDOT need not be in a form such that the property transferred to the QDOT would qualify for a marital deduction under section 2056(a). However, if other property is or has been transferred to the QDOT, 100 percent of the value of the transferee QDOT must qualify for the marital deduction under section 2056. For example, if the

decendent, a U.S. citizen, bequeaths property to a trust that does not satisfy the requirements of section 2056(b)(5) or (7), or to a trust that does not qualify as an estate trust under §20.2056(c)-2(b)(1)(i)-(iii), that trust cannot be used as a transferee QDOT by the surviving spouse, since after that trust is fully funded the portion of the value of the trust attributable to property bequeathed to the trust by the decedent will not qualify for a marital deduction under section 2056. Similarly, if the decedent, a nonresident not a citizen of the United States, bequeaths foreign situs assets to a trust created under his will, the surviving spouse may not transfer U.S. situs assets passing to the spouse outside of the will to that trust under this paragraph. See §20.2056A-3(c) with respect to protective elections. See §20.2056A-3(a) with respect to the time limitations for making the QDOT election.

(2) *Form of transfer or assignment.* A transfer or assignment of property to a QDOT must be in writing and otherwise be in accordance with all local law requirements for such assignment or transfer. The transfer or assignment may be of a specific asset or a group of assets, or a fractional share of either, or may be of a pecuniary amount. A transfer or assignment of less than an entire interest in an asset or a group of assets may be expressed by means of a formula (such as the minimum amount necessary to reduce the estate tax to zero). In the case of a transfer, a copy of the trust instrument evidencing the transfer must be submitted with the decedent's estate tax return. In the case of an assignment, a copy of the assignment must be submitted with the decedent's estate tax return.

(3) *Assets eligible for transfer or assignment.* If a transfer or assignment is of a specific asset or group of assets, only assets included in the decedent's gross estate and passing from the decedent to the spouse (or the proceeds from the sale, exchange or conversion of such assets) may be transferred or assigned to the QDOT. The noncitizen surviving spouse may not transfer or assign to the QDOT property owned by the surviving spouse at the time of the decedent's death in lieu of property included in the decedent's gross estate that passes to the spouse (or in lieu of the proceeds from the sale, exchange or conversion of such includible assets). In addition, if only a portion of an

asset is includible in the decedent's gross estate, the spouse may only transfer the portion that is so includible to the transferee trust under this paragraph (b)(3).

(4) *Pecuniary assignment—special rules.* If the assignment is expressed in the form of a pecuniary amount (such as a fixed dollar amount or a formula designed to reduce the decedent's estate tax to zero), the assignment must specify that—

(i) Assets actually transferred to the QDOT in satisfaction of the assignment have an aggregate fair market value on the date of actual transfer to the QDOT amounting to no less than the amount of the pecuniary transfer or assignment; or

(ii) The assets actually transferred to the QDOT be fairly representative of appreciation or depreciation in the value of all property available for transfer to the QDOT between the valuation date and the date of actual transfer to the QDOT, if the assignment is to be satisfied by accounting for the assets on the basis of their fair market value as of some date before the date of actual transfer to the QDOT.

(5) *Transfer tax treatment of transfer or assignment.* Property assigned or transferred to a QDOT pursuant to section 2056(d)(2)(B) is treated as passing from the decedent to a QDOT solely for purposes of section 2056(d)(2)(A). For all other purposes (e.g., income, gift, estate, generation-skipping transfer tax, and section 1491 excise tax), the surviving spouse is treated as the transferor of the property to the QDOT. However, the spouse is not considered the transferor of property to a QDOT if the transfer by the spouse constitutes a transfer that satisfies the requirements of section 2518(c)(3). For a special exception to the valuation rules of section 2702 in the case of a transfer by the surviving spouse to a QDOT, see §25.2702-1(c)(8) of this chapter.

(6) *Period for completion of transfer.* Property irrevocably assigned but not actually transferred to the QDOT before the estate tax return is filed must actually be conveyed and transferred to the QDOT under applicable local law before the administration of the decedent's estate is completed. If there is no administration of the decedent's estate (because for example, none of the decedent's assets are subject to probate under local law), the

conveyance must be made on or before the date that is one year after the due date (including extensions) for filing the decedent's estate tax return. If an actual transfer to the QDOT is not timely made, section 2056(d)(1)(A) applies and the marital deduction is not allowed. The executor of the decedent's estate (or other authorized legal representative) may request a private letter ruling from the Internal Revenue Service requesting an extension of the time for completing the conveyance or waiving the actual conveyance under specified circumstances under §301.9100-1(a) of this chapter.

(7) *Retirement accounts and annuities—(i) In general.* An assignment otherwise in compliance with this paragraph (b) of rights under annuities or other similar arrangements that are assignable and thus, are not described in paragraph (c) of this section, is treated as a transfer of such property to the QDOT regardless of the method of payment actually elected under such annuity or plan.

(ii) *Individual retirement annuities.* Individual retirement annuities described in section 408(b) are not assignable pursuant to section 408(b)(1) and thus, do not come within the purview of this paragraph (b)(7). See the procedures provided in paragraph (c) of this section.

(iii) *Individual retirement accounts.* Unless the terms of the account provide otherwise, individual retirement accounts described in section 408(a) are assignable and subject to the provisions of this paragraph (b)(7). However, under paragraph (c) of this section, the surviving spouse may treat an individual retirement account as nonassignable and, therefore, eligible for the procedures in paragraph (c) of this section if the spouse timely complies with the requirements in paragraph (c) of this section.

(iv) *Other effects of assignment.* The provisions of this paragraph (b)(7) apply solely for purposes of qualifying the annuity or account under the rules of §20.2056A-2 and this section. See, for example, section 408(d) and 4980A regarding the consequences of an assignment for purposes other than this paragraph (b)(7).

(8) *Protective assignment.* A protective assignment of property to a QDOT may be made only if, at the time the federal estate tax return is filed, the executor of the decedent's estate rea-

sonably believes that there is a bona fide issue that concerns either the residency or citizenship of the decedent, the citizenship of the surviving spouse, whether all or a portion of an asset is includible in the decedent's gross estate, or the amount or nature of the property the surviving spouse is entitled to receive. For example, if at the time the federal estate tax return is filed, either the estate is involved in a bona fide will contest, there is uncertainty regarding the inclusion in the gross estate of an asset which, if includible, would be eligible for the QDOT election, or there is uncertainty regarding the status of the decedent as a resident alien or a nonresident alien for estate tax purposes, or a similar uncertainty regarding the citizenship status of the surviving spouse, a protective assignment may be made. The protective assignment must be made on a written statement signed by the assignor under penalties of perjury on or before the date prescribed under paragraph (b)(1) of this section, and must identify the specific assets to which the assignment refers and the specific basis for the protective assignment. However, the protective assignment may otherwise be defined by means of a formula (such as the minimum amount necessary to reduce the estate tax to zero). Once made, the protective assignment cannot be revoked. For example, if a protective assignment is made because a bona fide question exists as to the includibility of an asset in the decedent's gross estate and it is later finally determined that the asset is so includible, the protective assignment becomes effective with respect to the asset and cannot thereafter be revoked. Protective assignments are, in all events, subject to paragraph (b)(6) of this section. A copy of the protective assignment must be submitted with the decedent's estate tax return.

(c) *Nonassignable annuities and other arrangements*—(1) *Definition and general rule.* For purposes of this section, a *nonassignable annuity or other arrangement* means a plan, annuity, or other arrangement (whether qualified or not qualified under part I of subchapter D of chapter 1 of subtitle A of the Internal Revenue Code) that qualifies for the marital deduction but for section 2056(d)(1)(A), and whose payments are not assignable or transferable to the QDOT under either federal law (see, e.g., section 401(a)(13)), state

law, foreign law, or the terms of the plan or arrangement itself. For purposes of this paragraph (c), a surviving spouse's interest as beneficiary of an individual retirement annuity described in section 408(b) is a nonassignable annuity or other arrangement. See section 408(b)(1). For purposes of this paragraph (c), a surviving spouse's interest as beneficiary of an individual retirement account described in section 408(a), although assignable under that section, is considered to be a nonassignable annuity or other arrangement eligible for the procedures contained in this paragraph (c), at the option of the surviving spouse, if the requirements of this paragraph are otherwise satisfied. See paragraph (b)(7) of this section if the spouse elects to treat the account as assignable. In the case of a plan, annuity, or other arrangement which is not assignable or transferable (or is treated as such), the property passing under the plan from the decedent is treated as meeting the requirements §20.2056A-2, and the requirements of §20.2056A-2T(d) (pertaining, respectively, to general requirements, qualified marital interest requirements, statutory requirements, and requirements to ensure collection of the tax) if the requirements of either paragraph (c)(2) or (3) of this section are satisfied. Thus, the property will be treated as passing in the form of a QDOT, notwithstanding that the spouse does not irrevocably transfer or assign the annuity or other payment to the QDOT as provided in paragraph (b) of this section. The Commissioner will prescribe by administrative guidance the extent, if any, to which the provisions of this paragraph (c) apply to a rollover from a qualified trust to an eligible retirement plan within the meaning of section 402(c) or a distribution from an individual retirement account or an individual retirement annuity that is paid into an individual retirement account or an individual retirement annuity within the meaning of section 408(d)(3).

(2) *Agreement to remit section 2056A estate tax on corpus portion of each annuity payment.* The requirements of this paragraph (c)(2) are satisfied if—

(i) The noncitizen surviving spouse agrees to pay on an annual basis, as described in paragraph (c)(6)(i) of this section, the estate tax imposed under section 2056A(b)(1) due on the corpus portion, as defined in paragraph (c)(4)

of this section, of each nonassignable annuity or other payment received under the plan or arrangement. However, for purposes of this paragraph (c)(2), if the financial circumstances of the spouse are such that an amount equal to all or a portion of the corpus portion of a nonassignable annuity payment received by the spouse would be subject to a hardship exemption (as defined in §20.2056A-5(c)) if paid from a QDOT, then all or a corresponding part of the corpus portion will be exempt from the tax payment requirement under this paragraph (c)(2);

(ii) The executor of the decedent's estate files with the estate tax return the Information Statement described in paragraph (c)(5) of this section;

(iii) The executor files with the estate tax return the Agreement To Pay Section 2056A Estate Tax described in paragraph (c)(6) of this section; and

(iv) The executor makes the election under §20.2056A-3 with respect to the nonassignable annuity or other payment.

(3) *Agreement to roll over corpus portion of annuity payment to QDOT.* The requirements of this paragraph (c)(3) are satisfied if—

(i) The noncitizen surviving spouse agrees to roll over and transfer, within the time prescribed under paragraph (c)(7)(i) of this section, the corpus portion of each annuity payment to a QDOT, whether the QDOT is created by the decedent's will, the executor of the decedent's estate, or the surviving spouse. However, for purposes of this section, if the financial circumstances of the spouse are such that an amount equal to all or a portion of the corpus portion of a nonassignable annuity payment received by the spouse would be subject to a hardship exemption (as defined in §20.2056A-5(c)) if paid from a QDOT, then all or a corresponding part of the corpus portion will be exempt from the rollover requirement under this paragraph (c)(3);

(ii) A QDOT for the benefit of the surviving spouse is established prior to the date that the estate tax return is filed and on or prior to the last date prescribed by law that the QDOT election may be made;

(iii) The executor of the decedent's estate files with the estate tax return the Information Statement described in paragraph (c)(5) of this section;

(iv) The executor files with the estate tax return the Agreement To Roll

Over Annuity Payments described in paragraph (c)(7) of this section; and

(v) The executor makes the election under §20.2056A-3 with respect to the nonassignable annuity or other payment. See §20.2056A-5(c)(3)(iv)(A), regarding distributions from the QDOT reimbursing the spouse for income taxes paid (either by actual payment or withholding) by the spouse with respect to amounts transferred to the QDOT pursuant to this paragraph (c)(3).

(4) *Determination of corpus portion*—(i) *Corpus portion*. For purposes of this paragraph (c), the corpus portion of each nonassignable annuity or other payment is the corpus amount of the annual payment divided by the total annual payment.

(ii) *Corpus amount*. (A) The corpus amount of the annual payment is determined in accordance with the following formula:

$$\text{Corpus Amount} = \frac{\text{Total present value of annuity or other payment}}{\text{Expected annuity term}}$$

(B) The *total present value of the annuity or other payment* is the present value of the nonassignable annuity or other payment as of the date of the decedent's death, determined in accordance with the interest rates and mortality data prescribed by section 7520. The *expected annuity term* is the number of years that would be required for the scheduled payments to exhaust a hypothetical fund equal to the present value of the scheduled payments. This is determined by first dividing the total present value of the payments by the annual payment. From the quotient so obtained, the expected annuity term is derived by identifying the term of years that corresponds to the annuity factor equal to the quotient. This is determined by using column 1 of Table B, for the applicable interest rate, contained in Publication 1457, *Alpha Volume*. A copy of this publication may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402. If the quotient obtained falls between two terms, the longer term is used.

(5) *Information Statement*—(i) *In general*. In order for a nonassignable annuity or other payment described in

this paragraph (c) to qualify under either paragraph (c)(2) or (3) of this section, the Information Statement described in paragraph (c)(5)(ii) of this section must be filed with the decedent's federal estate tax return. The Information Statement must be signed under penalties of perjury by both the executor of the decedent's estate and by the surviving spouse of the decedent (or by the legal representative of the surviving spouse if the surviving spouse is legally incompetent to sign the statement). The Statement must contain all of the information prescribed by this paragraph (c)(5).

(ii) *Annuity source information*—(A) *Employment-related annuity*. If the nonassignable annuity or other payment is employment-related, the following information must be provided—

(1) The name and address of the employer;

(2) The date of retirement or other separation from employment of the decedent;

(3) The name and address of the pension fund, insurance company, or other obligor that is paying the annuity (or similar payment); and

(4) The identification number, if any, that the obligor has assigned to the annuity or other payment.

(B) *Annuity not employment-related*. If the nonassignable annuity or other payment is not employment-related, the following information must be provided—

(1) The name and address of the person or entity paying the nonassignable annuity or other payment;

(2) The date of acquisition of the nonassignable annuity contract by the decedent or by the decedent and the surviving spouse; and

(3) The identification number, if any, that the obligor has assigned to the nonassignable annuity or other payment.

(iii) *The total annuity amount payable each year*. The total amount payable annually under the nonassignable annuity or other arrangement, including a description of whether the annuity is payable monthly, quarterly, or at some other interval, and a description of any scheduled changes in the annuity payout amount.

(iv) *The duration of the annuity*. A description of the term of the nonassignable annuity or other payment in years, if it is determined by a term

certain, and the name, address, and birthdate of any measuring life if the nonassignable annuity or other payment is determined by one or more lives.

(v) *The market interest rate under section 7520*. The applicable interest rate as determined under section 7520.

(vi) *Determination of corpus portion of each payment (in accordance with paragraph (c)(4) of this section)*. The following items are required in order to determine the corpus portion of each payment—

(A) The present value of the nonassignable annuity or other payment as of the decedent's death;

(B) The expected annuity term;

(C) The corpus amount of the annual annuity payments (paragraph (c)(5)(vi)(A) of this section divided by paragraph (c)(5)(vi)(B) of this section); and

(D) The corpus portion of the annual payments (paragraph (c)(5)(vi)(C) of this section divided by the total amount payable annually).

(vii) *Recipient QDOT*. In the case of an agreement to rollover under paragraph (c)(3) of this section, the following must be provided—

(A) The name and address of the trustee of the QDOT who is the U.S. Trustee; and

(B) The name and taxpayer identification number of the QDOT.

(viii) *Certification statement*. The executor of the decedent's estate and the surviving spouse of the decedent (or the legal representative of the surviving spouse if the surviving spouse is legally incompetent to so certify) must each sign a Certification Statement as follows:

Under penalties of perjury, I hereby certify that, to the best of my knowledge and belief, the information reported in this Information Statement is true, correct and complete.

(6) *Agreement to pay section 2056A estate tax*—(i) *Payment of section 2056A estate tax*. The tax payable under paragraph (c)(2) of this section is payable on an annual basis, commencing in the calendar year following the calendar year of the receipt by the surviving spouse of the spouse's first annuity payment. Form 706QDT and the payment are due on April 15th of each year following the calendar year in which an annuity payment is received except that, in the year of the deceased spouse's death, the Form 706-QDT and the payment are not due

prior to the due date, including extensions, for filing the deceased spouse's estate tax return, or if no return is filed, no later than 9 months from the date of the deceased spouse's death; and, in the year of the surviving spouse's death, the Form 706-QDT must be filed and the payment made no later than 9 months from the date of the surviving spouse's death. See §20.2056A-11 for extensions of time for filing Form 706-QDT and paying the section 2056A estate tax.

(ii) *Agreement.* In order for a non-assignable annuity or other payment described in this paragraph (c) to qualify under paragraph (c)(2) of this section, the executor of the decedent's estate must file with the estate tax return the following Agreement To Pay Section 2056A Estate Tax, which must be signed by the surviving spouse of the decedent (or by the surviving spouse's legal representative if the surviving spouse is legally incompetent to sign the agreement):

I [_____ name _____] hereby agree that I will report all annuity payments received under the [name of plan or arrangement] on Form 706-QDT for the calendar year and remit, on an annual basis, to the Internal Revenue Service the estate tax that is imposed under section 2056A(b)(1) of the Internal Revenue Code on the corpus portion of each annuity payment (as defined in §20.2056A-4(c)(4) of the Estate Tax Regulations) received under the plan during the calendar year. I also agree that Form 706-QDT is to be filed no later than April 15th of the year following the calendar year in which any annuity payments are received except that: in the case of annuity payments received in the year of my spouse's death, Form 706-QDT and the payment shall not be due prior to the due date, including extensions, for filing my spouse's estate tax return or, if no return is filed, no later than 9 months from the date of my spouse's death (except if I am granted an extension of time to file Form 706-QDT under the provisions of §20.2056A-11); and in the year of my death, the Form 706-QDT must be filed and the payment made no later than the date my estate tax return is filed (or if no return is filed, no later than 9 months from the date of my death). I further agree that if I fail to timely file Form 706-QDT or to timely pay the tax imposed on the corpus portion of any annuity payment (deter-

mined after any extensions of time to pay granted to me under the provisions of §20.2056A-11), I may become immediately liable to pay the amount of the tax determined by application of section 2056A(b)(1) on the entire remaining present value of the annuity, calculated as of the beginning of the year in which the payment was received with respect to which I failed to timely pay the tax or failed to timely file the return. However, I may make an application for relief under §301.9100-1 of the Procedure and Administration Regulations, from the consequences of failing to timely file the Form 706-QDT or failing to timely pay the tax on the corpus portion. [The following sentence is applicable only in cases where the plan or arrangement is established and administered by a person or an entity that is located outside of the United States.] I agree, at the request of the District Director, [or the Assistant Commissioner (International) in the case of a surviving spouse of a nonresident noncitizen decedent or a surviving spouse of a United States citizen who died domiciled outside the United States] to enter into a security agreement to secure my undertakings under this agreement.

(7) *Agreement to roll over annuity payments—(i) Roll over of corpus portion.* Beginning in the calendar year of the receipt by the surviving spouse of the spouse's first annuity payment, the corpus portion of each annuity payment, as determined under paragraph (c)(4) of this section, must, within 60 days of receipt, be transferred to a QDOT. In addition, all annuity payments received during the calendar year must be reported on Form 706-QDT no later than April 15th of the year following the year in which the annuity payments are received, except that in the year of the surviving spouse's death, the Form 706-QDT must be filed no later than the date the estate tax return is filed (or if no return is filed, no later than 9 months from the date of the surviving spouse's death). See §20.2056A-11 for extensions of time for filing Form 706-QDT.

(ii) *Agreement.* In order for a non-assignable annuity or other payment described in this paragraph (c) to qualify under paragraph (c)(3) of this section, the executor of the decedent's estate must file with the estate tax return the following Agreement To

Roll Over Annuity Payments, which must be signed by the surviving spouse of the decedent (or by the legal representative of the surviving spouse if the surviving spouse is legally incompetent to sign the agreement):

I [_____ name _____] hereby agree that within 60 days of receipt of each annuity payment paid under the [name of plan or arrangement], I will transfer an amount equal to _____ percent (the corpus portion determined under §20.2056A-4(c)(4) of the Estate Tax Regulations) of each annuity payment to [identify the QDOT]. Further, I will report all annuity payments received during the calendar year under the [name of plan or arrangement] on Form 706-QDT including a schedule of transfers to the [identify the QDOT]. I also agree that Form 706-QDT is to be filed no later than April 15th of the year following the year in which any annuity payments are received except that: in the case of annuity payments received in the year of my spouse's death, Form 706-QDT shall not be due prior to the due date, including extensions, for filing my spouse's estate tax return, or, if no return is filed, no later than 9 months from the date of my spouse's death (except if I am granted an extension of time to file Form 706-QDT under the provisions of §20.2056A-11); and in the year of my death, the Form 706-QDT must be filed no later than the date my estate tax return is filed (or if no return is filed, no later than 9 months from the date of my death), and except if I am granted an extension of time to file Form 706-QDT under the provisions of §20.2056A-11. I further agree that if I fail to timely transfer any required amount with respect to any annuity payment, or fail to timely file Form 706-QDT reporting the transfers for any year, I may become immediately liable to pay the amount of the tax determined by application of section 2056A(b)(1) on the entire remaining present value of the annuity, calculated as of the beginning of the year in which the payment was received with respect to which I failed to make the timely transfer or timely file a return. However, I may make an application for relief under §301.9100-1 of the Procedure and Administration Regulations, from the consequences of failing to timely file Form 706-QDT or failing to timely transfer the corpus portion of any annuity payment to the QDOT. [The following sentence is applicable

only in cases where the plan or arrangement is established and administered by a person or an entity that is located outside of the United States.] I agree, at the request of the District Director [or the Assistant Commissioner (International) in the case of a surviving spouse of a nonresident non-citizen decedent or a surviving spouse of a United States citizen who died domiciled outside the United States] to enter into a security agreement to secure my undertakings under this agreement.

(d) *Examples.* The provisions of this section are illustrated by the following examples. In each of the following examples the decedent, *D*, a citizen of the United States, died after August 22, 1995, and *D*'s surviving spouse, *S*, is not a United States citizen at the time of *D*'s death.

Example 1. Transfer and assignment of probate and nonprobate property to QDOT. (i) *S* is the beneficiary of the following probate and nonprobate assets included in *D*'s gross estate:

| | |
|--|----------------|
| Pecuniary bequest under will | \$400,000 |
| Proceeds of life insurance | 200,000 |
| <i>D</i> 's interest in property owned jointly with <i>S</i> includible in the gross estate under §2040(a) | 300,000 |
| Devise of real property under will | <u>100,000</u> |
| Total | \$1,000,000 |

(ii) Before the estate tax return for *D*'s estate is filed and before the date that the QDOT election must be made, *S* creates a QDOT pursuant to which all income is payable to *S* for life and the remainder is distributable to *S*'s children. *S* retains a power of appointment over the disposition of the remainder to ensure that *S* does not make an immediate gift of the remainder of the trust. Also, before the estate tax return is filed and before the date that the QDOT election must be made, *S* transfers the life insurance proceeds and the specifically devised real property to the QDOT. *S* decides not to transfer the property that had been jointly owned to the QDOT. Because *S* has not received distribution of the pecuniary bequest before *D*'s estate tax return is filed and before the date that the QDOT election must be made, *S* irrevocably assigns the interest in the pecuniary bequest to the QDOT. Assume that the pecuniary bequest is in fact transferred by *S* to the QDOT before the estate administration is concluded. *D*'s executor makes a QDOT election on the estate tax return for the \$700,000 in property that *S* has transferred and assigned to the QDOT. A marital deduction of \$700,000 is allowed to *D*'s estate assuming the estate tax return is filed and the QDOT election is made within the time limitation prescribed in §20.2056A-3(a). No marital deduction is allowed for the \$300,000 interest in jointly-owned property not transferred to the QDOT.

Example 2. Formula assignment. Under the terms of *D*'s will, the entire probate estate passes

outright to *S*. Prior to the date *D*'s estate tax return is filed and before the date that the QDOT election must be made, *S* establishes a QDOT and *S* executes an irrevocable assignment in which *S* assigns to the QDOT, "that portion of the gross estate necessary to reduce the estate tax to zero, taking into account all available credits and deductions." The assignment meets the requirements of paragraph (b) of this section, assuming that the QDOT is funded by the time that administration of *D*'s estate is completed.

Example 3. Jointly owned property. At the time of *D*'s death, *D* and *S* hold real property as joint tenants with right of survivorship. In accordance with section 2056(d)(1)(B), section 2040(a), and §20.2056A-8(a), 60 percent of the value of the property is included in *D*'s gross estate. *S* establishes a QDOT and, prior to the date the estate tax return is filed and before the date that the QDOT election must be made, *S* transfers a 60 percent interest in the real property to the QDOT. The transfer satisfies the requirements of paragraph (b) of this section.

Example 4. Computation of corpus portion of annuity payment. (i) At the time of *D*'s death, *D* is a participant in an employees' pension plan described in section 401(a). On *D*'s death, *D*'s spouse *S*, a resident of the United States, becomes entitled to receive a survivor's annuity of \$72,000 per year, payable monthly, for life. At the time of *D*'s death, *S* is age 60. Assume that under section 7520, the appropriate discount rate to be used for valuing annuities in the case of this decedent is 9 percent. The annuity factor at 9 percent for a person age 60 is 8.3031. The adjustment factor at 9 percent for monthly payments is 1.0406. Accordingly, the right to receive \$72,000 a year on a monthly basis is equal to the right to receive \$74,923 ($\$72,000 \times 1.0406$) on an annual basis.

(ii) The corpus portion of each annuity payment received by *S* is determined as follows. The first step is to determine the annuity factor for the number of years that would be required to exhaust a hypothetical fund that has a present value and a payout corresponding to *S*'s interest in the payments under the plan, determined as follows:

$$(A) \text{ Present value of } S\text{'s annuity:} \\ \$74,923 \times 8.3031 = \$622,093$$

$$(B) \text{ Annuity Factor for Expected Annuity Term:} \\ \$622,093/\$74,923 = 8.3031$$

(iii) The second step is to determine the number of years that would be required for *S*'s annuity to exhaust a hypothetical fund of \$622,093. The term certain annuity factor of 8.3031 falls between the annuity factors for 15 and 16 years in a 9 percent term certain annuity table (Column 1 of Table B, Publication 1457 *Alpha Volume* which may be purchased from the Superintendent of Documents, United States Government Printing Office, Washington, DC 20402). Accordingly, the expected annuity term is 16 years.

(iv) The third step is to determine the corpus amount by dividing the expected term of 16 years into the present value of the hypothetical fund as follows:

$$\text{Corpus amount of annual payment:} \\ \$622,093/16 = \$38,881$$

(v) In the fourth step, the corpus portion of each annuity payment is determined by dividing

the corpus amount of each annual payment by the annual annuity payment as follows:

$$\text{Corpus portion of each annuity payment:} \\ \$38,881/\$74,923 = .52$$

(vi) Accordingly, 52 percent of each payment to *S* is deemed to be a distribution of corpus. A marital deduction is allowed for \$622,093, the present value of the annuity as of *D*'s date of death, if either: *S* agrees to roll over the corpus portion of each payment to a QDOT and the executor files the Information Statement described in paragraph (c)(5) of this section and the Roll Over Agreement described in paragraph (c)(7) of this section; or *S* agrees to pay the tax due on the corpus portion of each payment and the executor files the Information Statement described in paragraph (c)(5) of this section and the Payment Agreement described in paragraph (c)(6) of this section.

Example 5. Transfer to QDOT subject to gift tax. *D*'s will bequeaths \$700,000 outright to *S*. The bequest qualifies for a marital deduction under section 2056(a) except that it does not pass in a QDOT. *S* creates an irrevocable trust that meets the requirements for a QDOT and transfers the \$700,000 to the QDOT. The QDOT instrument provides that *S* is entitled to all the income from the QDOT payable at least annually and that, upon the death of *S*, the property remaining in the QDOT is to be distributed to the grandchildren of *D* and *S* in equal shares. The trust instrument contains all other provisions required to qualify as a QDOT. On *D*'s estate tax return, *D*'s executor makes a QDOT election under section 2056A(a)(3). Solely for purposes of the marital deduction, the property is deemed to pass from *D* to the QDOT. *D*'s estate is entitled to a marital deduction for the \$700,000 value of the property passing from *D* to *S*. *S*'s transfer of property to the QDOT is treated as a gift of the remainder interest for gift tax purposes because *S*'s transfer creates a vested remainder interest in the grandchildren of *D* and *S*. Accordingly, as of the date that *S* transfers the property to the QDOT, a gift tax is imposed on the present value of the remainder interest. See §25.2702-1(c)(8) of this chapter exempting *S*'s transfer from the special valuation rules contained in section 2702. At *S*'s death, *S* is treated as the transferor of the property into the trust for estate tax and generation-skipping transfer tax purposes. See, e.g., sections 2036 and 2652(a)(1). The trust is not eligible for a reverse QTIP election by *D*'s estate under section 2652(a)(3) because a QTIP election cannot be made for the QDOT. This is so because the marital deduction is allowed under section 2056(a) for the outright bequest to the spouse and the spouse is then separately treated as the transferor of the property to the QDOT.

§20.2056A-5 Imposition of section 2056A estate tax.

(a) *In general.* An estate tax is imposed under section 2056A(b)(1) on the occurrence of a taxable event, as defined in section 2056A(b)(9). The tax is generally equal to the amount of estate tax that would have been imposed if the amount involved in the taxable event had been included in the decedent's taxable estate and had not

been deductible under section 2056. See section 2056A(b)(3) and paragraph (c) of this section for certain exceptions from taxable events.

(b) *Amounts subject to tax*—(1) *Distribution of principal during the spouse's lifetime.* If a taxable event occurs during the noncitizen surviving spouse's lifetime, the amount on which the section 2056A estate tax is imposed is the amount of money and the fair market value of the property that is the subject of the distribution (including property distributed from the trust pursuant to the exercise of a power of appointment), including any amount withheld from the distribution by the U.S. Trustee to pay the tax. If, however, the tax is not withheld by the U.S. Trustee but is paid by the U.S. Trustee out of other assets of the QDOT, an amount equal to the tax so paid is treated as an additional distribution to the spouse in the year that the tax is paid.

(2) *Death of surviving spouse.* If a taxable event occurs as a result of the death of the surviving spouse, the amount subject to tax is the fair market value of the trust assets on the date of the spouse's death (or alternate valuation date if applicable). See also section 2032A. Any corpus portion amounts, within the meaning of §20.2056A-4(c)(4)(i), remaining in a QDOT upon the surviving spouse's death, are subject to tax under section 2056A(b)(1)(B), as well as any residual payments resulting from a nonassignable plan or arrangement that, upon the surviving spouse's death, are payable to the spouse's estate or to successor beneficiaries.

(3) *Trust ceases to qualify as QDOT.* If a taxable event occurs as a result of the trust ceasing to qualify as a QDOT (for example, the trust ceases to have at least one U.S. Trustee), the amount subject to tax is the fair market value of the trust assets on the date of disqualification.

(c) *Distributions and dispositions not subject to tax*—(1) *Distributions of principal on account of hardship.* Section 2056A(b)(3)(B) provides an exemption from the section 2056A estate tax for distributions to the surviving spouse on account of hardship. A distribution of principal is treated as made on account of hardship if the distribution is made to the spouse from the QDOT in response to an immediate and substantial financial need relating to the spouse's health, maintenance,

education, or support, or the health, maintenance, education, or support of any person that the surviving spouse is legally obligated to support. A distribution is not treated as made on account of hardship if the amount distributed may be obtained from other sources that are reasonably available to the surviving spouse; e.g., the sale by the surviving spouse of personally owned, publicly traded stock or the cashing in of a certificate of deposit owned by the surviving spouse. Assets such as closely held business interests, real estate and tangible personalty are not considered sources that are reasonably available to the surviving spouse. Although a hardship distribution of principal is exempt from the section 2056A estate tax, it must be reported on Form 706-QDT even if it is the only distribution that occurred during the filing period. See §20.2056A-11 regarding filing requirements for Form 706-QDT.

(2) *Distributions of income to the surviving spouse.* Section 2056A(b)(3)-(A) provides an exemption from the section 2056A estate tax for distributions of income to the surviving spouse. In general, for purposes of section 2056A(b)(3)(A), the term *income* has the same meaning as is provided in section 643(b), except that income does not include capital gains. In addition, income does not include any other item that would be allocated to corpus under applicable local law governing the administration of trusts irrespective of any specific trust provision to the contrary. In cases where there is no specific statutory or case law regarding the allocation of such items under the law governing the administration of the QDOT, the allocation under this paragraph (c)(2) will be governed by general principles of law (including but not limited to any uniform state acts, such as the Uniform Principal and Income Act, or any Restatements of applicable law). Further, except as provided in this paragraph (c)(2) or in administrative guidance published by the Internal Revenue Service, income does not include items constituting income in respect of a decedent (IRD) under section 691. However, in cases where a QDOT is designated by the decedent as a beneficiary of a pension or profit sharing plan described in section 401(a) or an individual retirement account or annuity described in section 408, the proceeds of which are payable to the QDOT in the form of an annuity, any

payments received by the QDOT may be allocated between income and corpus using the method prescribed under §20.2056A-4(c) for determining the corpus and income portion of an annuity payment.

(3) *Certain miscellaneous distributions and dispositions.* Certain miscellaneous distributions and dispositions of trust assets are exempt from the section 2056A estate tax, including but not limited to the following—

(i) Payments for ordinary and necessary expenses of the QDOT (including bond premiums and letter of credit fees);

(ii) Payments to applicable governmental authorities for income tax or any other applicable tax imposed on the QDOT (other than a payment of the section 2056A estate tax due on the occurrence of a taxable event as described in paragraph (b) of this section);

(iii) Dispositions of trust assets by the trustees (such as sales, exchanges, or pledging as collateral) for full and adequate consideration in money or money's worth; and

(iv) Pursuant to section 2056A-(b)(15), amounts paid from the QDOT to reimburse the surviving spouse for any tax imposed on the spouse under Subtitle A of the Internal Revenue Code on any item of income of the QDOT to which the surviving spouse is not entitled under the terms of the trust. Such distributions include (but are not limited to) amounts paid from the QDOT to reimburse the spouse for income taxes paid by the spouse (either by actual payment or through withholding) with respect to amounts received from a nonassignable annuity or other arrangement that are transferred by the spouse to a QDOT pursuant to §20.2056A-4(c)(3); and income taxes paid by the spouse (either by actual payment or through withholding) with respect to amounts received in a lump sum distribution from a qualified plan if the lump sum distribution is assigned by the surviving spouse to a QDOT. For purposes of this paragraph (c)(3)-(iv), the amount of attributable tax eligible for reimbursement is the difference between the actual income tax liability of the spouse and the spouse's income tax liability determined as if the item had not been included in the spouse's gross income in the applicable taxable year.

§20.2056A-6 Amount of tax.

(a) *Definition of tax.* Section 2056A(b)(2) provides for the computation of the section 2056A estate tax. For purposes of sections 2056A(b)(2)-(A)(i) and (ii), in determining the tax that would have been imposed under section 2001 on the estate of the first decedent, the rates in effect on the date of the first decedent's death are used. For this purpose, the provisions of section 2001(c)(2) (pertaining to phaseout of graduated rates and unified credit) apply. In addition, for purposes of sections 2056A(b)(2)(A)(i) and (ii), *the tax which would have been imposed by section 2001 on the estate of the decedent* means the net tax determined under section 2001 or 2101, as the case may be, after allowance of any allowable credits, including the unified credit allowable under section 2010, the credit for state death taxes under section 2011, the credit for tax on prior transfers under section 2013, and the credit for foreign death taxes under section 2014. See paragraph (b)(4) of this section regarding the application of the credits under sections 2011 and 2014. In the case of a decedent non-resident not a citizen of the United States, the applicable credits are determined under section 2102. The estate tax (net of any applicable credits) imposed under section 2056A(b)(1) constitutes an estate tax for purposes of section 691(c)(2)(A).

(b) *Benefits allowed in determining amount of section 2056A estate tax—*
 (1) *General rule.* Section 2056A(b)(10) provides for the allowance of certain benefits in computing the section 2056A estate tax. Except as provided in this section, the rules of each of the credit, deduction and deferral provisions, as provided in the Internal Revenue Code must be complied with.

(2) *Treatment as resident.* For purposes of section 2056A(b)(10)(A), a noncitizen spouse is treated as a resident of the United States for purposes of determining whether the QDOT property is includible in the spouse's gross estate under chapter 11 of the Internal Revenue Code, and for purposes of determining whether any of the credits, deductions or deferral provisions are allowable with respect to the QDOT property to the estate of the spouse.

(3) *Special rule in the case of trusts described in section 2056(b)(8).* In the case of a QDOT in which the spouse's

interest qualifies for a marital deduction under section 2056(b)(8), the provisions of section 2056A(b)(10)(A) apply in determining the allowance of a charitable deduction in computing the section 2056A estate tax, notwithstanding that the QDOT is not includible in the spouse's gross estate.

(4) *Credit for state and foreign death taxes.* If the assets of the QDOT are included in the surviving spouse's gross estate for federal estate tax purposes, or would have been so includible if the spouse had been a United States resident, and state or foreign death taxes are paid by the spouse's estate with respect to the QDOT, the taxes paid by the spouse's estate with respect to the QDOT are creditable, to the extent allowable under section 2011 or 2014, as applicable, in computing the section 2056A estate tax. In addition, state or foreign death taxes previously paid by the decedent/transferor's estate are also creditable in computing the section 2056A estate tax to the extent allowable under sections 2011 and 2014. Specifically, the tax that would have been imposed on the decedent's estate if the taxable estate had been increased by the value of the QDOT assets on the spouse's death plus the amount involved in prior taxable events (section 2056A(b)(2)(A)(i)), is determined after allowance of a credit equal to the lesser of the state or foreign death tax previously paid by the decedent's estate, or the amount prescribed under section 2011(b) or 2014(b) computed based on a taxable estate increased by such amounts. Similarly, the tax that would have been imposed on the decedent's estate if the taxable estate had been increased only by the amount involved in prior taxable events (section 2056A(b)(2)(A)(ii)) is determined after allowance of a credit equal to the lesser of the state or foreign death tax previously paid by the decedent's estate, or the amount prescribed under section 2011(b) or 2014(b) computed based on a taxable estate increased by the amount involved in such prior taxable events. See paragraph (d), *Example 2*, of this section.

(5) *Alternate valuation and special use valuation—*(i) *In general.* In order to claim the benefits of alternate valuation under section 2032, or special use valuation under section 2032A, for purposes of computing the section 2056A estate tax, an election must be made on the Form 706-QDT that is

filed with respect to the balance remaining in the QDOT upon the death of the surviving spouse. In addition, the separate requirements for making the section 2032 and/or section 2032A elections under those sections and the regulations thereunder must be complied with except that, for this purpose, the surviving spouse is treated as a resident of the United States regardless of the surviving spouse's actual residency status. Solely for purposes of this paragraph (b)(5), the citizenship of the first decedent is immaterial.

(ii) *Alternate valuation.* For purposes of the alternate valuation election under section 2032, the election may not be made unless the election decreases both the value of the property remaining in the QDOT upon the death of the surviving spouse and the net amount of section 2056A estate tax due. Once made, the election is irrevocable.

(iii) *Special use valuation.* For purposes of section 2032A, the Designated Filer (in the case of multiple QDOTs) or the U.S. Trustee may elect to value certain farm and closely held business real property at its farm or business use value, rather than its fair market value, if all of the requirements under section 2032A and the applicable regulations are met, except that, for this purpose, the surviving spouse is treated as a resident of the United States regardless of the spouse's actual residency status. The total value of property valued under section 2032A in the QDOT cannot be decreased from fair market value by more than \$750,000.

(c) *Miscellaneous rules.* See sections 2056A(b)(2)(B)(i) and 2056A(b)(2)(C) for special rules regarding the appropriate rate of tax. See section 2056A(b)(2)(B)(ii) for provisions regarding a credit or refund with respect to the section 2056A estate tax.

(d) *Examples.* The rules of this section are illustrated by the following examples.

Example 1. (i) *D*, a United States citizen, dies in 1995 a resident of State X, with a gross estate of \$1,200,000. Under *D*'s will, a pecuniary bequest of \$700,000 passes to a QDOT for the benefit of *D*'s spouse *S*, who is a resident but not a citizen of the United States. *D*'s estate tax is computed as follows:

| | | |
|----------------------|--------------|------------|
| Gross estate | \$ 1,200,000 | |
| Marital Deduction | (700,000) | |
| Taxable Estate | \$ 500,000 | |
| Gross Tax | | \$ 155,800 |
| Less: Unified Credit | | (155,800) |
| Net Tax | | 0 |

(ii) *S* dies in 1997 at which time *S* is still a resident of the United States and the value of the assets of the QDOT is \$700,000. Assuming there were no taxable events during *S*'s lifetime with respect to the QDOT, the estate tax imposed under section 2056A(b)(1)(B) is \$235,000, computed as follows:

| | | |
|-----------------------------------|--------------|------------|
| <i>D</i> 's actual taxable estate | \$ 500,000 | |
| QDOT property | 700,000 | |
| Total | \$ 1,200,000 | |
| Gross Tax | | \$ 427,800 |
| Less: Unified Credit | | (192,800) |
| Net Tax | | \$ 235,000 |

| | |
|--|------------|
| Less: Tax that would have been imposed on <i>D</i> 's actual taxable estate of \$500,000 | 0 |
| Section 2056A Estate Tax | \$ 235,000 |

Example 2. (i) The facts are the same as in *Example 1*, except that *D*'s gross estate was \$2,000,000 and *D*'s estate paid \$70,000 in state death taxes to State X. *D*'s estate tax is computed as follows:

| | | |
|--|--------------|------------|
| Gross Estate | \$ 2,000,000 | |
| Marital Deduction | (700,000) | |
| Taxable Estate | \$ 1,300,000 | |
| Gross Tax | | \$ 469,800 |
| Less: Unified Credit | | 192,800 |
| State Death Tax Credit | | |
| Limitation (lesser of \$51,600 or \$70,000 tax paid) | 51,600 | (244,400) |
| Estate Tax | | \$ 225,400 |

(ii) *S* dies in 1997 at which time *S* is still a resident of the United States and the value of the assets of the QDOT is \$800,000. *S*'s estate pays \$40,000 in State X death taxes with respect to the inclusion of the QDOT in *S*'s gross estate for state death tax purposes. Assuming there were no taxable events during *S*'s lifetime with respect to the QDOT, the estate tax imposed under section 2056A(b)(1)(B) is \$ 304,800 computed as follows:

| | | |
|-----------------------------------|--------------|------------|
| <i>D</i> 's Actual Taxable Estate | \$ 1,300,000 | |
| QDOT Property | 800,000 | |
| Total | \$ 2,100,000 | |
| Gross Tax | | \$ 829,800 |
| Less: Unified Credit | | (192,800) |
| Pre-2011 section 2056A estate tax | | \$ 637,000 |

(A) State Death Tax Credit Computation:

- (1) State death tax paid by *S*'s estate with respect to the QDOT [\$40,000] plus state death tax previously paid by *D*'s estate [\$70,000] = \$110,000.
- (2) Credit limit under section 2011(b) (based on *D*'s adjusted taxable estate of \$ 2,040,000 under sections 2056A(b)(2)(A) and 2011(b)) = \$106,800.

(B) State death tax credit allowable against section 2056A estate tax (lesser of paragraph (ii)(A)(1) or (2) of this *Example 2*)

| | |
|---|------------|
| Net Tax | \$ 530,200 |
| Less: Tax that would have been imposed on <i>D</i> 's taxable estate of \$1,300,000 | 225,400 |
| Section 2056A Estate Tax | \$ 304,800 |

§20.2056A-7 Allowance of prior transfer credit under section 2013.

(a) *Property subject to QDOT election.* Section 2056(d)(3) provides special rules for computing the section 2013 credit allowed with respect to property subject to a QDOT election. In computing the credit under section 2013, the amount of the credit is determined under section 2013 and the regulations thereunder, except that—

(1) The first limitation as described in section 2013(b) and §20.2013-2 is the amount of the estate tax imposed under section 2056A(b)(1)(A), with respect to distributions during the spouse's life, and under section 2056A(b)(1)(B), with respect to the value of the QDOT assets on the spouse's death;

(2) In computing the second limitation as described in section 2013(c) and §20.2013-3, the value of the property transferred to the decedent (as defined in section 2013(d) and §20.2013-4) is deemed to be the value of the QDOT assets on the date of death of the surviving spouse. The value as so determined is not reduced by the section 2056A estate tax imposed at the time of the spouse's death; and

(3) The amount of the credit is determined without regard to the percentage limitations contained in section 2013(a).

(b) *Property not subject to QDOT election.* If property includible in a decedent's gross estate passes to a noncitizen surviving spouse (the transferee) and no deduction is allowed to the decedent's estate for that interest in property under section 2056(a) solely because the requirements of section 2056(d)(2) are not satisfied, and the transferee spouse dies with an estate that is subject to tax under section 2001 or 2101, as the case may be, any credit for tax on prior transfers allowable to the estate of the transferee spouse under section 2013 with respect to such interest in property is determined in accordance with the rules of section 2013 and the regulations thereunder, except that the amount of the credit is determined without regard to the percentage limitations contained in section 2013(a).

(c) *Example.* The application of this section may be illustrated by the following example:

Example. The facts are the same as in §20.2056A-6, *Example 2*(ii). *D*, a United States

citizen, dies in 1994, a resident of State X, with a gross estate of \$2,000,000. Under *D*'s will, a pecuniary bequest of \$700,000 passes to a QDOT for the benefit of *D*'s spouse *S*, who is a resident but not a citizen of the United States. *S* dies in 1997 at which time *S* is still a resident of the United States and the value of the assets of the QDOT is \$800,000. There were no taxable events during *S*'s lifetime. An estate tax of \$304,800 is imposed under section 2056A(b)(1)-(B). *S*'s taxable estate, including the value of the QDOT (\$800,000), is \$1,500,000.

(i) Under paragraph (a)(1) of this section, the first limitation for purposes of section 2013(b) is \$304,800, the amount of the section 2056A estate tax.

(ii) Under paragraph (a)(2) of this section, the second limitation for purposes of section 2013(c) is computed as follows:

(A) *S*'s net estate tax payable under §20.2013-3(a)(1), as modified under paragraph (a)(2) of this section, is computed as follows:

| | | |
|---------------------------------|-----------|-------------|
| Taxable estate | | \$1,500,000 |
| Gross estate tax | | 555,800 |
| Less: Unified credit | \$192,800 | |
| Credit for state death taxes | 64,400 | 257,200 |
| Pre-2013 net estate tax payable | | \$298,600 |

(B) *S*'s net estate tax payable under §20.2013-3(a)(2), as modified under paragraph (a)(2) of this section, is computed as follows:

| | | |
|------------------------------|-----------|-----------|
| Taxable estate | | \$700,000 |
| Gross estate tax | | 229,800 |
| Less: Unified credit | \$192,800 | |
| Credit for state death taxes | 18,000 | 210,800 |
| Net tax payable | | \$ 19,000 |

(C) *Second Limitation:*

| | | |
|--|-----------|------------|
| Paragraph (ii)(A) of this <i>Example</i> | \$298,600 | |
| Less: Paragraph (ii)(B) of this <i>Example</i> | 19,000 | \$ 279,600 |

(iii) Credit for tax on prior transfers = \$279,600 (lesser of paragraphs (i) or (ii) of this *Example*).

§20.2056A-8 Special rules for joint property.

(a) *Inclusion in gross estate—(1) General rule.* If property is held by the decedent and the surviving spouse of the decedent as joint tenants with right of survivorship, or as tenants by the entirety, and the surviving spouse is not a United States citizen (or treated as a United States citizen) at the time of the decedent's death, the property is subject to inclusion in the decedent's gross estate in accordance with the rules of section 2040(a) (general rule for includibility of joint interests), and section 2040(b) (special rule for includibility of certain joint interests of

husbands and wives) does not apply. Accordingly, the rules contained in section 2040(a) and §20.2040-1 govern the extent to which such joint interests are includible in the gross estate of a decedent who was a citizen or resident of the United States. Under §20.2040-1(a)(2), the entire value of jointly held property is included in the decedent's gross estate unless the executor submits facts sufficient to show that property was not entirely acquired with consideration furnished by the decedent, or was acquired by the decedent and the other joint owner by gift, bequest, devise or inheritance. If the decedent is a nonresident not a citizen of the United States, the rules of this paragraph (a)(1) apply pursuant to sections 2103, 2031, 2040(a), and 2056(d)(1)(B).

(2) *Consideration furnished by surviving spouse.* For purposes of applying section 2040(a), in determining the amount of consideration furnished by the surviving spouse, any consideration furnished by the decedent with respect to the property before July 14, 1988, is treated as consideration furnished by the surviving spouse to the extent that the consideration was treated as a gift to the spouse under section 2511, or to the extent that the decedent elected to treat the transfer as a gift to the spouse under section 2515 (to the extent applicable). For purposes of determining whether the consideration was a gift by the decedent under section 2511, it is presumed that the decedent was a citizen of the United States at the time the consideration was so furnished to the spouse. The special rule of this paragraph (a)(2) is applicable only if the donor spouse predeceases the donee spouse and not if the donee spouse predeceases the donor spouse. In cases where the donee spouse predeceases the donor spouse, any portion of the consideration treated as a gift to the donee spouse/decedent on the creation of the tenancy (or subsequently thereafter), regardless of the date the tenancy was created, is not treated as consideration furnished by the donee spouse/decedent for purposes of section 2040(a).

(3) *Amount allowed to be transferred to QDOT.* If, as a result of the application of the rules described above, only a portion of the value of a jointly-held property interest is includible in a decedent's gross estate, only that portion that is so includible may be transferred to a QDOT under section 2056(d)(2). See §20.2056A-4(b)(1) and (d), *Example 3*.

(b) *Surviving spouse becomes citizen.* Paragraph (a) of this section does not apply if the surviving spouse meets the requirements of section 2056(d)(4). For the definition of resident in applying section 2056(d)(4), see §20.0-1(b).

(c) *Examples.* The provisions of this section are illustrated by the following examples:

Example 1. In 1987, *D*, a United States citizen, purchases real property and takes title in the names of *D* and *S*, *D*'s spouse (a noncitizen, but a United States resident), as joint tenants with right of survivorship. In accordance with §25.2511-1(h)(5) of this chapter, one-half of the value of the property is a gift to *S*. *D* dies in 1995. Because *S* is not a United States citizen, the provisions of section 2040(a) are determinative of the extent to which the real property is includible in *D*'s gross estate. Because the joint tenancy was established before July 14, 1988, and under the applicable provisions of the Internal Revenue Code and regulations the transfer was treated as a gift of one-half of the property, one-half of the value of the property is deemed attributable to consideration furnished by *S* for purposes of section 2040(a). Accordingly, only one-half of the value of the property is includible in *D*'s gross estate under section 2040(a).

Example 2. The facts are the same as in *Example 1*, except that *S* dies in 1995 survived by *D* who is not a citizen of the United States. For purposes of applying section 2040(a), *D*'s gift to *S* on the creation of the tenancy is not treated as consideration furnished by *S* toward the acquisition of the property. Accordingly, since *S* made no other contributions with respect to the property, no portion of the property is includible in *S*'s gross estate.

Example 3. The facts are the same as in *Example 1*, except that *D* and *S* purchase real property in 1990 making the down payment with funds from a joint bank account. All subsequent mortgage payments and improvements are paid from the joint bank account. The only funds deposited in the joint bank account are the earnings of *D* and *S*. It is established that *D* earned approximately 60% of the funds and *S* earned approximately 40% of the funds. *D* dies in 1995. The establishment of *S*'s contribution to the joint bank account is sufficient to show that *S* contributed 40% of the consideration for the property. Thus, under paragraph §20.2040-1(a)-(2), 60% of the value of the property is includible in *D*'s gross estate.

§20.2056A-9 Designated Filer.

Section 2056A(b)(2)(C) provides special rules where more than one QDOT is established with respect to a decedent. The designation of a person responsible for filing a return under section 2056A(b)(2)(C)(i) (the Designated Filer) must be made on the decedent's federal estate tax return, or on the first Form 706-QDT that is due and is filed by its prescribed date, including extensions. The Designated Filer must be a U.S. Trustee. If the

U.S. Trustee is an individual, that individual must have a tax home (as defined in section 911(d)(3)) in the United States. At least sixty days before the due date for filing the tax returns for all of the QDOTs, the U.S. Trustee(s) of each of the QDOTs must provide to the Designated Filer all of the necessary information relating to distributions from their respective QDOTs. The section 2056A estate tax due from each QDOT is allocated on a pro rata basis (based on the ratio of the amount of each respective distribution constituting a taxable event to the amount of all such distributions), unless a different allocation is required under the terms of the governing instrument or under local law. Unless the decedent has provided for a successor Designated Filer, if the Designated Filer ceases to qualify as a U.S. Trustee, or otherwise becomes unable to serve as the Designated Filer, the remaining trustees of each QDOT must select a qualifying successor Designated Filer (who is also a U.S. Trustee) prior to the due date for the filing of Form 706-QDT (including extensions). The selection is to be indicated on the Form 706-QDT. Failure to select a successor Designated Filer will result in the application of section 2056A-(b)(2)(C).

§20.2056A-10 Surviving spouse becomes citizen after QDOT established.

(a) *Section 2056A estate tax no longer imposed under certain circumstances.* Section 2056A(b)(12) provides that a QDOT is no longer subject to the imposition of the section 2056A estate tax if the surviving spouse becomes a citizen of the United States and the following conditions are satisfied—

(1) The spouse either was a United States resident (for the definition of resident for this purpose, see §20.2056A-1(b)) at all times after the death of the decedent and before becoming a United States citizen, or no taxable distributions are made from the QDOT before the spouse becomes a United States citizen (regardless of the residency status of the spouse); and

(2) The U.S. Trustee(s) of the QDOT notifies the Internal Revenue Service and certifies in writing that the surviving spouse has become a United States citizen. Notice is to be made by filing a final Form 706-QDT on or before April 15th of the calendar year

following the year in which the surviving spouse becomes a United States citizen, unless an extension of time for filing is granted under section 6081.

(b) *Special election by spouse.* If the surviving spouse becomes a United States citizen and the spouse is not a United States resident at all times after the death of the decedent and before becoming a United States citizen, and a tax was previously imposed under section 2056A(b)(1)(A) with respect to any distribution from the QDOT before the surviving spouse becomes a United States citizen, the estate tax imposed under section 2056A(b)(1) does not apply to distributions after the spouse becomes a citizen if—

(1) The spouse elects to treat any taxable distribution from the QDOT prior to the spouse's election as a taxable gift made by the spouse for purposes of section 2001(b)(1)(B) (referring to adjusted taxable gifts), and for purposes of determining the amount of the tax imposed by section 2501 on actual taxable gifts made by the spouse during the year in which the spouse becomes a citizen or in any subsequent year;

(2) The spouse elects to treat any previous reduction in the section 2056A estate tax by reason of the decedent's unified credit (under either section 2010 or section 2102(c)) as a reduction in the spouse's unified credit under section 2505 for purposes of determining the amount of the credit allowable with respect to taxable gifts made by the surviving spouse during the taxable year in which the spouse becomes a citizen, or in any subsequent year; and

(3) The elections referred to in this paragraph (b) are made by timely filing a Form 706-QDT on or before April 15th of the year following the year in which the surviving spouse becomes a citizen (unless an extension of time for filing is granted under section 6081) and attaching notification of the election to the return.

§20.2056A-11 Filing requirements and payment of the section 2056A estate tax.

(a) *Distributions during surviving spouse's life.* Section 2056A(b)(5)(A) provides the due date for payment of the section 2056A estate tax imposed on distributions during the spouse's lifetime. An extension of not more than

6 months may be obtained for the filing of Form 706-QDT under section 6081-(a) if the conditions specified therein are satisfied. See also §20.2056A-5(c)-(1) regarding the requirements for filing a Form 706-QDT in the case of a distribution to the surviving spouse on account of hardship, and §20.2056A-2T(d)(3) regarding the requirements for filing Form 706-QDT in the case of the required annual statement.

(b) *Tax at death of surviving spouse.* Section 2056A(b)(5)(B) provides the due date for payment of the section 2056A estate tax imposed on the death of the spouse under section 2056A(b)-(1)(B). An extension of not more than 6 months may be obtained for the filing of the Form 706-QDT under section 6081(a), if the conditions specified therein are satisfied. The obtaining of an extension of time to file under section 6081(a) does not extend the time to pay the section 2056A estate tax as prescribed under section 2056A(b)(5)(B).

(c) *Extension of time for paying section 2056A estate tax—*(1) *Extension of time for paying tax under section 6161(a)(2).* Pursuant to sections 2056A(b)(10)(C) and 6161(a)(2), upon a showing of reasonable cause, an extension of time for a reasonable period beyond the due date may be granted to pay any part of the estate tax that is imposed upon the surviving spouse's death under section 2056A(b)-(1)(B) and shown on the final Form 706-QDT, or any part of any installments of such tax payable under section 6166 (including any part of a deficiency prorated to any installment under such section). The extension may not exceed 10 years from the date prescribed for payment of the tax (or in the case of an installment or part of a deficiency prorated to an installment, if later, not beyond the date that is 12 months after the due date for the last installment). Such extension may be granted by the district director or the director of the service center where the Form 706-QDT is filed.

(2) *Extension of time for paying tax under section 6161(a)(1).* An extension of time beyond the due date to pay any part of the estate tax imposed on lifetime distributions under section 2056A(b)(1)(A), or imposed at the death of the surviving spouse under section 2056A(b)(1)(B), may be granted for a reasonable period of time, not to exceed 6 months (12 months in the case of the estate tax imposed under

section 2056A(b)(1)(B) at the surviving spouse's death), by the district director or the director of the service center where the Form 706-QDT is filed.

(d) *Liability for tax.* Under section 2056A(b)(6), each trustee (and not solely the U.S. Trustee(s)) of a QDOT is personally liable for the amount of the estate tax imposed in the case of any taxable event under section 2056A(b)(1). In the case of multiple QDOTs with respect to the same decedent, each trustee of a QDOT is personally liable for the amount of the section 2056A estate tax imposed on any taxable event with respect to that trustee's QDOT, but is not personally liable for tax imposed with respect to taxable events involving QDOTs of which that person is not a trustee. However, the assets of any QDOT are subject to collection by the Internal Revenue Service for any tax resulting from a taxable event with respect to any other QDOT established with respect to the same decedent. The trustee may also be personally liable as a withholding agent under section 1461 or other applicable provisions of the Internal Revenue Code.

§20.2056A-12 Increased basis for section 2056A estate tax paid with respect to distribution from a QDOT.

Under section 2056A(b)(13), in the case of any distribution from a QDOT on which an estate tax is imposed under section 2056A(b)(1)(A), the distribution is treated as a transfer by gift for purposes of section 1015, and any estate tax paid under section 2056A(b)(1)(A) is treated as a gift tax. See §1.1015-5(c)(4) and (5) of this chapter for rules for determining the amount by which the basis of the distributed property is increased.

§20.2056A-13 Effective date.

The provisions of §§20.2056A-1 through 20.2056A-12 are effective with respect to estates of decedents dying after August 22, 1995.

Par. 7. §20.2101-1 is revised to read as follows:

§20.2101-1 Estates of nonresidents not citizens; tax imposed.

(a) *Imposition of tax.* Section 2101 imposes a tax on the transfer of the taxable estate of a nonresident who is

not a citizen of the United States at the time of death. In the case of estates of decedents dying after November 10, 1988, the tax is computed at the same rates as the tax that is imposed on the transfer of the taxable estate of a citizen or resident of the United States in accordance with the provisions of sections 2101(b) and (c). For the meaning of the terms *resident*, *nonresident*, and *United States*, as applied to a

decedent for purposes of the estate tax, see §20.0-1(b)(1) and (2). For the liability of the executor for the payment of the tax, see section 2002. For special rules as to the phaseout of the graduated rates and unified credit, see sections 2001(c)(2) and 2101(b).

(b) *Special rates in the case of certain decedents.* In the case of an estate of a nonresident who was not a citizen of the United States and who

died after December 31, 1976, and on or before November 10, 1988, the tax on the nonresident's taxable estate is computed using the formula provided under section 2101(b), except that the rate schedule in paragraph (c) of this section is to be used in lieu of the rate schedule in section 2001(c).

(c) *Rate schedule for decedents dying after December 31, 1976 and on or before November 10, 1988.*

| | |
|--|---|
| If the amount for which the tentative tax to be computed is: | The tentative tax is: |
| Not over \$100,000..... | 6% of such amount. |
| Over \$100,000 but not over \$500,000..... | \$6,000, plus 12% of excess over \$100,000. |
| Over \$500,000 but not over \$1,000,000..... | \$54,000, plus 18% of excess over \$500,000. |
| Over \$1,000,000 but not over \$2,000,000..... | \$144,000, plus 24% of excess over \$1,000,000. |
| Over \$2,000,000..... | \$384,000, plus 30% of excess over \$2,000,000. |

Par. 8. Section 20.2102-1 is amended by adding paragraph (c) to read as follows:

§20.2102-1 Estates of nonresidents not citizens; credits against tax.

* * * * *

(c) *Unified credit—(1) In general.* Subject to paragraph (c)(2) of this section, in the case of estates of decedents dying after November 10, 1988, a unified credit of \$13,000 is allowed against the tax imposed by section 2101 subject to the limitations of section 2102(c).

(2) *When treaty is applicable.* To the extent required under any treaty obligation of the United States, the estate of a nonresident not a citizen of the United States is allowed the unified credit permitted to a United States citizen or resident of \$192,800, multiplied by the proportion that the total gross estate of the decedent situated in the United States bears to the decedent's total gross estate wherever situated.

(3) *Certain residents of possessions.* In the case of a decedent who is considered to be a nonresident not a citizen of the United States under section 2209, there is allowed a unified credit equal to the greater of \$13,000, or \$46,800 multiplied by the proportion that the decedent's gross estate situated in the United States bears to the total

gross estate of the decedent wherever situated.

Par. 9. Section 20.2106-1 is amended as follows:

1. Paragraph (a)(3) is revised.
2. The last sentence of paragraph (b) is removed.
3. Paragraph (c) is removed.

The revision reads as follows:

§20.2106-1 Estates of nonresidents not citizens; taxable estate; deductions in general.

(a) * * *

(3) Subject to the special rules set forth at §20.2056A-1(c), the amount which would be deductible with respect to property situated in the United States at the time of the decedent's death under the principles of section 2056. Thus, if the surviving spouse of the decedent is a citizen of the United States at the time of the decedent's death, a marital deduction is allowed with respect to the estate of the decedent if all other applicable requirements of section 2056 are satisfied. If the surviving spouse of the decedent is not a citizen of the United States at the time of the decedent's death, the provisions of section 2056, including specifically the provisions of section 2056(d) and (unless section 2056(d)(4) applies) the provisions of section 2056A (QDOTs) must be satisfied.

* * * * *

§20.2106-2 [Amended]

Par. 10. In §20.2106-2, paragraph (c) is removed and reserved.

PART 25—GIFT TAX; GIFTS MADE AFTER DECEMBER 31, 1954

Par. 11. The authority citation for part 25 is revised to read as follows:
Authority: 26 U.S.C. 7805.

Par. 12. Section 25.2503-2 is amended as follows:

1. The first sentence in paragraph (a) is revised.
2. Paragraph (f) is added.
3. The revision and addition read as follows:

§25.2503-2 Exclusion from gifts.

(a) * * * Except as provided in paragraph (f) of this section (involving gifts to a noncitizen spouse), the first \$10,000 of gifts made to any one donee during the calendar year 1982 or any calendar year thereafter, except gifts of future interests in property as defined in §§25.2503-3 and 25.2503-4, is excluded in determining the total amount of gifts for the calendar year. * * *

* * * * *

(f) *Special rule in the case of gifts made on or after July 14, 1988, to a spouse who is not a United States citizen—(1) In general.* Subject to the special rules set forth at §20.2056A-

1(c) of this chapter, in the case of gifts made on or after July 14, 1988, if the donee of the gift is the donor's spouse and the donee spouse is not a citizen of the United States at the time of the gift, the first \$100,000 of gifts made during the calendar year to the donee spouse (except gifts of future interests) is excluded in determining the total amount of gifts for the calendar year. The rule of this paragraph (f) applies regardless of whether the donor is a citizen or resident of the United States for purposes of chapter 12 of the Internal Revenue Code.

(2) *Gifts made after June 29, 1989.* In the case of gifts made after June 29, 1989, the \$100,000 exclusion provided in paragraph (f)(1) of this section applies only if the gift in excess of the otherwise applicable annual exclusion is in a form that qualifies for the gift tax marital deduction under section 2523(a) but for the provisions of section 2523(i)(1) (disallowing the marital deduction if the donee spouse is not a United States citizen.) See §25.2523(i)-1(d), *Example 4*.

(3) *Effective date.* This paragraph (f) is effective with respect to gifts made after August 22, 1995.

Par. 13. §§25.2523(i)-1, 25.2523(i)-2 and 25.2523(i)-3 are added to read as follows:

§25.2523(i)-1 *Disallowance of marital deduction when spouse is not a United States citizen.*

(a) *In general.* Subject to §20.2056A-1(c) of this chapter, section 2523(i)(1) disallows the marital deduction if the spouse of the donor is not a citizen of the United States at the time of the gift. If the spouse of the donor is a citizen of the United States at the time of the gift, the gift tax marital deduction under section 2523(a) is allowed regardless of whether the donor is a citizen or resident of the United States at the time of the gift, subject to the otherwise applicable rules of section 2523.

(b) *Exception for certain joint and survivor annuities.* Paragraph (a) does not apply to disallow the marital deduction with respect to any transfer resulting in the acquisition of rights by a noncitizen spouse under a joint and survivor annuity described in section 2523(f)(6).

(c) *Increased annual exclusion—(1) In general.* In the case of gifts made

from a donor to the donor's spouse for which a marital deduction is not allowable under this section, if the gift otherwise qualifies for the gift tax annual exclusion under section 2503(b), the amount of the annual exclusion under section 2503(b) is \$100,000 in lieu of \$10,000. However, in the case of gifts made after June 29, 1989, in order for the increased annual exclusion to apply, the gift in excess of the otherwise applicable annual exclusion under section 2503(b) must be in a form that qualifies for the marital deduction but for the disallowance provision of section 2523(i)(1). See paragraph (d), *Example 4*, of this section.

(2) *Status of donor.* The \$100,000 annual exclusion for gifts to a non-citizen spouse is available regardless of the status of the donor. Accordingly, it is immaterial whether the donor is a citizen, resident or a nonresident not a citizen of the United States, as long as the spouse of the donor is not a citizen of the United States at the time of the gift and the conditions for allowance of the increased annual exclusion have been satisfied. See §25.2503-2(f).

(d) *Examples.* The principles outlined in this section are illustrated in the following examples. Assume in each of the examples that the donee, *S*, is *D*'s spouse and is not a United States citizen at the time of the gift.

Example 1. Outright transfer of present interest. In 1995, *D*, a United States citizen, transfers to *S*, outright, 100 shares of *X* corporation stock valued for federal gift tax purposes at \$130,000. The transfer is a gift of a present interest in property under section 2503(b). Additionally, the gift qualifies for the gift tax marital deduction except for the disallowance provision of section 2523(i)(1). Accordingly, \$100,000 of the \$130,000 gift is excluded from the total amount of gifts made during the calendar year by *D* for gift tax purposes.

Example 2. Transfer of survivor benefits. In 1995, *D*, a United States citizen, retires from employment in the United States and elects to receive a reduced retirement annuity in order to provide *S* with a survivor annuity upon *D*'s death. The transfer of rights to *S* in the joint and survivor annuity is a gift by *D* for gift tax purposes. However, under paragraph (b) of this section, the gift qualifies for the gift tax marital deduction even though *S* is not a United States citizen.

Example 3. Transfer of present interest in trust property. In 1995, *D*, a resident alien, transfers property valued at \$500,000 in trust to *S*, who is also a resident alien. The trust instrument provides that the trust income is payable to *S* at least quarterly and *S* has a testamentary general power to appoint the trust corpus. The transfer to *S* qualifies for the marital deduction under

section 2523 but for the provisions of section 2523(i)(1). Because *S* has a life income interest in the trust, *S* has a present interest in a portion of the trust. Accordingly, *D* may exclude the present value of *S*'s income interest (up to \$100,000) from *D*'s total 1995 calendar year gifts.

Example 4. Transfer of present interest in trust property. The facts are the same as in *Example 3*, except that *S* does not have a testamentary general power to appoint the trust corpus. Instead, *D*'s child, *C*, has a remainder interest in the trust. If *S* were a United States citizen, the transfer would qualify for the gift tax marital deduction if a qualified terminable interest property election was made under section 2523(f)(4). However, because *S* is not a U.S. citizen, *D* may not make a qualified terminable interest property election. Accordingly, the gift does not qualify for the gift tax marital deduction but for the disallowance provision of section 2523(i)(1). The \$100,000 annual exclusion under section 2523(i)(2) is not available with respect to *D*'s transfer in trust and *D* may not exclude the present value of *S*'s income interest in excess of \$10,000 from *D*'s total 1995 calendar year gifts.

Example 5. Spouse becomes citizen after transfer. *D*, a United States citizen, transfers a residence valued at \$350,000 on December 20, 1995, to *D*'s spouse, *S*, a resident alien. On January 31, 1996, *S* becomes a naturalized United States citizen. On *D*'s federal gift tax return for 1995, *D* must include \$250,000 as a gift (\$350,000 transfer less \$100,000 exclusion). Although *S* becomes a citizen in January, 1996, *S* is not a citizen of the United States at the time the transfer is made. Therefore, no gift tax marital deduction is allowable. However, the transfer does qualify for the \$100,000 annual exclusion.

§25.2523(i)-2 *Treatment of spousal joint tenancy property where one spouse is not a United States citizen.*

(a) *In general.* In the case of a joint tenancy with right of survivorship between spouses, or a tenancy by the entirety, where the donee spouse is not a United States citizen, the gift tax treatment of the creation and termination of the tenancy (regardless of whether the donor is a citizen, resident or nonresident not a citizen of the United States at such time), is governed by the principles of sections 2515 and 2515A (as such sections were in effect before their repeal by the Economic Recovery Tax Act of 1981). However, in applying these principles, the donor spouse may not elect to treat the creation of a tenancy in real property as a gift, as provided in section 2515(c) (prior to its repeal by the Economic Recovery Tax Act of 1981, Pub. L. 97-34, 95 Stat. 172).

(b) *Tenancies by the entirety and joint tenancies in real property—(1) Creation of the tenancy on or after July 14, 1988.* Under the principles of section 2515 (without regard to section

2515(c)), the creation of a tenancy by the entirety (or joint tenancy) in real property (either by one spouse alone or by both spouses), and any additions to the value of the tenancy in the form of improvements, reductions in indebtedness thereon, or otherwise, is not deemed to be a transfer of property for purposes of the gift tax, regardless of the proportion of the consideration furnished by each spouse, but only if the creation of the tenancy would otherwise be a gift to the donee spouse who is not a citizen of the United States at the time of the gift.

(2) *Termination*—(i) *Tenancies created after December 31, 1954 and before January 1, 1982 not subject to an election under section 2515(c), and tenancies created on or after July 14, 1988.* When a tenancy to which this paragraph (b) applies is terminated on or after July 14, 1988, other than by reason of the death of a spouse, then, under the principles of section 2515, a spouse is deemed to have made a gift to the extent that the proportion of the total consideration furnished by the spouse, multiplied by the proceeds of the termination (whether in the form of cash, property, or interests in property), exceeds the value of the proceeds of termination received by the spouse. See section 2523(i), and §§25.2523(i)-1 and §25.2503-2(f) as to certain of the tax consequences that may result upon

termination of the tenancy. This paragraph (b)(2)(i) applies to tenancies created after December 31, 1954, and before January 1, 1982, not subject to an election under section 2515(c), and to tenancies created on or after July 14, 1988.

(ii) *Tenancies created after December 31, 1954 and before January 1, 1982 subject to an election under section 2515(c) and tenancies created after December 31, 1981 and before July 14, 1988.* When a tenancy to which this paragraph (a) applies is terminated on or after July 14, 1988, other than by reason of the death of a spouse, then, under the principles of section 2515, a spouse is deemed to have made a gift to the extent that the proportion of the total consideration furnished by the spouse, multiplied by the proceeds of the termination (whether in the form of cash, property, or interests in property), exceeds the value of the proceeds of termination received by the spouse. See section 2523(i), and §§25.2523(i)-1 and 25.2503-2(f) as to certain of the tax consequences that may result upon termination of the tenancy. In the case of tenancies to which this paragraph applies, if the creation of the tenancy was treated as a gift to the noncitizen donee spouse under section 2515(c) (in the case of tenancies created prior to 1982) or section 2511 (in the case of

tenancies created after December 31, 1981 and before July 14, 1988), then, upon termination of the tenancy, for purposes of applying the principles of section 2515 and the regulations thereunder, the amount treated as a gift on creation of the tenancy is treated as consideration originally belonging to the noncitizen spouse and never acquired by the noncitizen spouse from the donor spouse. This paragraph (b)(2)(ii) applies to tenancies created after December 31, 1954, and before January 1, 1982, subject to an election under section 2515(c), and to tenancies created after December 31, 1981, and before July 14, 1988.

(3) *Miscellaneous provisions*—(i) *Tenancy by the entirety.* For purposes of this section, *tenancy by the entirety* includes a joint tenancy between husband and wife with right of survivorship.

(ii) *No election to treat as gift.* The regulations under section 2515 that relate to the election to treat the creation of a tenancy by the entirety as constituting a gift and the consequences of such an election upon termination of the tenancy (§§25.2515-2 and 25.2515-4) do not apply for purposes of section 2523(i)(3).

(4) *Examples.* The application of this section may be illustrated by the following examples:

Example 1. In 1992, A, a United States citizen, furnished \$200,000 and A's spouse B, a resident alien, furnished \$50,000 for the purchase and subsequent improvement of real property held by them as tenants by the entirety. The property is sold in 1998 for \$300,000. A receives \$225,000 and B receives \$75,000 of the sales proceeds. The termination results in a gift of \$15,000 by A to B, computed as follows:

| | |
|--|---|
| <u>\$200,000 (consideration furnished by A)</u> | X |
| \$250,000 (total consideration furnished by both spouses) | |
| | |
| \$300,000 (proceeds of termination) = \$240,000 (Proceeds of termination attributable to A.) | |
| | |
| \$240,000 – \$225,000 (proceeds received by A) = \$15,000 gift by A to B. | |

Example 2. In 1986, A purchased real property for \$300,000 and took title in the names of A and B, A's spouse, as joint tenants. Under section 2511 and §25.2511-1(h)(1) of the regulations, A was treated as making a gift of one-half of the value of the property (\$150,000) to B. In 1995, the real property is sold for \$400,000 and B receives the entire proceeds of sale. For purposes of determining the amount of the gift on termination of the tenancy under the principles of section 2515 and the regulations thereunder, the amount treated as a gift to B on creation of the tenancy under section 2511 is treated as B's contribution towards the purchase of the property. Accordingly, the termination of the tenancy results in a gift of \$200,000 from A to B determined as follows:

| | |
|--|---|
| <u>\$150,000 (consideration furnished by A)</u> | X |
| \$300,000 (total consideration deemed furnished by both spouses) | |
| | |
| \$400,000 (proceeds of termination) = \$200,000 (Proceeds of termination attributable to A.) | |
| | |
| \$200,000 – 0 (proceeds received by A) = \$200,000 gift by A to B. | |

(c) *Tenancies by the entirety in personal property where one spouse is not a United States citizen*—(1) *In general.* In the case of the creation (either by one spouse alone or by both spouses where at least one of the spouses is not a United States citizen) of a joint interest in personal property with right of survivorship, or additions to the value thereof in the form of improvements, reductions in the indebtedness thereof, or otherwise, the retained interest of each spouse, solely for purposes of determining whether there has been a gift by the donor to the spouse who is not a citizen of the United States at the time of the gift, is treated as one-half of the value of the joint interest. See section 2523(i) and §§25.2523(i)-1 and 25.2503-2(f) as to certain of the tax consequences that may result upon creation and termination of the tenancy.

(2) *Exception.* The rule provided in paragraph (c)(1) of this section does not apply with respect to any joint interest in property if the fair market value of the interest in property (determined as if each spouse had a right to sever) cannot reasonably be ascertained except by reference to the life expectancy of one or both spouses. In these cases, actuarial principles may need to be resorted to in determining the gift tax consequences of the transaction.

§25.2523(i)-3 *Effective date.*

The provisions of §§25.2523(i)-1 and 25.2523(i)-2 are effective in the case of gifts made after August 22, 1995.

Par. 14. In §25.2702-1, paragraph (c)(8) is added to read as follows:

§25.2702-1 *Special valuation rules in the case of transfers of interests in trust.*

* * * * *

(c) * * *

(8) *Transfer or assignment to a Qualified Domestic Trust.* A transfer or assignment (as described in section 2056(d)(2)(B)) by a noncitizen surviving spouse of property to a Qualified Domestic Trust under the circumstances described in §20.2056A-4(b) of this chapter, where the surviving spouse retains an interest in the transferred property that is not a qualified interest and the transfer is not described in section 2702(a)(3)(A)(ii) or 2702(c)(4).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 15. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 16. In §602.101, paragraph (c) is amended by adding entries in numerical order in the table to read as follows:

§602.101 *OMB Control numbers.*

* * * * *

(c) * * *

| CFR part or section where identified and described | Current OMB control number |
|--|----------------------------|
|--|----------------------------|

* * * * *

| | |
|-------------|-----------|
| 20.2056A-3 | 1545-1360 |
| 20.2056A-4 | 1545-1360 |
| 20.2056A-10 | 1545-1360 |

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved December 21, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 21, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 22, 1995, 60 F.R. 43531)

Section 2056A.—Qualified Domestic Trust

26 CFR 20.2056A-2T: *Requirements for qualified domestic trust (temporary).*

T.D. 8613

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 20 and 602

Requirements to Ensure Collection of Section 2056A Estate Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance relating to the additional requirements necessary to ensure the collection of the estate tax imposed under section 2056A(b) with respect to taxable events involving qualified domestic trusts (QDOTs) described in section 2056A(a). The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [PS-25-94, page 502, this Bulletin].

DATES: These regulations are effective August 22, 1995.

These regulations apply to estates of decedents dying after February 19, 1996.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1443.

For further information concerning this collection of information, and where to submit comments on the collections of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in *** [PS-25-94, page 502, this Bulletin].

Background

This document contains amendments to the Estate Tax Regulations (26 CFR part 20) under section 2056A of the Internal Revenue Code of 1986 (Code). Section 2056A was added by section 5033 of the Technical and Miscellaneous Revenue Act of 1988. These temporary regulations provide additional requirements that must be satisfied in order for a trust to qualify as a QDOT. The requirements are necessary to ensure the collection of the section

2056A estate tax that is imposed upon any distribution of principal from the QDOT, upon the death of the surviving spouse, or if the trust ceases to qualify as a QDOT.

Explanation of Provisions

Section 2056A(a)(2) authorizes the Secretary to promulgate regulations that will ensure the collection of the estate tax imposed under section 2056A(b). In accordance with this grant of regulatory authority, a notice of proposed rulemaking was published in the Federal Register (58 FR 305 [PS-102-88, 1993-1 C.B. 885]), on January 5, 1993. The Service received written comments on the proposed regulations and, on April 2, 1993, held a public hearing on the regulations. After consideration of all written and oral comments received, it was determined to issue these regulations as temporary and proposed regulations in order to obtain additional public comment with respect to the additional requirements necessary to ensure collection of the section 2056A estate tax in view of the significant number of changes made from the text of the proposed regulations. The remainder of the proposed regulations under section 2056A have been adopted as final regulations in TD 8612 [page 00, this Bulletin].

Under §20.2056A-2(d)(1) of the proposed regulations, if the fair market value of the assets of the QDOT at the death of the decedent exceeds \$2 million, the trust instrument must require that: (1) at least one trustee be a bank as defined in section 581 or (2) the trustee furnish a bond or security to the IRS in an amount equal to 65 percent of the fair market value of the trust corpus, determined as of the date of the decedent's death. The proposed regulations further provide that if the fair market value of the QDOT assets at the date of the decedent's death is \$2 million or less, the QDOT need not meet the "bank" or "bond" requirement if, as an alternative, the trust instrument expressly provides that no more than 35 percent of the fair market value of the trust assets, determined annually, may be invested in real property that is not located in the United States.

Numerous comments were received regarding these additional regulatory requirements for qualification as a QDOT. Several commentators suggested that requiring the estate to post

a bond or appoint a bank as trustee in all cases where trust assets exceed \$2 million imposed a burden on these trusts that was expensive and unnecessary. These commentators indicated that the Service's interest in ensuring collection of the section 2056A estate tax would be adequately protected, regardless of the value of the QDOT assets, if either a bank is acting as a trustee, the estate posts a bond, or the trust instrument prohibits investment in foreign real property in excess of the permissible limits. Thus, in the view of these commentators, a trust consisting entirely of liquid assets, regardless of value, would require no special security mechanisms to ensure collection of the section 2056A estate tax (inasmuch as the QDOT would not own any foreign real property). These recommendations have not been adopted.

The temporary regulations generally retain the framework contained in the proposed regulations. The legislative history underlying the enactment of section 2056A expresses Congress' concerns regarding the ability to collect the section 2056A estate tax and contains a clear directive to require appropriate security mechanisms to ensure collection. H.R. Rep. No. 795, 100th Cong. 2d Sess. 592 (July 26, 1988). Thus, the provisions in the proposed regulations requiring a surety arrangement or a bank trustee if the trust is sufficiently large, or contains significant foreign real property, have been retained, because it is believed that these requirements best effectuate the Congressional mandate. With respect to such QDOTs, collection of the section 2056A estate tax can not be adequately assured in the absence of special security measures. Further, it is believed that the \$2 million threshold for imposing additional security requirements equitably balances the interests of the Government with the financial constraints of smaller QDOTs.

However, many revisions have been made in the temporary regulations that are intended to provide flexibility and guidance and to alleviate any undue burden attributable to the special security requirements.

In response to comments that the bank trustee provision contained in §20.2056A-2(d)(1)(i)(A) of the proposed regulations (requiring a bank described in section 581 to act as the U.S. Trustee) discriminates against foreign banks, the temporary regulations provide that a United States branch of

a foreign bank may satisfy the bank trustee requirement, provided that the trust instrument names at least one United States Trustee to serve as co-trustee of the QDOT at all times during the administration of the QDOT.

Another commentator suggested that an individual attorney be authorized to act as the U.S. Trustee in lieu of a United States bank in order to satisfy the "bank trustee" requirement. The comment reflects a historical practice in certain localities of an attorney serving as professional trustee of substantial trusts with the backing of the financial resources of the attorney's law firm. This alternative proposal is not incorporated in the temporary regulations. Under the procedures provided in §20.2056A-2T(d)(4), the IRS is considering whether an arrangement may qualify as an alternate security arrangement where an attorney (or firm) actively engaged in the administration of estates and trusts acts as trustee and has individually, and with the other members of the attorney's firm, sufficient assets under management. During the period prior to the publication of guidance in the Internal Revenue Bulletin regarding alternate plans or arrangements, the IRS will accept letter ruling requests as to suitable alternate arrangements.

Section 20.2056A-2(d)(2) of the proposed regulations provides that if the U.S. Trustee is an individual United States citizen, the individual must have a tax home, as defined in section 911(d)(3), in the United States. Comments have been received suggesting that this requirement should be deleted since many attorneys, executives, and other individuals that would be willing to serve as the U.S. Trustee are resident abroad in the conduct of their business. This change has not been made. In order to assure collection of the section 2056A estate tax, the U.S. Trustee must be subject to United States judicial process at all times during the administration of the trust.

The sections of the proposed regulations discussing security arrangements with respect to QDOTs in excess of \$2 million have been substantially modified in the temporary regulations. As noted above, the proposed regulations provided for the posting of a bond as an alternative to employing a bank as the QDOT U.S. Trustee. However, it was recognized that in certain situations, because of statutory restrictions and logistical concerns with monitoring

cancellation of the surety arrangement, other security arrangements might be more desirable.

Accordingly, to address these concerns §20.2056A-2T(d)(1)(i)(C) specifically authorizes letters of credit, in lieu of providing a bank trustee or bond, as a permissible security arrangement. The letter of credit may be issued by a bank described in section 581 or a U.S. branch of a foreign bank. Alternatively, the letter of credit may be issued by a foreign bank and confirmed by a bank described in section 581. Section 20.2056A-2T(d)(1)(i)(B) and (C) contain specific guidelines outlining the terms of the bond and letter of credit required, and provide a sample format for each. In general, the bond or letter of credit must be for a term of at least one year and must be automatically renewable at the expiration of the term, on an annual basis thereafter, unless the IRS is notified at least 60 days prior to the expiration of the term (including periods of automatic renewals) that the security will not be renewed. The IRS will treat the notice of failure to renew as a taxable event and draw on the instrument, unless an alternative form of security is substituted.

Further, under the temporary regulations, if the bond or letter of credit security arrangement is used, the QDOT must provide that if the IRS draws on the bond or letter of credit, neither the U.S. Trustee nor any other person will seek a return of the funds until after April 15th of the following calendar year, the date the Form 706QDT reporting a taxable event would ordinarily be due. This requirement is intended to ensure that the IRS will be able to retain any funds drawn upon since, after the due date of the return, the IRS would have the ability to make a jeopardy assessment under section 6861, if appropriate. The IRS is contemplating the development of internal procedures whereby the taxpayer may request review of the IRS's decision to draw upon the bond or letter of credit. In addition, prior to drawing on the bond or letter of credit, the IRS will make every effort to contact the parties to verify that the action is appropriate under the circumstances.

In addition, if the bond or letter of credit security arrangement is employed, and if it is finally determined that the fair market value of the QDOT assets is in excess of the value as originally reported on the return,

then the U.S. Trustee is accorded a reasonable period of time to increase the bond or letter of credit to the requisite amount. However, §20.2056A-2T(d)(1)(i)(D) provides that if the QDOT assets are undervalued by 50 percent or more, the marital deduction will be disallowed unless a good faith reasonable cause standard is satisfied. This provision ensures that the QDOT will be adequately secured and discourages egregious undervaluations of the QDOT assets. A similar rule is provided in §20.2056A-2T(d)(1)(ii) with respect to the \$2 million threshold for providing additional security arrangements.

Comments were received suggesting that, for purposes of determining the \$2 million threshold under §20.2056A-2(d)(1) of the proposed regulations, the value of the surviving spouse's residence should be excluded. It has also been suggested that the surviving spouse's residence be excluded from both the bond and the foreign real property requirements of the regulations. It is recognized that if a significant portion of the trust value consists of the surviving spouse's principal residence, an asset that will normally generate no income, the costs associated with the posting of the bond, providing a letter of credit or employing an institutional trustee to manage the trust's assets may be burdensome. However, in cases involving any real property, regardless of use, situated outside the United States, a significant collection risk is presented in the absence of the additional security measures required under the regulations.

Accordingly, §20.2056A-2T(d)(1)(iii) provides that the value (measured at the decedent's death) attributable to the surviving spouse's principal residence (within the meaning of section 1034) wherever situated (and related furnishings), up to an aggregate value of \$600,000, may be excluded for purposes of determining if the \$2 million threshold is exceeded. In addition, the temporary regulations provide that the value of the principal residence (and related furnishings), wherever situated, up to an aggregate value of \$600,000, may be excluded for purposes of determining the amount of the bond or letter of credit (if required). However, the value of the principal residence (and related furnishings) will continue to be included in determining, with respect to QDOTs of less than \$2

million, whether the 35 percent foreign real property threshold under §20.2056A-2T(d)(1)(ii) has been exceeded.

Under §20.2056A-2T(d)(1)(iii), the term *related furnishings* includes standard furniture and commonly included items such as appliances, fixtures, decorative items, and china, that are not beyond the value associated with normal household and decorative use. Rare artwork, valuable antiques, and automobiles of any kind or class, are not included within the meaning of this term. Further, the principal residence exclusion ceases to apply if the property ceases to be used as a principal residence, or the residence is sold and the "adjusted sales price" (as defined in section 1034(b)(1)) is not reinvested within twelve months thereafter in another principal residence. If the principal residence exclusion applies, the U.S. Trustee must file an annual statement as provided in §20.2056A-2T(d)(3). Upon cessation of qualification for the exclusion, the U.S. Trustee must, within 120 days thereafter, bring the trust into full compliance with §20.2056A-2T(d)(1)(i) or (ii), whichever is applicable (determined as if the principal residence exclusion had not been applicable to the estate).

Section 20.2056A-2T(d)(1)(ii) clarifies that the \$2 million threshold is determined without regard to any indebtedness with respect to the assets comprising the QDOT. It is not necessary to know at the time a QDOT agreement is executed whether the QDOT will exceed the \$2 million threshold or whether the QDOT will be \$2 million or less and thus eligible to meet the 35 percent foreign real property requirement. A QDOT agreement will satisfy the requirements of the temporary regulations by stating the regulations' requirements in the alternative and leaving the determination as to which requirements apply to the particular QDOT to be determined at the date of death (or the alternate valuation date, if applicable).

In response to comments, the look-through rule contained in §20.2056A-2(d)(1)(ii)(B) of the proposed regulations has been revised to apply only to trusts with less than \$2 million in assets that seek QDOT qualification by satisfying the 35 percent foreign real property requirement, (as opposed to posting a bond or providing a letter of credit, or utilizing a bank trustee). The look-through rule will not apply if an

alternative security arrangement is provided.

A comment was made that the look-through rule should only apply when a QDOT that owns stock in a corporation with 15 or fewer shareholders, or an interest in a partnership with 15 or fewer partners, has a controlling interest in the entity. This suggestion has not been adopted. The regulation focuses on the number of shareholders or partners in the entity because the fewer the number of shareholders or partners, the more likely that the entity may be a family holding company created for the purpose of avoiding the QDOT security rules. The control that the QDOT may be able to exert over the entity is not the primary concern. However, a *de minimis* rule is adopted to avoid application of the look-through rule under certain circumstances. Accordingly, the temporary regulations provide that the look-through rule only applies if the QDOT owns (including interests that it is deemed to own) more than 20% of the voting interest or value in the corporation or more than a 20% capital interest in the partnership.

Comments were received that the anti-abuse rule contained in §20.2056A-2(d)(1)(iii) of the proposed regulations was overly broad. It has been determined that the breadth of the rule is necessary to ensure collection of the tax and, therefore, the rule as proposed is not modified.

Comments have been received recommending elimination of the rule under §20.2056A-2(d)(3) of the proposed regulations, requiring that personal property and written evidence of intangible personal property must be physically located in the United States at all times during the term of the QDOT. These comments noted that domestic brokerage companies often provide for custody of foreign securities outside of the United States to facilitate sale of the securities. This practice would make it difficult, if not impossible, for QDOTs to comply with the intangible personal property rule. In light of these comments, the requirement that tangible and intangible personal property be located in the United States has been deleted from the temporary regulations.

Section 20.2056A-2(d)(4) of the proposed regulations requires the U.S. Trustee to file an annual statement with the IRS providing certain information and summarizing the assets held by the QDOT and the fair market value of

each asset. Comments were received recommending that the annual statement requirement should not apply if the bank or bond requirement is satisfied. Additionally, the commentators recommended that annual filing should be required only if the QDOT holds foreign real property. After fully considering these comments, it was determined that modifications to the annual reporting requirement were warranted. Under §20.2056A-2T(d)(3), the annual statement is required to be filed only in cases where: (1) the QDOT directly (before application of the look-through rule) owns foreign real property (unless the bank, bond, or letter of credit security requirement is met); (2) the principal residence exclusion applies, regardless of the situs of the residence or whether the bank, bond, or letter of credit requirement is met; or (3) after applying the look-through rule (as limited in application by the temporary regulations), the QDOT is treated as owning any foreign real property. Additional rules apply if the principal residence exclusion ceases to apply or the residence is sold. In addition, the temporary regulations have been modified to provide that the annual statement is to be filed with the Form 706-QDT rather than with the Form 1041 as provided in the proposed regulations. This change was necessary because not all QDOTs are required to file Form 1041.

Comments have also been received recommending that the IRS provide specific examples of acceptable alternate arrangements and situations justifying a waiver under §20.2056A-2(d)(5) of the proposed regulations. The IRS intends to provide guidance to be published in the Internal Revenue Bulletin on this subject. As noted above, until such guidance is published, the IRS will accept requests for letter rulings on acceptable alternate arrangements.

In general, these regulations are effective with respect to estates of decedents dying after the date that is 180 days after the date these regulations are published in the Federal Register. In order for a trust subject to these regulations to qualify as a QDOT, the trust must contain the governing instrument requirements of §20.2056A-2T(d)(1)(i) and (ii) at the time of death, or be reformed, pursuant to the terms of the governing instrument, or judicially under section 2056(d)(5). However, in response to comments, special

transitional rules in the case of incompetency and in the case of certain irrevocable trusts have been added pursuant to which a trust is deemed to meet the governing instrument requirements of §20.2056A-2T(d)(1)(i) and (ii) even though such requirements are not contained in the governing instrument, providing certain requirements are met.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 20 and 602 are amended as follows:

PART 20—ESTATE TAXES; ESTATES OF DECEDENTS DYING AFTER AUGUST 14, 1954

Paragraph 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. Section 20.2056A-2T is added to read as follows:

§20.2056A-2T Requirements for qualified domestic trust (temporary).

(a) through (c) [Reserved] For further guidance see §20.2056A-2(a) through (c).

(d) *Additional requirements to ensure collection of the section 2056A estate tax—(1) Security and other arrangements for payment of estate tax imposed under section 2056A(b)(1)—(i) QDOTs with assets in excess of \$2*

million. If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, exceeds \$2 million as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iii) of this section), the trust instrument must meet the requirements of either paragraph (d)(1)(i)(A), (B), or (C) of this section at all times during the term of the QDOT. The QDOT may alternate between any of the arrangements provided in paragraphs (d)(1)(i)(A), (B), and (C) of this section provided that, at any given time, at least one of the arrangements is in effect.

(A) *Bank Trustee.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must require that during the entire term of the QDOT, at least one U.S. Trustee be a bank, as defined in section 581. Alternatively, the trust instrument must, except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, require that during the entire term of the QDOT, at least one trustee be a United States branch of a foreign bank, provided that the trust instrument must also require that, during the entire term of the QDOT, a U.S. Trustee act as a trustee with such foreign bank trustee.

(B) *Bond.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must require that the U.S. Trustee furnish a bond in favor of the Internal Revenue Service in an amount equal to 65 percent of the fair market value of the trust assets (without regard to any indebtedness thereon) as of the date of

the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iii) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee shall have a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the bond accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the bond must remain in effect until the termination of the trust and the payment of any tax liability finally determined to be due under section 2056A(b).

(1) *Requirements with respect to the bond.* The bond must be with a satisfactory surety, as prescribed under section 7101 and §301.7101-1 of this chapter (Regulations on Procedure and Administration), and shall be subject to Internal Revenue Service review as may be prescribed by the Commissioner. The bond may not be cancelled. The bond must be for a term of at least one year and must be automatically

renewable at the end of such term, on an annual basis thereafter, unless notice of failure to renew is received by the IRS at least 60 days prior to the end of the term, including periods of automatic extensions. Any notice of failure to renew must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the decedent's estate (Internal Revenue Service, District Director, [specify location] District Office, Estate and Gift Tax Examination Group, [specify Street Address, City, State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate and Gift Tax Examination Group, Assistant Commissioner (International), CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Service will not draw on the bond if, within 30 days of receipt of the notice of failure to renew, the U.S. Trustee notifies the Service (at the same address to which notice of failure to renew is to be sent) that an alternate arrangement under paragraphs (d)(1)(i)(A), (B), or (C) of this section has been secured and that such arrangement will take effect immediately prior to or upon expiration of the bond.

(2) *Form of bond.* The bond must be in the following form (or in a form that is the same as the following form in all material respects), or in such alternative form as the Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter):

Bond in Favor of the Internal Revenue Service To Secure Payment of Section 2056A Estate Tax Imposed Under Section 2056A(b) of the Internal Revenue Code.

KNOW ALL PERSONS BY THESE PRESENTS, That the undersigned, _____ the SURETY, and _____, the PRINCIPAL, are irrevocably held and firmly bound to pay the Internal Revenue Service upon written demand that amount of any tax up to \$[amount determined under paragraph (d)(1)(i)(B) of this section], imposed under section 2056A(b)(1) of the Internal Revenue Code (including penalties and interest on said tax) determined by the Internal Revenue Service to be payable with respect to the principal as trustee for: [Identify trust and governing instrument, name and address of trustee], a qualified domestic trust as defined in section 2056A(a) of the Internal Revenue Code, for the payment of which the said Principal and said Surety, bind themselves, their heirs, executors, administrators, successors and assigns, jointly and severally, firmly by these presents.

WHEREAS, The Internal Revenue Service may demand payment under this bond at any time if the Internal Revenue Service in its sole discretion determines that a taxable event with respect to the trust has occurred; the trust no longer qualifies as a qualified domestic trust as described in section 2056A(a) of the Internal Revenue Code and the regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) has been made. Demand by the Internal Revenue Service for payment may be made whether or not the tax and tax return (Form 706-QDT) with respect to the taxable event is due at the time of such demand, or an assessment has been made by the Internal Revenue Service with respect to such tax.

NOW THEREFORE, The condition of this obligation is such that it shall not be cancelled and, if payment of all tax liability finally determined to be imposed under section 2056A(b) is made, then this obligation shall be null and void; otherwise, this obligation is to remain in full force and effect for one year from its effective date and is to be automatically renewable on an annual basis unless, at least 60 days prior to the expiration date, including periods of automatic renewals, the surety notifies the Internal Revenue Service by Registered or Certified Mail, return receipt requested, of such failure to renew. Receipt of such notice of failure to renew may be considered a taxable event unless an alternate security arrangement is obtained by the trustee prior to the date of expiration and the Trustee notifies the Internal Revenue Service of such alternate security arrangement. The surety shall remain liable for all taxable events occurring prior to the date of expiration. All notices required under this instrument should be sent to District Director, [specify location] District Office, Estate and Gift Tax Examination Group, Street Address, City, State, Zip Code. (In the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States, all notices should be sent to Estate and Gift Tax Examination Group, Assistant Commissioner (International), CP:IN:D:C:EX:HQ:1114, Washington, DC 20024).

This bond shall be effective as of _____.

Principal _____ Date _____

Surety _____ Date _____

(3) *Additional governing instrument requirements.* The trust instrument must also provide that in the event the Internal Revenue Service draws on the bond, in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until April 15th of the calendar year following the year in which the bond is drawn upon. After such date, any such remittance will be treated as a deposit and will be returned (without interest) upon request of the U.S. Trustee, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706-QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(4) *Procedure.* The bond is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the bond is granted under §301.9100 of this chapter. The U.S. Trustee must provide a written statement with the bond that provides a list of the assets that will be used to fund the QDOT and the respective values of such assets. The written statement must also indicate whether

any exclusions under paragraph (d)(1)-(iii) of this section are claimed.

(C) *Letter of credit.* Except as otherwise provided in paragraph (d)(6)(ii) or (iii) of this section, the trust instrument must require that the U.S. Trustee furnish an irrevocable letter of credit issued by a bank, as defined in section 581, issued by a United States branch of a foreign bank, or issued by a foreign bank and confirmed by a bank as defined in section 581, in an amount equal to 65 percent of the fair market value of the trust assets (without regard to any indebtedness thereon) as of the date of the decedent's death (or alternate valuation date, if applicable), as finally determined for federal estate tax purposes (and as further adjusted as provided in paragraph (d)(1)(iii) of this section). If, after examination of the estate tax return, the fair market value of the trust assets, as originally reported on the estate tax return, is adjusted (pursuant to a judicial proceeding or otherwise) resulting in a final determination of the value of the assets as reported on the return, the U.S. Trustee shall have a reasonable period of time (not exceeding 60 days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to adjust the amount of the letter of credit accordingly. But see, paragraph (d)(1)(i)(D) of this section for a special rule in the case of a substantial undervaluation of QDOT

assets. Unless an alternate arrangement under paragraph (d)(1)(i)(A), (B), or (C) of this section, or an arrangement prescribed under paragraph (d)(4) of this section, is provided, or the trust is otherwise no longer subject to the requirements of section 2056A pursuant to section 2056A(b)(12), the letter of credit must remain in effect until the termination of the trust and the payment of any tax liability finally determined to be due under section 2056A(b).

(I) *Requirements with respect to letter of credit.* The letter of credit shall be irrevocable and provide for sight payment. The letter of credit must be for a term of at least one year and must be automatically renewable at the end of such term, at least on an annual basis, unless notice of failure to renew is received by the Internal Revenue Service at least sixty days prior to the end of the term, including periods of automatic renewals. If the letter of credit is issued by the U.S. branch of a foreign bank and such U.S. branch is closing, the branch (or foreign bank) must notify the Internal Revenue Service of such closure and the notice of closure must be received at least 60 days prior to the date of closure. Any notice of failure to renew or closure of a U.S. branch of a foreign bank must be sent to the Estate and Gift Tax Group in the District Office of the Internal Revenue Service that has examination jurisdiction over the dece-

dent's estate (Internal Revenue Service, District Director, [specify location] District Office, Estate and Gift Tax Examination Group, [Street Address, City State, Zip Code]) (or in the case of noncitizen decedents and United States citizens who die domiciled outside the United States, Estate and Gift Tax Examination Group, Assistant Commissioner (International), CP:IN:D:C:EX:HQ:1114, Washington, DC 20024). The Internal Revenue

Service will not draw on the letter of credit if, within 30 days of receipt of the notice of failure to renew or closure of the U.S. branch of a foreign bank, the U.S. Trustee notifies the Service (at the same address to which notice is to be sent) that an alternate arrangement under paragraph(d)(1)(i)(A), (B), or (C) of this section has been secured and that such arrangement will take effect immediately prior to or upon expiration

of the letter of credit or closure of the U.S. branch of the foreign bank.

(2) *Form of letter of credit.* The letter of credit shall be made in the following form (or in a form that is the same as the following form in all material respects), or such alternative form as the Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service

Attention: District Director, [specify location] District Office
Estate and Gift Tax Examination Group
[Street Address, City, State, ZIP Code]

[Or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate and Gift Tax Examination Group,
Assistant Commissioner (International)
CP:IN:D:C:EX:HQ:1114
Washington, DC 20024].

Dear Sirs:

We hereby establish our irrevocable Letter of Credit No. _____ in your favor for drawings up to U.S. \$ [Applicant should provide bank with amount which Applicant determined under paragraph (d)(1)(i)(C)] effective immediately. This Letter of Credit is issued, presentable and payable at our office at _____ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _____ at said office.

For information and reference only, we are informed that this Letter of Credit relates to [Applicant should provide bank with the identity of qualified domestic trust and governing instrument], and the name, address, and identifying number of the trustee is [Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any].

Drawings on this Letter of Credit are available upon presentation of the following documents:

1. Your draft drawn at sight on us bearing our Letter of Credit No. _____; and
2. Your signed statement as follows:

The amount of the accompanying draft is payable under [identify bank] irrevocable Letter of Credit No. _____ pursuant to section 2056A of the Internal Revenue Code and the regulations promulgated thereunder, because the Internal Revenue Service in its sole discretion has determined that a "taxable event" with respect to the trust has occurred; e.g., the trust no longer qualifies as a qualified domestic trust as described in section 2056A of the Internal Revenue Code and regulations promulgated thereunder, or a distribution subject to the tax imposed under section 2056A(b)(1) of the Internal Revenue Code has been made.

Except as expressly stated herein, this undertaking is not subject to any agreement, requirement or qualification. The obligation of [Name of Issuing Bank] under this Letter of Credit is the individual obligation of [Name of Issuing Bank] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Letter of Credit that it is deemed to be automatically extended without amendment for a period of one year from the expiry date hereof, or any future expiration date, unless at least 60 days prior to any expiration date, we send to you notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your address indicated above, that we elect not to consider this Letter of Credit renewed for any such additional period. Upon receipt of such notice, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

[In the case of a letter of credit issued by a U.S. branch of a foreign bank the following language must be added]. It is a further condition of this Letter of Credit that if the U.S. branch of [name of foreign bank] is to be closed, that at least sixty days prior to such closing, we send you notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your address indicated above, that this branch will be closing. Such notice will specify the actual date of closing. Upon receipt of such notice, you may draw hereunder on or before the date of closure, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Letter of Credit is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Letter of Credit renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Letter of Credit is drawn against within 30 days after the resumption of business.

Except as stated herein, this Letter of Credit cannot be modified or revoked without your consent.

Authorized Signature _____ Date _____

(3) *Form of confirmation.* If the requirements of this paragraph (d)(1)(i)(C) are satisfied by the issuance of a letter of credit by a foreign bank confirmed by a bank as defined in section 581, the confirmation shall be made in the following form (or in a form that is the same as the following form in all material respects), or such alternative form as the Commissioner may prescribe by guidance published in the Internal Revenue Bulletin (see §602.101(d)(2) of this chapter):

[Issue Date]

To: Internal Revenue Service

Attention: District Director, [specify location]
District Office
Estate and Gift Tax Examination Group
[State Address, City, State, ZIP Code]

[or in the case of nonresident noncitizen decedents and United States citizens who die domiciled outside the United States,

To: Estate and Gift Tax Examination Group,
Assistant Commissioner (International)
CP:IN:D:C:EX:HQ:1114
Washington, DC 20024].

Dear Sirs:

We hereby confirm the enclosed irrevocable Letter of Credit No. _____, and amendments thereto, if any, in your favor by _____ [Issuing Bank] for drawings up to U.S. \$_____ [same amount as in initial Letter of Credit] effective immediately. This confirmation is issued, presentable and payable at our office at _____ and expires at 3:00 p.m. [EDT, EST, CDT, CST, MDT, MST, PDT, PST] on _____ at said office.

For information and reference only, we are informed that this Confirmation relates to [Applicant should provide bank with the identity of qualified domestic trust and governing instrument], and the name, address, and identifying number of the trustee is [Applicant should provide bank with the trustee name, address and the QDOT's TIN number, if any].

We hereby undertake to honor your sight draft(s) drawn as specified in the Letter of Credit.

Except as expressly stated herein, this undertaking is not subject to any agreement, condition or qualification. The obligation of [Name of Confirming Bank] under this Confirmation is the individual obligation of [Name of Confirming Bank] and is in no way contingent upon reimbursement with respect thereto.

It is a condition of this Confirmation that it is deemed to be automatically extended without amendment for a period of one year from the expiry date hereof, or any future expiration date, unless at least sixty days prior to any expiration date, we send to you notice by Registered Mail or Certified Mail, return receipt requested, or by courier to your address indicated above, that we elect not to consider this Confirmation renewed for any such additional period. Upon receipt of such notice, you may draw hereunder on or before the then current expiration date, by presentation of your draft and statement as stipulated above.

Except where otherwise stated herein, this Confirmation is subject to the Uniform Customs and Practice for Documentary Credits, 1993 Revision, ICC Publication No. 500. If we notify you of our election not to consider this Confirmation renewed and the expiration date occurs during an interruption of business described in Article 17 of said Publication 500, unless you had consented to cancellation prior to the expiration date, the bank hereby specifically agrees to effect payment if this Confirmation is drawn against within 30 days after the resumption of business.

Except as stated herein, this Confirmation cannot be modified or revoked without your consent.

Authorized Signature _____

Date _____

(4) *Additional governing instrument requirements.* The trust instrument must also provide that in the event that the Internal Revenue Service draws on the letter of credit (or confirmation) in accordance with its terms, neither the U.S. Trustee nor any other person will seek a return of any part of the remittance until April 15th of the calendar year following the year in which the letter of credit (or confirmation) is drawn upon. After such date, any such remittance will be treated as a deposit and will be returned (without interest) upon request of the U.S. Trustee after the date specified above, unless it is determined that assessment or collection of the tax imposed by section 2056A(b)(1) is in jeopardy, within the meaning of section 6861. If an assessment under section 6861 is made, the remittance will first be credited to any tax liability reported on the Form 706-QDT, then to any unpaid balance of a section 2056A(b)(1)(A) tax liability (plus interest and penalties) for any prior taxable years, and any balance will then be returned to the U.S. Trustee.

(5) *Procedure.* The letter of credit (and confirmation, if applicable) is to be filed with the decedent's federal estate tax return, Form 706 or 706NA (unless an extension for filing the letter of credit is granted under §301.9100 of this chapter). The U.S. Trustee must provide a written statement with the letter of credit that provides a list of the assets that will be used to fund the QDOT and the respective values of such assets. The written statement must also indicate whether any exclusions under paragraph (d)(1)(iii) of this section are claimed.

(D) *Disallowance of marital deduction in case of substantial undervaluation of QDOT property in certain situations.* (1) If either—

(i) The bond or letter of credit security arrangement under paragraph (d)(1)(i)(B) or (C) of this section is chosen by the U.S. Trustee; or

(ii) The QDOT property as originally reported on the decedent's estate tax return is valued at \$2 million or less but, as finally determined for federal estate tax purposes, the QDOT property is determined to be in excess of \$2 million, then the marital deduction will be disallowed in its entirety for failure to comply with the requirements of section 2056A if the value of the QDOT property reported on the estate tax return is 50 percent or less of the amount finally determined to be the correct value of such property for federal estate tax purposes.

(2) The preceding sentence shall not apply if—

(i) There was reasonable cause for such undervaluation; and (ii) The fiduciary of the estate acted in good faith with respect to such undervaluation. For this purpose, §1.6664-4(b) of this chapter applies, to the extent applicable, with respect to the facts and circumstances to be taken into account in making this determination.

(ii) *QDOTs with assets of \$2 million or less.* If the fair market value of the assets passing, treated, or deemed to have passed to the QDOT (or in the form of a QDOT), determined without reduction for any indebtedness with respect to the assets, as finally determined for federal estate tax purposes, is \$2 million or less as of the date of the decedent's death or, if applicable, the alternate valuation date (adjusted as provided in paragraph (d)(1)(iii) of this section), the trust instrument must require that no more than 35 percent of the fair market value of the trust assets, determined annually on the last day of the taxable year of the trust (or on the last day of the calendar year if the QDOT does not have a taxable year), may consist of real property located outside of the United States, or the trust must meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. See paragraph (d)(1)(ii)(D) of this section for special rules in the case of principal distribu-

tions from a QDOT and fluctuations in the value of the foreign real property held by a QDOT due to changes in value of foreign currency. See paragraph (d)(1)(iii) of this section for a special rule for principal residences. If the fair market value, as originally reported on the decedent's estate tax return, of the assets passing or deemed to have passed to the QDOT (determined without reduction for any indebtedness with respect to the assets) is \$2 million or less, but the fair market value of the assets as finally determined for federal estate tax purposes is more than \$2 million, the U.S. Trustee shall have a reasonable period of time (not exceeding sixty days after the conclusion of the proceeding or other action resulting in a final determination of the value of the assets) to meet the requirements prescribed by paragraph (d)(1)(i)(A), (B), or (C) of this section. However, see paragraph (d)(1)(i)(D) of this section in the case of a substantial undervaluation of QDOT assets.

(A) *Multiple QDOTs.* For purposes of this paragraph (d)(1)(ii), if more than one QDOT is established for the benefit of the surviving spouse, the fair market value of all the QDOTs are aggregated in determining whether the \$2 million threshold under this paragraph (d)(1)(ii) is exceeded.

(B) *Look-through rule.* For purposes of determining whether no more than 35 percent of the fair market value of the QDOT assets consists of foreign real property, if the QDOT owns more than 20% of the voting stock or value in a corporation with 15 or fewer shareholders, or more than 20% of the capital interest of a partnership with 15 or fewer partners, then all assets owned by the corporation or partnership are deemed to be owned directly by the QDOT to the extent of the QDOT's pro rata share of the assets of that corporation or partnership. In the case of a partnership, the QDOT partner's pro rata share shall be based on the greater of its interest in the capital or profits of the partnership. For purposes of this paragraph, all stock in the corporation,

or interests in the partnership, as the case may be, owned by or held for the benefit of the surviving spouse, or any members of the surviving spouse's family (within the meaning of section 267(c)(4)), are treated as owned by the QDOT solely for purposes of determining the number of partners or shareholders in the entity and the QDOT's percentage voting interest or value in the corporation or capital interest in the partnership, but not for the purpose of determining the QDOT's pro rata share of the assets of the entity.

(C) *Interests in other entities.* Interests owned by the QDOT in other entities (such as an interest in a trust) are accorded treatment consistent with that described in paragraph (d)(1)(ii)(B) of this section.

(D) *Special rule for foreign real property.* For purposes of this paragraph (d)(1)(ii), if, on the last day of any taxable year during the term of the QDOT (or the last day of the calendar year if the QDOT does not have a taxable year), the value of foreign real property owned by the QDOT exceeds 35 percent of the fair market value of the trust assets due to distributions of QDOT principal during that year or because of fluctuations in the value of the foreign currency in the jurisdiction where the real estate is located, the QDOT will not be treated as failing to meet the requirements of paragraph (d)(1) of this section and, therefore, will not cease to be a QDOT within the meaning of §20.2056A-5(b)(3) if, by the end of the taxable year (or the last day of the calendar year if the QDOT does not have a taxable year) of the QDOT immediately following the year in which the 35 percent limit was exceeded, the value of the foreign real property held by the QDOT does not exceed 35 percent of the fair market value of the trust assets or, alternatively, the QDOT meets the requirements of either paragraph (d)(1)(i)(A), (B), or (C) of this section on or before the close of that succeeding year.

(iii) *Special rules for principal residence and related personal effects—*
(A) *Two million dollar threshold.* For purposes of determining whether the \$2 million threshold under paragraphs (d)(1)(i) and (ii) of this section has been exceeded, the executor of the estate may elect to exclude up to \$600,000 in value attributable to real property wherever situated (and related furnishings) owned directly by the

QDOT that is used by the surviving spouse as the spouse's principal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election is made by attaching a written statement claiming the exclusion to the estate tax return on which the QDOT election is made.

(B) *Security requirement.* For purposes of determining the amount of the bond or letter of credit required in cases where paragraph (d)(1)(i)(B) or (C) of this section applies, the executor of the estate may elect to exclude, during the term of the QDOT, up to \$600,000 in value attributable to real property, wherever situated (and related furnishings) owned directly by the QDOT that is used by the surviving spouse as the spouse's principal residence and that passes, or is treated as passing, to the QDOT under section 2056(d). The election may be made regardless of whether the real property is situated within or without the United States. The election is made by attaching to the estate tax return on which the QDOT election is made a written statement claiming the exclusion.

(C) *Foreign real property limitation.* The special rules of this paragraph (d)(1)(iii) do not apply for purposes of determining whether more than 35 percent of the QDOT assets consist of foreign real property under paragraph (d)(1)(ii) of this section.

(D) *Principal residence.* For purposes of this paragraph (a)(1)(iii), the term *principal residence* has the same meaning as prescribed in section 1034 and the regulations thereunder. A principal residence may include appurtenant structures used by the surviving spouse for residential purposes and adjacent land not in excess of that which is reasonably appropriate for residential purposes (taking into account the residence's size and location).

(E) *Related furnishings.* The term *related furnishings* means furniture and commonly included items such as appliances, fixtures, decorative items and china, that are not beyond the value associated with normal household and decorative use. Rare artwork, valuable antiques, and automobiles of any kind or class are not within the meaning of this term.

(F) *Annual statement.* If one or both of the exclusions provided in paragraph (d)(1)(iii)(A) or (B) of this section are elected by the executor of the estate,

the U.S. Trustee must file the statement required under paragraph (d)(3) of this section at the time and in the manner provided in paragraph (d)(3) of this section. In addition, an annual statement must be filed by the U.S. Trustee under the circumstances described in paragraphs (d)(3)(iii)(C) and (D) of this section.

(G) *Cessation of use.* Except as provided in this paragraph (d)(1)(iii)-(G), if the residence ceases to be used as the principal residence of the spouse, or if the residence is sold during the term of the QDOT, the exclusions provided in paragraph (d)(1)(iii)(A) and (B) of this section will cease to apply. However, in the case of such a sale, the exclusions will continue to apply if, within 12 months of the date of sale, the amount of the adjusted sales price (as defined in section 1034(b)(1)) is used to purchase a new principal residence for the spouse. If less than the amount of the adjusted sales price is so reinvested, then the amount of the exclusions initially claimed by the QDOT are reduced proportionately based on the amount of excess adjusted sales price not so reinvested compared to the entire adjusted sales price. If the QDOT ceases to qualify for all or any portion of the initially claimed exclusions, paragraph (d)(1)(i) of this section, if applicable (determined as if the portion of the exclusions disallowed had not been initially claimed by the QDOT), must be complied with no later than 120 days after the effective date of the cessation. The Internal Revenue Service may provide in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) for appropriate exceptions to the cessation of use rule contained in this paragraph (d)(1)(iii) where the principal residence of a surviving spouse is substituted for another principal residence, when both residences are held in a QDOT.

(iv) *Anti-abuse rule.* Regardless of whether the QDOT designates a bank as the U.S. Trustee under paragraph (d)(1)(i)(A) of this section (or otherwise complies with paragraph (d)(1)(i)(A) of this section by naming a foreign bank with a United States branch as a trustee to serve with the U.S. Trustee), complies with paragraph (d)(1)(i)(B) or (C) of this section, or is subject to and complies with the foreign real property requirements of

paragraph (d)(1)(ii) of this section, the trust immediately ceases to qualify as a QDOT if the trust utilizes any device or arrangement that has, as a principal purpose, the avoidance of liability for the estate tax imposed under section 2056A(b)(1), or the prevention of the collection of the tax. For example, the trust may become subject to this paragraph (d)(1)(iv) if the U.S. Trustee that is selected is a domestic corporation established with insubstantial capitalization by the surviving spouse or members of the spouse's family.

(2) *Individual trustees.* If the U.S. Trustee is an individual United States citizen, the individual must have a tax home (as defined in section 911(d)(3)) in the United States.

(3) *Annual reporting requirements—*
(i) *In general.* The U.S. Trustee must file a written statement described in paragraph (d)(3)(iii) of this section, if the QDOT satisfies any one of the following criteria for the applicable reporting years—

(A) The QDOT directly owns any foreign real property on the last day of its taxable year (or the last day of the calendar year if it has no taxable year), and the QDOT does not satisfy the requirements of paragraph (d)(1)(i)(A), (B), or (C) of this section by employing a bank as trustee or providing security; or

(B) The principal residence exclusion under paragraph (d)(1)(iii) of this section applies during the taxable year (or during the calendar year if the QDOT has no taxable year); or

(C) The principal residence previously subject to the exclusion under paragraph (d)(1)(iii) of this section is sold, or that principal residence ceases to be used as a principal residence, during the taxable year (or during the calendar year if the QDOT does not have a taxable year); or

(D) After the application of the look-through rule contained in paragraph (d)(1)(ii)(B) of this section, the QDOT is treated as owning any foreign real property on the last day of the taxable year (or the last day of the calendar year if the QDOT has no taxable year).

(ii) *Time and manner of filing.* The written statement, containing the information described in paragraph (d)(3)(iii) of this section, is to be filed for the taxable year of the QDOT (calendar year if the QDOT does not have a taxable year) for which any of the

events or conditions requiring the filing of a statement under paragraph (d)(3)(i) of this section have occurred or have been satisfied. The written statement is to be submitted to the Internal Revenue Service by filing a Form 706-QDT, with the statement attached, no later than April 15th of the calendar year following the calendar year in which or with which the taxable year of the QDOT ends (or by April 15th of the following year if the QDOT has no taxable year), unless an extension of time is obtained under §20.2056A-11(a). The Form 706-QDT, with attached statement, must be filed regardless of whether the Form 706-QDT is otherwise required to be filed under the provisions of this chapter. Failure to file timely the statement may subject the QDOT to the rules of paragraph (d)(1)(iv) of this section.

(iii) *Contents of statement.* The written statement must contain the following information—

(A) The name, address, and taxpayer identification number, if any, of the U.S. Trustee and the QDOT; and

(B) A list summarizing the assets held by the QDOT, together with the fair market value of each listed QDOT asset, determined as of the last day of the taxable year (December 31 if the QDOT does not have a taxable year) for which the written statement is filed. If the look-through rule contained in paragraph (d)(1)(ii)(B) of this section applies, then the partnership, corporation, trust or other entity must be identified and the QDOT's pro rata share of the foreign real property and other assets owned by that entity must be listed on the statement as if directly owned by the QDOT; and

(C) If a principal residence previously subject to the exclusion under paragraph (d)(1)(iii) of this section is sold during the taxable year (or during the calendar year if the QDOT does not have a taxable year), the statement must provide the date of sale, the adjusted sales price (as defined in section 1034(b)(1)), the extent to which the amount of the adjusted sales price has been or will be used to purchase a new principal residence and, if not timely reinvested, the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable; and

(D) If the principal residence ceases to be used as a principal residence by the surviving spouse during the taxable

year (or during the calendar year if the QDOT does not have a taxable year), the written statement must describe the steps that will or have been taken to comply with paragraph (d)(1)(i) of this section, if applicable.

(4) *Request for alternate arrangement or waiver.* If the Commissioner provides guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) pursuant to which a testator, executor, or the U.S. Trustee may adopt an alternate plan or arrangement to assure collection of the section 2056A estate tax, and if such an alternate plan or arrangement is adopted in accordance with such published guidance, then the QDOT will be treated, subject to paragraph (d)(1)(iv) of this section, as meeting the requirements of paragraph (d)(1) of this section. Until such guidance is published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), taxpayers may submit a request for a private letter ruling for the approval of an alternate plan or arrangement proposed to be adopted to assure collection of the section 2056A estate tax in lieu of the requirements prescribed in this paragraph (d)(4).

(5) *Adjustment of dollar threshold and exclusion.* The Commissioner may increase or decrease the dollar amounts referred to in paragraph (d)(1)(i), (ii) or (iii) of this section in accordance with guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(6) *Effective date and special rules.*
(i) This paragraph (d) is effective for estates of decedents dying after February 19, 1996.

(ii) *Special rule in the case of incompetency.* A revocable trust or a trust created under the terms of a will is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that such requirements are not contained in the governing instrument, if the trust instrument (or will) was executed on or before November 20, 1995, and—

(A) The testator or settlor dies after February 19, 1996;

(B) The testator or settlor is, on November 20, 1995, and at all times thereafter, under a legal disability to amend the will or trust instrument;

(C) The will or trust instrument does not provide the executor or the U.S. Trustee with a power to amend the instrument in order to meet the requirements of section 2056A; and

(D) The U.S. Trustee provides a written statement with the federal estate tax return (Form 706 or 706NA) that the trust is being administered (or will be administered) so as to be in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

(iii) *Special rule in the case of certain irrevocable trusts.* An irrevocable trust is deemed to meet the governing instrument requirements of this paragraph (d) notwithstanding that such requirements are not contained in the governing instrument if the trust was executed on or before November 20, 1995, and:

(A) The settlor dies after February 19, 1996;

(B) The trust instrument does not provide the U.S. Trustee with a power to amend the trust instrument in order to meet the requirements of section 2056A; and

(C) The U.S. Trustee provides a written statement with the decedent's federal estate tax return (Form 706 or 706NA) that the trust is being administered in actual compliance with the requirements of this paragraph (d) and will continue to be administered so as to be in actual compliance with this paragraph (d) for the duration of the trust. This statement must be binding on all successor trustees.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (c) is amended by adding the entry “20.2056A–2T(d) . . . 1545–1443” in numerical order in the table.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved December 21, 1994.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 21, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 22, 1995, 60 F.R. 43554)

Chapter 12.—Gift Tax Subchapter B.—Transfers

Section 2511.—Transfers in General

26 CFR 25.2511–2: Cessation of donor's dominion and control.

If a donor-grantor makes a transfer to a trust and reserves an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the donor-grantor (within the meaning of § 672(c) of the Code), is the reservation of the power tantamount to a reservation by the donor-grantor of the trustee's discretionary powers of distribution? See Rev. Rul. 95–58, page 191.

Chapter 13.—Tax on Certain Generation-Skipping Transfers Subchapter A.—Tax Imposed

Section 2601.—Tax Imposed

26 CFR 20.2601–1: Effective dates.

Whether a trust that is excepted from the application of the generation-skipping transfer tax because it was irrevocable on September 25, 1985, will lose its excepted status if the situs of the trust is changed from the U.S. to a situs outside of the United States? See Rev. Proc. 95–50, page 430.

Subtitle C.—Employment Taxes Chapter 21.—Federal Insurance Contributions Act Subchapter C.—General Provisions

Section 3121.—Definitions

26 CFR 31.3121(a)(2)–1: Payments under employers' plans on account of retirement, sickness or accident disability, medical or hospitalization expenses, or death.

Rev. Proc. 82–20, relating to the taxability of sick pay is declared obsolete. See Rev. Proc. 95–43, page 412.

Chapter 22.—Railroad Retirement Tax Act Subchapter C.—Tax on Employers

Section 3221.—Rate of Tax

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in

Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C. Section 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning October 1, 1995, shall be at the rate of 33 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning October 1, 1995, 36.3 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 63.7 percent of the taxes collected under such Sections 3211(b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: August 29, 1995.

By Authority of the Board.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on September 8, 1995, 8:45 a.m., and published in the issue of the Federal Register for September 11, 1995, 60 F.R. 47194)

Subchapter D.—General Provisions

Section 3231.—Definitions

26 CFR 31.3231(e)–1: Compensation.

Rev. Proc. 82–20, relating to the taxability of sick pay is declared obsolete. See Rev. Proc. 95–43, page 412.

Chapter 25.—General Provisions Relating to Employment Taxes

Section 3505.—Liability of Third Parties Paying or Providing for Wages

26 CFR 31.3505–1: Liability of third parties paying or providing for wages.

T.D. 8604

Liability of Third Parties Paying or Providing for Wages: Suit Period and Its Extension and Maximum Amount Recoverable

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding the liability of lenders, sureties, or other third persons for withholding taxes when those persons have supplied funds, either directly to employees or to or for the account of an employer, for the specific purpose of paying wages of the employees of that employer. The final regulations affect third parties paying or providing for wages.

EFFECTIVE DATE: August 1, 1995.

SUPPLEMENTARY INFORMATION:

Background

These final regulations contain changes to §31.3505-1. Section 3505 of the Internal Revenue Code (Code) was added by section 105(a) of the Federal Tax Lien Act of 1966, Pub. L. 89-719 (1966) [1966-2 C.B. 623]. Treasury regulations were issued with an effective date of August 19, 1976 (TD 7430 [1976-2 C.B. 314]). Neither the Code section nor the regulations has been amended since enactment or issuance, respectively. The IRS published a notice of proposed rulemaking in the Federal Register on November 22, 1994, (59 FR 60099 [GL-32-94, 1994-2 C.B. 872]) providing proposed rules under section 3505 of the Code. No public comments were received and accordingly, the final regulations are identical to the proposed regulations.

Explanation of Provisions

Under section 3505(b), if a lender, surety, or other person (the lender) supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of that employer, and the lender has actual notice or knowledge (within the mean-

ing of section 6323(i)(1)) that the employer does not intend or will not be able to make timely payment or deposit of the required withholding taxes, the lender shall be liable to the United States in a sum equal to the taxes (together with interest) that are not paid over to the United States by the employer with respect to those wages. The lender's liability for withholding taxes, in lieu of the employer, is limited to an amount equal to 25 percent of the amount of wages so supplied to or for the account of the employer. See section 3505(b) (final sentence).

Existing regulations provide that the 25-percent limitation applies only to the tax, and not the interest on that tax, with the result that the lender could be held liable for more than 25 percent of the amount of funds it supplied. The courts that have addressed this issue, however, have held that the 25-percent limitation on the amount of wages supplied by a third party is an absolute cap with respect to the recovery of withholding taxes and prejudgment interest. *United States v. Metro Constr. Co., Inc.*, 602 F.2d 879 (9th Cir. 1979); *United States v. Intercontinental Ind., Inc.*, 635 F.2d 1215 (6th Cir. 1980); *United States v. Hannan Co.*, 639 F.2d 284 (5th Cir. 1981); *Taubman v. United States*, 449 F. Supp. 520 (E.D. Mich. 1978). See also *O'Hare v. United States*, 878 F.2d 953 (6th Cir. 1989); *United States v. Security Pacific Business Credit, Inc.*, 956 F.2d 703 (7th Cir. 1992); *United States v. Vaccarella*, 735 F. Supp. 1421 (S.D. Ind. 1990).

These final regulations conform to judicial interpretation and clarify that interest will continue to be computed in addition to any withholding tax liability, but only to an overall maximum of 25 percent of the amount of the funds supplied by the lender.

The final regulations also change the period of limitations for collection of the withholding taxes and interest from six years to ten years. This revision will conform the period of limitations for the purposes of section 3505 with the general rule on limitations on collection. See section 6502, amended by the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, section 11317(a)(1) (1990).

Finally, §31.3505-1(d)(3) has been added to provide for extensions of the period of limitation for collection because, on occasion, the IRS or the lender requires additional time for compliance with the regulation.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 31 is amended as follows:

Part 31—EMPLOYMENT TAXES

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Paragraph 2. Section 31.3505-1 is amended by:

1. Removing the phrase "for such taxes" from the second sentence of paragraph (b)(1).
2. Removing the phrase "plus interest thereon" from the final sentence of paragraph (b)(2), *Example (1)*.
3. Removing the phrase "for withholding taxes" from the fifth sentence of paragraph (b)(2), *Example (2)*.
4. Removing the phrase "plus interest thereon" from the final sentence of paragraph (b)(2), *Example (2)*.
5. Revising the final sentence of paragraph (d)(1).
6. Revising the final sentence of paragraph (d)(2)(iii).
7. Adding paragraphs (d)(3) and (g).

The additions and revisions read as follows:

§31.3505-1 Liability of third parties paying or providing for wages.

* * * * *

(d) * * *

(1) * * * In the event that the lender, surety, or other person does not satisfy the liability imposed by section 3505, the United States may collect the liability by appropriate civil proceedings commenced within 10 years after assessment of the tax against the employer.

* * * * *

(2) * * *

(iii) * * * Thus, after the second payment by the employer, the lender's liability under section 3505(b) is \$75 (\$250 less \$175), plus interest due on the underpayment for the period of underpayment, to a maximum of \$250, 25 percent of the funds supplied.

(3) *Extensions of the period for collection.* Prior to the expiration of the 10-year period for collection after assessment against the employer, the lender, surety, or other third party may agree in writing with the district director, service center director, or compliance center director to extend the 10-year period for collection. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon. If any timely proceeding in court for the collection of the tax and any applicable interest is commenced, the period during which such tax and interest may be collected shall be extended and shall not expire until the liability for the tax (or a judgment against the lender, surety, or other third party arising from such liability) is satisfied or becomes unenforceable.

* * * * *

(g) *Effective date.* These regulations are effective on August 1, 1995.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved June 21, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on July 31, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 1, 1995, 60 F.R. 39109)

Subtitle D.—Miscellaneous Excise Taxes
Chapter 31.—Retail Excise Taxes
Subchapter A.—Luxury Passenger Automobiles

Section 4001.—Passenger Vehicles

The Service is providing inflation adjustments to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 1996. See Rev. Proc. 95-53, page 445.

Section 4003.—Special Rules

The Service is providing inflation adjustments to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 1996. (Price includes the price of installation of parts or accessories on a passenger vehicle within six months of the date after the vehicle was first placed in service.) See Rev. Proc. 95-53, page 445.

Subchapter B.—Special Fuels

Section 4041.—Imposition of Tax

26 CFR 48.4041-21: *Compressed natural gas (CNG).*

T.D. 8609

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 40, 48, and 602

Gasohol; Compressed Natural Gas

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to gasohol blending and the tax on compressed natural gas (CNG). The regulations reflect and implement certain changes made by the Energy Policy Act of 1992 (the Energy Act) and the Omnibus Budget Reconciliation Act of 1993 (the 1993 Act). The regulations relating to gasohol blending affect certain blenders, enterers, refiners, and throughputters. The regulations relating to CNG affect persons that sell or buy CNG for use as a fuel in a motor vehicle or motorboat.

EFFECTIVE DATE: These regulations are effective October 1, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1270. The estimated average annual reporting burden per respondent is .2 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On October 19, 1994, the IRS published in the Federal Register (59 FR 52735) proposed regulations (PS-66-93 [1994-2 C.B. 907]) that generally consolidate the rules relating to the gasoline tax and the diesel fuel tax into a single set of rules applicable to both fuels. These regulations also proposed rules relating to gasohol and CNG.

Written comments regarding these regulations were received and a public hearing was held on January 11, 1995. After consideration of the comments relating to gasohol and CNG, the proposed regulations on these topics are adopted as revised by this Treasury decision. Final regulations relating to the consolidation provisions contained in the proposed regulations will be issued later.

Explanation of provisions

CNG; Treatment of Liquefied Natural Gas (LNG)

Section 4041(a)(2) imposes a special motor fuels tax on any liquid (other than kerosene, gas oil, fuel oil, gasoline, or diesel fuel) that is sold for use or used as a fuel in a motor vehicle or motorboat. The rate of this tax is 18.4 cents per gallon (18.3 cents per gallon in the case of liquefied petroleum gas).

Effective October 1, 1993, section 4041(a)(3) (as added by the 1993 Act)

imposes a tax of 48.54 cents per MCF (thousand cubic feet) on CNG that is sold for use or used in a motor vehicle or motorboat.

CNG is a gas at the time it is delivered into the fuel supply tank of a motor vehicle or motorboat and when it is actually combusted in the engine. LNG, which is produced by compressing pipeline natural gas and cooling it to -260 degrees Fahrenheit, is a liquid when it is delivered into the fuel supply tank of a motor vehicle or motorboat, but is vaporized into a gas when it is actually combusted in the engine.

Several commentators suggested that the CNG rate, rather than the rate on special motor fuels, should apply to LNG because (1) both products have the same chemical composition, (2) both products are gases when they are actually combusted in an engine, and (3) LNG would be at a competitive disadvantage if taxed at the liquid rate.

The final regulations do not adopt this suggestion. Before the 1993 Act, the section 4041 special fuels tax applied to liquids sold for use or used as a fuel in motor vehicles or motorboats. Thus, LNG was subject to tax at the special fuels rate of 18.4 cents per gallon when the 1993 Act imposed a tax at a lower rate on CNG. The 1993 Act contained no provision that would change the treatment of LNG, nor is there any suggestion in the legislative history that Congress intended to do so.

CNG; Gasoline Gallon Equivalent

The CNG industry has recently begun to sell CNG on the basis of CNG's Gasoline Gallon Equivalent (GGE). Generally, a GGE represents a particular fuel's energy content relative to the energy content of gasoline; thus, vehicles can travel approximately the same distance with a GGE of CNG as with a gallon of gasoline.

Several commentators suggested that the final regulations should express the CNG tax rate in terms of GGE instead of in terms of MCF as provided in the Code. The final regulations do not adopt this suggestion. However, there is no restriction on taxpayers engaging in sales on the basis of GGE provided that the tax is actually paid at the rate of 48.54 cents per MCF.

Gasohol; tolerance rule

The gasoline tax rate on most removals and entries is 18.4 cents per

gallon (the regular tax rate). However, a reduction from the regular tax rate is allowed for gasohol (a gasoline/alcohol mixture containing a specified amount of alcohol) and gasoline removed or entered for the production of gasohol.

Prior to its amendment by the Energy Act, section 4081(c) treated a mixture of gasoline and alcohol as gasohol only if at least 10 percent of the mixture was alcohol. Regulations allow a tolerance for mixtures that contain less than 10 percent alcohol but at least 9.8 percent alcohol. Under the tolerance rule, a portion of the mixture equal to the number of gallons of alcohol in the mixture multiplied by 10 is considered to be gasohol. Any excess liquid in the mixture is taxed at the regular rate.

This tolerance rule accommodates operational problems associated with the blending of gasohol. For example, blenders may fail to attain the required 10-percent alcohol level because the device used to meter the amount of gasoline or alcohol delivered into a tank truck is imprecise or because the high-speed gasoline or alcohol pump used does not shut off at the proper moment. As noted in the preamble to an earlier regulation relating to gasohol tolerances (published in the Federal Register on August 21, 1987 (52 FR 31614)), this 2 percent tolerance is based upon a standard industry tolerance specification for wholesale measuring devices.

Effective January 1, 1993, section 4081(c) was amended to allow a reduction from the regular rate for mixtures containing at least 5.7 percent alcohol but less than 7.7 percent alcohol (5.7 percent gasohol) and mixtures containing at least 7.7 percent alcohol but less than 10 percent alcohol (7.7 percent gasohol).

The proposed regulations did not extend the tolerance rule to mixtures that contain less than 7.7 or 5.7 percent alcohol. Several commentators suggested that the tolerance rule be so extended. They noted that the same operational problems that occur with the blending of 10 percent gasohol also occur with the blending of 7.7 or 5.7 percent gasohol.

The final regulations adopt this suggestion and allow a tolerance for 7.7 and 5.7 percent gasohol in approximately the same percentage as that allowed for 10 percent gasohol. Any excess liquid in a mixture that qualifies

as 5.7 percent gasohol or 7.7 percent gasohol because of the tolerance rule is taxed at the regular rate.

Gasohol; alcohol-based ethers

The proposed regulations provide that alcohol (that is, alcohol that is not produced from petroleum, natural gas, or coal (including peat)) used to produce ethers such as ethyl tertiary butyl ether (ETBE) or methyl tertiary butyl ether (MTBE) is treated as alcohol for purposes of the reduced tax rates for gasohol. Some commentators suggested that, with respect to gasohol produced by blending gasoline made with alcohol-based ether at a refinery, the regulations should also provide (1) an allocation rule, and (2) guidance regarding the application of the income tax credit allowable by section 40.

Allocation rule. Traditionally, gasohol has been produced by delivering the requisite amount of alcohol into a transport trailer that contains gasoline while the trailer is at a terminal rack. The two components are blended together by the motion of the trailer as it moves on the highway.

Now, however, gasohol may be produced at the refinery with alcohol-based ether. This type of gasohol does not absorb water, which means it can be transported through a pipeline. However, after shipment from the refinery and before its removal at the terminal rack, much of this gasohol may have been diluted with non-qualifying blends because of the use of common-carrier pipelines, barges, and non-segregated storage facilities. As a result, the blend removed at the terminal rack may not qualify for the reduction from the regular rate due to commingling between the refinery and terminal rack. To address this issue, several commentators suggested an allocation system for gasohol that is produced before it reaches the terminal that would not depend on the actual existence of a qualified mixture at the taxing point. For example, a refiner that removes one million gallons of gasohol from its refinery for bulk shipment to a terminal could designate any one million gallons of gasoline that is removed at the terminal rack as gasohol, regardless of the actual alcohol-based ether content of the gasoline.

Other commentators, by contrast, opposed expanding the benefit for

gasohol made with ether-based alcohol by allowing such an allocation rule. Rather, these commentators argued that a batch of mixture should not be taxed at the reduced rate unless the mixture actually contains the requisite amount of alcohol at the taxing point.

The final regulations do not adopt the suggested allocation rule. Under section 4081(c), a reduction from the regular tax rate is allowable in the case of a taxable removal or entry of gasohol. Thus, a taxable removal or entry of gasoline that does not contain the requisite amount of alcohol at the time of the taxable removal or entry is not a removal of gasohol and is subject to tax at the regular rate.

However, the final regulations do address concerns arising from this relatively recent development of producing gasohol at the refinery rather than at the terminal rack. Specifically, section 4101 provides that every person required to be registered with respect to the gasoline tax must register at such time, in such form and manner, and subject to such terms and conditions as the Secretary may prescribe by regulations. Pursuant to that provision, the final regulations provide that a refiner registered by the IRS that produces a batch of gasohol may treat itself as not registered with respect to a bulk removal of that gasohol. If the refiner treats itself in this manner, the removal would not be exempt from the tax under section 4081(a)(1)(B), which provides that the bulk removal by a registered refiner for delivery to a terminal operated by a registered terminal operator is not subject to the tax. However, because the mixture would qualify as gasohol at the time of removal from the refinery, it would be subject to tax at the reduced rate. The final regulations also provide that the refiner is not required to deposit this tax before filing the return relating to that tax.

If a refiner chooses this option, tax also will be imposed under §48.4081-2(b) at the full rate when the fuel is removed at the terminal rack, but a refund of this second tax may then be allowable to the position holder under section 4081(e).

Application of section 40. Section 40 allows an income tax credit to the producer of certain mixtures of alcohol and gasoline. Under section 40(c), the amount of this credit with respect to

any alcohol is reduced to take into account any benefit provided with respect to such alcohol solely by reason of the application of section 4081(c).

One commentator suggested that the final regulations provide that a refiner that produces a mixture of gasoline with an alcohol-based ether always is eligible for the section 40 credit, without reduction under section 40(c).

The final regulations do not adopt this suggestion because it is inconsistent with section 40(c), which requires a reduction in the credit whenever a mixture is taxed at a reduced rate for gasohol under section 4081(c).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 40, 48, and 602 are amended as follows:

**PART 40—EXCISE TAX
PROCEDURAL REGULATIONS**

Paragraph 1. The authority citation for part 40 continues to read in part as follows:

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

§40.6302(c)-0 [Removed]

Par. 2. Section 40.6302(c)-0 is removed.

Par. 3. In §40.6302(c)-1, paragraph (e)(4) is added to read as follows:

§40.6302(c)-1 Use of Government depositaries.

* * * * *

(e) * * *

(4) *Taxes excluded; certain removals of gasohol from refineries.* No deposit is required in the case of the tax imposed under §48.4081-3(b)(1)(iii) of this chapter.

* * * * *

**PART 48—MANUFACTURERS
AND RETAILERS EXCISE TAXES**

Par. 4. The authority citation for part 48 is amended by removing the entries for Sections 48.4041.21 and 48.4081-2 to read in part as follows:

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

Par. 5. In §48.4041-8, paragraph (f) is amended by:

- 1. Revising the introductory text of paragraph (f)(1).
- 2. Revising paragraph (f)(1)(i).
- 3. Redesignating paragraph (f)(1)(ii) as paragraph (f)(1)(iii) and adding a new paragraph (f)(1)(ii).
- 4. Removing from paragraph (f)(2) the language “diesel fuel or”.

The revisions and additions read as follows:

§48.4041-8 Definitions.

* * * * *

(f) *Special motor fuel.* (1) Except as provided in paragraph (f)(2) of this section, *special motor fuel* means any liquid fuel, including—

- (i) Any liquefied petroleum gas (such as propane, butane, pentane, or mixtures of the same);
- (ii) Liquefied natural gas; or

* * * * *

Par. 6. Section 48.4041-21 is revised to read as follows:

§48.4041-21 Compressed natural gas (CNG).

(a) *Delivery of CNG into the fuel supply tank of a motor vehicle or motorboat—*(1) *Imposition of tax.* Tax is imposed on the delivery of compressed natural gas (CNG) into the fuel supply tank of the propulsion engine of

a motor vehicle or motorboat unless tax was previously imposed on the CNG under paragraph (b) of this section.

(2) *Liability for tax.* If the delivery of the CNG is in connection with a sale, the seller of the CNG is liable for the tax imposed under paragraph (a)(1) of this section. If the delivery of the CNG is not in connection with a sale, the operator of the motor vehicle or motorboat, as the case may be, is liable for the tax imposed under paragraph (a)(1) of this section.

(b) *Bulk sales of CNG—(1) In general.* Tax is imposed on the sale of CNG that is not in connection with the delivery of the CNG into the fuel supply tank of the propulsion engine of a motor vehicle or motorboat if, by the time of the sale—

(i) The buyer has given the seller a written statement stating that the entire quantity of the CNG covered by the statement is for use as a fuel in a motor vehicle or motorboat; and

(ii) The seller has given the buyer a written acknowledgement of receipt of the statement described in paragraph (b)(1)(i) of this section.

(2) *Liability for tax.* The seller of the CNG is liable for the tax imposed under this paragraph (b).

(c) *Exemptions—(1) In general.* The taxes imposed under this section do not apply to a delivery or sale of CNG for a use described in §48.4082-4T(c)(1) through (5)(A) or (c)(6) through (11). However, if the person otherwise liable for tax under this section is the seller of the CNG, the exemption under this section applies only if, by the time of sale, the seller receives an unexpired certificate (as described in this paragraph (c)) from the buyer and has no reason to believe any information in the certificate is false.

(2) *Certificate; in general.* The certificate to be provided by a buyer of CNG is to consist of a statement that is signed under penalties of perjury by a person with authority to bind the buyer, should be in substantially the same form as the model certificate provided in paragraph (c)(4) of this section, and should contain all information necessary to complete the model certificate. A new certificate must be given if any

information in the current certificate changes. The certificate may be included as part of any business records normally used to document a sale. The certificate expires on the earliest of the following dates:

(i) The date one year after the effective date of the certificate (which may be no earlier than the date it is signed).

(ii) The date a new certificate is provided to the seller.

(iii) The date the seller is notified by the Internal Revenue Service or the buyer that the buyer's right to provide a certificate has been withdrawn.

(3) *Withdrawal of the right to provide a certificate.* The Internal Revenue Service may withdraw the right of a buyer of CNG to provide a certificate under this paragraph (c) if the buyer uses CNG to which a certificate applies in a taxable use. The Internal Revenue Service may notify any seller to whom the buyer has provided a certificate that the buyer's right to provide a certificate has been withdrawn.

(4) *Model certificate.*

CERTIFICATE OF PERSON BUYING COMPRESSED NATURAL GAS (CNG)
FOR A NONTAXABLE USE

(To support tax-free sales of CNG under section 4041 of the Internal Revenue Code.)

Name, address, and employer identification number of seller _____ (“Buyer”) certifies the following under penalties of perjury: _____ Name of buyer

The CNG to which this certificate relates will be used in a nontaxable use.

This certificate applies to the following (complete as applicable):

If this is a single purchase certificate, check here _____ and enter:

1. Invoice or delivery ticket number _____
2. _____ (number of MCFs)

If this is a certificate covering all purchases under a specified account or order number, check here _____ and enter:

1. Effective date _____
2. Expiration date _____ (period not to exceed 1 year after the effective date)
3. Buyer account or order number _____

Buyer will not claim a credit or refund under section 6427 of the Internal Revenue Code for any CNG to which this certificate relates.

Buyer will provide a new certificate to the seller if any information in this certificate changes.

Buyer understands that if Buyer violates the terms of this certificate, the Internal Revenue Service may withdraw Buyer's right to provide a certificate.

Buyer has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Buyer that the right to provide a certificate has been withdrawn from a purchaser to which Buyer sells CNG tax free.

Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making any fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Printed or typed name of person signing

Title of person signing

Employer identification number

Address of Buyer

Signature and date signed

(d) *Rate of tax.* The rate of the tax imposed under this section is the rate prescribed by section 4041(a)(3).

(e) *Effective date.* This section is effective October 1, 1995.

§48.4081-0 [Removed]

Par. 7. Section 48.4081-0 is removed.

Par. 8. In §48.4081-3, paragraph (b)(1) is revised to read as follows:

§48.4081-3 Gasoline tax; taxable events other than removal at the terminal rack.

* * * * *

(b) * * * (1) *In general.* Except as provided in §48.4081-4 (relating to gasoline blendstocks) and paragraph (b)(2) of this section (relating to an exception for certain refineries), tax is imposed on the following removals of gasoline from a refinery:

(i) The removal is by bulk transfer and the refiner or the owner of the gasoline immediately before the removal is not a gasoline registrant.

(ii) The removal is at the rack.

(iii) After September 30, 1995, the removal is of a batch of gasohol from an approved refinery by bulk transfer and the refiner treats itself with respect to the removal as a person that is not registered under section 4101. See §48.4101-3. For the rule providing that no deposit is required in the case of the tax imposed under this paragraph (b)(1)(iii), see §40.6302(c)-1 (e)(4) of this chapter. For the rule allowing inspections of facilities where gasohol is produced, see section 4083.

Par. 9. Section 48.4081-6 is revised to read as follows:

§48.4081-6 Gasoline tax; gasohol.

(a) *Overview.* This section provides rules for determining the applicability of reduced rates of tax on a removal or entry of gasohol or of gasoline used to produce gasohol. Rules are also provided for the imposition of tax on the separation of gasoline from gasohol and the failure to use gasoline that has been taxed at a reduced rate to produce gasohol.

(b) *Explanation of terms—(1) Alcohol—(i) In general; source of the alcohol.* Except as provided in paragraph (b)(1)(ii) of this section, alcohol means any alcohol that is not a derivative product of petroleum, natural gas, or coal (including peat). Thus, the term includes methanol and ethanol that are not derived from petroleum, natural gas, or coal (including peat). The term also includes alcohol produced either within or outside the United States.

(ii) *Proof and denaturants.* Alcohol does not include alcohol with a proof of less than 190 degrees (determined without regard to added denaturants). If the alcohol added to a fuel/alcohol mixture (the added alcohol) includes impurities or denaturants, the volume of alcohol in the mixture is determined under the following rules:

(A) The volume of alcohol in the mixture includes the volume of any impurities (other than added denaturants and any fuel with which the alcohol is mixed) that reduce the purity of the added alcohol to not less than 190 proof (determined without regard to added denaturants).

(B) The volume of alcohol in the mixture includes the volume of any approved denaturants that reduce the purity of the added alcohol, but only to

the extent that the volume of the approved denaturants does not exceed five percent of the volume of the added alcohol (including the approved denaturants). If the volume of the approved denaturants exceeds five percent of the volume of the added alcohol, the excess over five percent is considered part of the nonalcohol content of the mixture.

(C) For purposes of this paragraph (b)(1)(ii), approved denaturants are any denaturants (including gasoline and nonalcohol fuel denaturants) that reduce the purity of the added alcohol and are added to such alcohol under a formula approved by the Secretary.

(iii) *Products derived from alcohol.* If alcohol described in paragraphs (b)(1)(i) and (ii) of this section has been chemically transformed in producing another product (that is, the alcohol is no longer present as a separate chemical in the other product) and there is no significant loss in the energy content of the alcohol, any mixture containing the product includes the volume of alcohol used to produce the product. Thus, for example, a mixture of gasoline and ethyl tertiary butyl ether (ETBE), or of gasoline and methyl tertiary butyl ether (MTBE), includes any alcohol described in paragraphs (b)(1)(i) and (ii) of this section that is used to produce the ETBE or MTBE, respectively, in a chemical reaction in which there is no significant loss in the energy content of the alcohol.

(2) *Gasohol—(i) In general—(A) Gasohol is a mixture of gasoline and alcohol that is 10 percent gasohol, 7.7 percent gasohol, or 5.7 percent gasohol. The determination of whether a particular mixture is 10 percent gasohol, 7.7 percent gasohol, or 5.7 percent gasohol is made on a batch-by-batch basis. A*

batch of gasohol is a discrete mixture of gasoline and alcohol.

(B) If a particular mixture is produced within the bulk transfer/terminal system (for example, at a refinery), the determination of whether the mixture is gasohol is made at the time of the taxable removal or entry of the mixture.

(C) If a particular mixture is produced outside of the bulk transfer/terminal system (for example, by splash blending after the gasoline has been removed from the terminal at the rack), the determination of whether the mixture is gasohol is made immediately after the mixture is produced. In such a case, the contents of the batch typically correspond to a gasoline meter delivery ticket and an alcohol meter delivery ticket, each of which shows the number of gallons of liquid delivered into the mixture. The volume of each component in a batch (without adjustment for temperature) ordinarily is determined by the number of metered gallons shown on the delivery tickets for the gasoline and alcohol delivered. However, if metered gallons of gasoline and alcohol are added to a tank already containing more than a minor amount of liquid, the determination of whether a batch satisfies the alcohol-content requirement will be made by taking into account the amount of alcohol and non-alcohol fuel contained in the liquid already in the tank. Ordinarily, any amount in excess of 0.5 percent of the capacity of the tank will not be considered minor.

(ii) *10 percent gasohol*—(A) *In general.* A batch of gasoline/alcohol mixture is 10 percent gasohol if it contains at least 9.8 percent alcohol by volume, without rounding.

(B) *Batches containing less than 10 percent but at least 9.8 percent alcohol.* If a batch of mixture contains less than 10 percent alcohol but at least 9.8 percent alcohol, without rounding, only a portion of the batch is considered to be 10 percent gasohol. That portion equals the number of gallons of alcohol in the batch multiplied by 10. Any remaining liquid in the mixture is excess liquid.

(iii) *7.7 percent gasohol*—(A) *In general.* A batch of gasoline/alcohol mixture is 7.7 percent gasohol if it contains less than 9.8 percent alcohol but at least 7.55 percent alcohol by volume, without rounding.

(B) *Batches containing less than 7.7 percent but at least 7.55 percent*

alcohol. If a batch of mixture contains less than 7.7 percent alcohol but at least 7.55 percent alcohol, without rounding, only a portion of the batch is considered to be 7.7 percent gasohol. That portion equals the number of gallons of alcohol in the batch multiplied by 12.987. Any remaining liquid in the mixture is excess liquid.

(iv) *5.7 percent gasohol*—(A) *In general.* A batch of gasoline/alcohol mixture is 5.7 percent gasohol if it contains less than 7.55 percent alcohol but at least 5.59 percent alcohol by volume, without rounding.

(B) *Batches containing less than 5.7 percent but at least 5.59 percent alcohol.* If a batch of mixture contains less than 5.7 percent alcohol but at least 5.59 percent alcohol, without rounding, only a portion of the batch is considered to be 5.7 percent gasohol. That portion equals the number of gallons of alcohol in the batch multiplied by 17.544. Any remaining liquid in the mixture is excess liquid.

(v) *Tax on excess liquid.* If tax was imposed on the excess liquid in any gasohol at the gasohol production tax rate (as defined in paragraph (e)(1) of this section), the excess liquid in the batch is considered to be gasoline with respect to which there is a failure to blend into gasohol for purposes of paragraph (f) of this section. If tax was imposed on the excess liquid at the rate of tax described in section 4081(a), a credit or refund under section 6427(f) is not allowed with respect to the excess liquid.

(vi) *Examples.* The following examples illustrate this paragraph (b)(2). In these examples, a gasohol blender creates a gasoline/alcohol mixture by pumping a specified amount of gasoline into an empty tank and then adding a specified amount of alcohol.

Example 1. Mixtures containing exactly 10 percent alcohol. The applicable delivery tickets show that the mixture is made with 7200 metered gallons of gasoline and 800 metered gallons of alcohol. Accordingly, the mixture contains 10 percent alcohol (as determined based on the delivery tickets provided to the blender) and qualifies as 10 percent gasohol.

Example 2. Mixtures containing less than 10 percent alcohol but at least 9.8 percent alcohol. The applicable delivery tickets show that the mixture is made with 7205 metered gallons of gasoline and 795 metered gallons of alcohol. Because the mixture contains less than 10 percent alcohol, but more than 9.8 percent alcohol (as determined based on the delivery tickets provided to the blender), 7950 gallons of the mixture qualify as 10 percent gasohol. If tax was imposed on the gasoline in the mixture at

the gasohol production rate applicable to 10 percent gasohol, the remaining 50 gallons of the mixture (the excess liquid) are treated as gasoline with respect to which there was a failure to blend into gasohol for purposes of paragraph (f) of this section. If tax was imposed on the gasoline in the mixture at the rate of tax described in section 4081(a), a credit or refund under section 6427(f) is allowed only with respect to 7155 gallons of gasoline.

Example 3. Mixtures containing less than 5.59 percent alcohol. The applicable delivery tickets show that the mixture is made with 7568 metered gallons of gasoline and 436 metered gallons of alcohol. Because the mixture contains only 5.45 percent alcohol (as determined based on the delivery tickets provided to the blender), the mixture does not qualify as gasohol.

(3) *Gasohol blender.* *Gasohol blender* means any person that regularly buys gasoline and alcohol and produces gasohol for use in its trade or business or for resale.

(4) *Registered gasohol blender.* *Registered gasohol blender* means a person that is registered under section 4101 as a gasohol blender.

(c) *Rate of tax on gasoline removed or entered for gasohol production*—(1) *In general.* The rate of tax imposed on gasoline under §48.4081–2(b) (relating to tax imposed at the terminal rack), §48.4081–3(b)(1) (relating to tax imposed at the refinery), or §48.4081–3(c)(1) (relating to tax imposed on entries) is the gasohol production tax rate if—

(i) The person liable for tax under §48.4081–2(c)(1) (the position holder), §48.4081–3(b)(3) (the refiner), or §48.4081–3(c)(2) (the enterer) is a taxable fuel registrant and a registered gasohol blender, and such person produces gasohol with the gasoline within 24 hours after removing or entering the gasoline; or

(ii) The gasoline is sold in connection with the removal or entry, the person liable for tax under §48.4081–2(c)(1) (the position holder), §48.4081–3(b)(3) (the refiner), or §48.4081–3(c)(2) (the enterer) is a taxable fuel registrant and the person, at the time of the sale,—

(A) Has an unexpired certificate (as described in paragraph (c)(2) of this section) from the buyer; and

(B) Has no reason to believe that any information in the certificate is false.

(2) *Certificate*—(i) *In general.* The certificate referred to in paragraph (c)(1)(ii)(A) of this section is a statement that is to be provided by a registered gasohol blender that is

signed under penalties of perjury by a person with authority to bind the registered gasohol blender, is in substantially the same form as the model certificate provided in paragraph (c)(2)-(ii) of this section, and contains all information necessary to complete such model certificate. A new certificate must be given if any information in the

current certificate changes. The certificate may be included as part of any business records normally used to document a sale. The certificate expires on the earliest of the following dates:
(A) The date one year after the effective date of the certificate (which may be no earlier than the date it is signed).

(B) The date the registered gasohol blender provides a new certificate to the seller.
(C) The date the seller is notified by the Internal Revenue Service or the gasohol blender that the gasohol blender's registration has been revoked or suspended.
(ii) *Model certificate.*

CERTIFICATE OF REGISTERED GASOHOL BLENDER

(To support sales of gasoline at the gasohol production tax rate under section 4081(c) of the Internal Revenue Code)

Name, address, and employer identification number of seller _____ (Buyer) certifies the following under penalties of perjury: _____
Name of Buyer

Buyer is registered as a gasohol blender with registration number _____. Buyer's registration has not been suspended or revoked by the Internal Revenue Service.

The gasoline bought under this certificate will be used by Buyer to produce gasohol (as defined in §48.4081-6(b) of the Manufacturers and Retailers Excise Tax Regulations) within 24 hours after buying the gasoline.

Type of gasohol Buyer will produce (check one only):

- _____ 10% gasohol
- _____ 7.7% gasohol
- _____ 5.7% gasohol

If the gasohol the Buyer will produce will contain ethanol, check here: _____.

This certificate applies to the following (complete as applicable):

If this is a single purchase certificate, check here _____ and enter:

1. Account number _____
2. Number of gallons _____

If this is a certificate covering all purchases under a specified account or order number, check here _____ and enter:

1. Effective date _____
2. Expiration date _____ (period not to exceed 1 year after the effective date)
3. Buyer account or order number _____

Buyer will not claim a credit or refund under section 6427(f) of the Internal Revenue Code for any gasoline covered by this certificate.

Buyer agrees to provide seller with a new certificate if any information on this certificate changes.

Buyer understands that Buyer's registration may be revoked if the gasoline covered by this certificate is resold or is used other than in Buyer's production of the type of gasohol identified above.

Buyer will reduce any alcohol mixture credit under section 40(b) by an amount equal to the benefit of the gasohol production tax rate under section 4081(c) for the gasohol to which this certificate relates.

Buyer understands that the fraudulent use of this certificate may subject Buyer and all parties making any fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Printed or typed name of person signing

Title of person signing

Employer identification number

Address of Buyer

Signature and date signed

(iii) *Use of Form 637 or letter of registration as a gasohol blender's certificate prohibited.* A copy of the certificate of registry (Form 637) or letter of registration issued to a gasohol blender by the Internal Revenue Service is not a gasohol blender's certificate described in paragraph (c)(2)(ii) of this section.

(d) *Rate of tax on gasohol removed or entered.* The rate of tax imposed on removals or entries of any gasohol under §§48.4081-2(b), 48.4081-3(b)(1), and 48.4081-3(c)(1) is the gasohol tax rate. The rate of tax imposed on removals and entries of excess liquid described in paragraph (b)(2) of this section is the rate of tax applicable to gasoline under section 4081(a).

(e) *Tax rates—(1) Gasohol production tax rate.* The gasohol production tax rate is the applicable rate of tax determined under section 4081(c)(2)(A).

(2) *Gasohol tax rate.* The gasohol tax rate is the applicable alcohol mixture rate determined under section 4081(c)(4)(A).

(f) *Later separation and failure to blend—(1) Later separation—(i) Imposition of tax.* A tax is imposed on the removal or sale of gasoline separated from gasohol with respect to which tax was imposed at a rate described in paragraph (e) of this section or with respect to which a credit or payment was allowed or made by reason of section 6427(f)(1).

(ii) *Liability for tax.* The person that owns the gasohol at the time gasoline is separated from the gasohol is liable for the tax imposed under paragraph (f)(1)(i) of this section.

(iii) *Rate of tax.* The rate of tax imposed under paragraph (f)(1)(i) of this section is the difference between the rate of tax applicable to gasoline not described in this section and the applicable gasohol production tax rate.

(2) *Failure to blend—(i) Imposition of tax.* Tax is imposed on the entry, removal, or sale of gasoline (including excess liquid described in paragraph (b)(2) of this section) with respect to which tax was imposed at a gasohol production tax rate if—

(A) The gasoline was not blended into gasohol; or

(B) The gasoline was blended into gasohol but the gasohol production tax rate applicable to the type of gasohol produced is greater than the rate of tax originally imposed on the gasoline.

(ii) *Liability for tax.* (A) In the case of gasoline with respect to which tax was imposed at the gasohol production tax rate under paragraph (c)(1)(i) of this section, the person liable for the tax imposed by paragraph (f)(2)(i) of this section is the person that was liable for tax on the entry or removal.

(B) In the case of gasoline with respect to which tax was imposed at the gasohol production tax rate under paragraph (c)(1)(ii) of this section, the person that bought the gasoline in connection with the entry or removal is liable for the tax imposed under paragraph (f)(2)(i) of this section.

(iii) *Rate of tax.* The rate of tax imposed on gasoline described in paragraph (f)(2)(i)(A) of this section is the difference between the rate of tax applicable to gasoline not described in this section and the rate of tax previously imposed on the gasoline. The rate of tax imposed on gasoline described in paragraph (f)(2)(i)(B) of this section is the difference between the gasohol production tax rate applicable to the type of gasohol produced and the rate of tax previously imposed on the gasoline.

(iv) *Example.* The following example illustrates this paragraph (f)(2):

Example. (i) A registered gasohol blender bought gasoline in connection with a removal described in paragraph (c)(1)(ii) of this section. Based on the blender's certification (described in paragraph (c)(2) of this section) that the blender would produce 10 percent gasohol with the gasoline, tax at the gasohol production tax rate applicable to 10 percent gasohol was imposed on the removal.

(ii) The blender then produced a mixture by splash blending in a tank holding approximately 8000 gallons of mixture. The applicable delivery tickets show that the mixture was blended by first pumping 7220 metered gallons of gasoline into the empty tank, and then pumping 780 metered gallons of alcohol into the tank. Because the mixture contains 9.75 percent alcohol (as determined based on the delivery tickets provided to the blender) the entire mixture qualifies as 7.7 percent gasohol, rather than 10 percent gasohol.

(iii) Because the 7220 gallons of gasoline were taxed at the gasohol production tax rate applicable to 10 percent gasohol but the gasoline was blended into 7.7 percent gasohol, a failure to blend has occurred with respect to the gasoline. As the person that bought the gasoline in connection with the taxable removal, the blender is liable for the tax imposed under paragraph (f)(2)(i) of this section. The amount of tax imposed is the difference between—

(A) 7220 gallons times the gasohol production tax rate applicable to 7.7 percent gasohol; and

(B) 7220 gallons times the gasohol production tax rate applicable to 10 percent gasohol.

(iv) Because the gasohol does not contain exactly 7.7 percent alcohol, the benefit of the

gasohol production tax rate with respect to the alcohol is less than the amount of the alcohol mixture credit under section 40(b) (determined before the application of section 40(c)). Accordingly, the blender may be entitled to claim an alcohol mixture credit for the alcohol used in the gasohol. Under section 40(c), however, the amount of the alcohol mixture credit must be reduced to take into account the benefit provided with respect to the alcohol by the gasohol production tax rate.

(g) *Effective date.* This section is effective August 7, 1995.

Par. 10. Section 48.4081-7 is amended as follows:

1. The heading for §48.4081-7 is revised.

2. In paragraphs (a) and (b), the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

3. Paragraphs (b)(4) and (c)(1) are revised.

4. In paragraph (c)(2), the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

5. Paragraph (c)(3) is revised.

6. In paragraphs (c)(4)(i)(A) and (B), (ii)(A) and (B), and (iii), the language "gasoline" is removed each place it appears and "taxable fuel" is added in its place.

7. In paragraph (c)(4)(iv)(A), the language "(or such other model statement as the Commissioner may prescribe)" is added immediately after "paragraph (c)(4)(iv)(B) of this section".

8. In paragraph (c)(4)(iv)(B):

a. The description of line 4 is revised to read: "Volume and type of taxable fuel sold".

b. In the first paragraph following line 4 the language "gasoline" is removed and "taxable fuel" is added in its place.

9. Paragraph (c)(5) is removed.

10. Paragraph (d) is revised.

11. Paragraph (f), *Example 1*, paragraph (i), is amended by: a. Removing the language "1993" in the first and fourth sentences and adding "1996" in its place.

b. Removing the language "paragraph (c)(2)" and adding "paragraph (c)" in its place.

12. Paragraph (f), *Example 1*, paragraph (ii), is amended by removing the language "1993" in the first and second sentences and adding "1996" in its place.

13. Paragraph (g) is revised.

The revisions read as follows:

§48.4081-7 Taxable fuel; conditions for refunds of taxable fuel tax under section 4081(e).

* * * * *

(b) * * *

(4) The person that paid the first tax to the government has met the reporting requirements of paragraph (c) of this section.

(c) * * * (1) Reporting by persons paying the first tax. Except as provided in paragraph (c)(3) of this section, the person that paid the first tax under §48.4081-3 (the first taxpayer) must file a report that is in substantially the same form as the model report provided in paragraph (c)(2) of this section (or such other model report as the Commissioner may prescribe) and contains all information necessary to complete such model report (the first taxpayer's report). A first taxpayer's report must be filed with the return to which the report relates (or at such other time, or in such other manner, as prescribed by the Commissioner).

* * * * *

(3) Optional reporting for certain taxable events. Paragraph (c)(1) of this section does not apply with respect to a tax imposed under §48.4081-2 (removal at a terminal rack), §48.4081-3(c)(1)(ii) (nonbulk entries into the United States), or §48.4081-3(g) (removals or sales by blenders). However, if the person liable for the tax expects that another tax will be imposed under section 4081 with respect to the taxable fuel, that person should (but is not required to) file a first taxpayer's report.

* * * * *

(d) Form and content of claim—(1) In general. The following rules apply to claims for refund under section 4081(e):

(i) The claim must be made by the person that paid the second tax to the government and must include all the information described in paragraph (d)(2) of this section.

(ii) The claim must be made on Form 8849 (or such other form as the Commissioner may designate) in accordance with the instructions on the

form. The form should be marked Section 4081(e) Claim at the top. Section 4081(e) claims must not be included with a claim for a refund under any other provision of the Internal Revenue Code.

(2) Information to be included in the claim. Each claim for a refund under section 4081(e) must contain the following information with respect to the taxable fuel covered by the claim:

(i) Volume and type of taxable fuel.
(ii) Date on which the claimant incurred the tax liability to which this claim relates (the second tax).

(iii) Amount of second tax that claimant paid to the government and a statement that claimant has not included the amount of this tax in the sales price of the taxable fuel to which this claim relates and has not collected that amount from the person that bought the taxable fuel from claimant.

(iv) Name, address, and employer identification number of the person that paid the first tax to the government.

(v) A copy of the first taxpayer's report that relates to the taxable fuel covered by the claim.

(vi) If the taxable fuel covered by the claim was bought other than from the first taxpayer, a copy of the statement of subsequent seller that the claimant received with respect to that taxable fuel.

* * * * *

(g) Effective date. This section is effective in the case of taxable fuel with respect to which the first tax is imposed after September 30, 1995.

Par. 11. Section 48.4101-3 is added to read as follows:

§48.4101-3 Registration.

(a) A refiner that is registered under section 4101 may treat itself with respect to the bulk removal of any batch of gasohol from its refinery as a person that is not registered under section 4101. See §48.4081-3(b)(1)(iii).

(b) This section is effective October 1, 1995.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 12. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§602.101 [Amended]

Par. 13. In §602.101, paragraph (c) is amended by removing the entry for 48.4041-21 from the table and adding the entry "48.4041-21 .. 1545-1270" in numerical order to the table.

Margaret Milner Richardson,
Commissioner of
Internal Revenue.

Approved July 25, 1995.

Leslie Samuels,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on August 4, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 7, 1995, 60 F.R. 40079)

Chapter 38.—Environmental Taxes
Subchapter D.—Ozone Depleting Chemicals, Etc.

Section 4681.—Imposition of Tax

26 CFR 52.4681-1: Taxes imposed with respect to ozone-depleting chemicals. (Also Section 4682.)

T.D. 8622

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 52 and 602

Exports of Chemicals that Deplete the Ozone Layer; Special Rules for Certain Medical Uses of Chemicals that Deplete the Ozone Layer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to taxes imposed on exports of ozone-depleting chemicals (ODCs), taxes imposed on ODCs used as medical sterilants or propellants in metered-dose inhalers, and floor stocks taxes on ODCs. The regulations reflect changes to the law made by the Omnibus Budget Reconciliation Act of 1989, the Omnibus Budget Reconciliation Act of 1990, and the Energy Policy Act of 1992 and

affect persons who manufacture, import, export, sell, or use ODCs.

EFFECTIVE DATE: These regulations are effective January 1, 1993.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1361.

Estimated average annual burden per recordkeeper: 0.2 hour.

Estimated average annual burden per respondent: 0.1 hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document contains amendments to the Environmental Tax Regulations (26 CFR part 52) relating to exports of ODCs under sections 4681 and 4682. Sections 4681 and 4682 were enacted as part of the Omnibus Budget Reconciliation Act of 1989, and amended by the Omnibus Budget Reconciliation Act of 1990 and the Energy Policy Act of 1992 (Energy Act).

Section 4682(d)(3) provides a limited exemption from tax for ODCs that are exported. Although final regulations (TD 8370 [1991-2 C.B. 377]) under sections 4681 and 4682 were published in the Federal Register on November 4, 1991 (56 FR 56303), the section relating to exports of ODCs was reserved.

The Energy Act increased and made uniform the base tax amounts for all ODCs and extended the floor stocks tax to calendar years after 1994. The Energy Act also provides a reduced rate of tax for (1) ODCs used as propellants in metered-dose inhalers (for years after 1992), (2) ODCs used as medical sterilants (for 1993 only), and (3) methyl chloroform (for 1993 only).

On January 15, 1993, proposed regulations (PS-89-91 [1993-1 C.B. 922]) relating to exports of ODCs and the Energy Act changes were published in the Federal Register (58 FR 4625). Written comments responding to the notice of proposed rulemaking were received. A public hearing was not held. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision. The comments and revisions are discussed below.

Explanation of Revisions and Summary of Comments

Mixtures

Under the 1991 final regulations, the creation of a mixture is treated as a taxable use of the ODCs contained in the mixture unless a person elects other treatment (the mixture election). The proposed regulations provided, however, that the creation of a mixture for export is not a taxable use of the ODCs contained in the mixture. Commenters supported the proposed rule and suggested that it also apply to mixtures created for feedstock use. These final regulations adopt the proposed rule and extend its application to include the creation of a mixture for feedstock use. However, these regulations do not adopt the suggestion that the rule be further extended to apply to sales of ODCs for the creation of a mixture.

Metered-dose Inhalers

Several commenters pointed out that the proposed definition of a metered-dose inhaler, by including the phrase *directly to the lungs*, excluded two of the eight types of inhalers. They suggested that we modify the definition to remove this phrase. The final regulations adopt this suggestion.

Exemption Amount

One commenter pointed out that the provisions of the proposed regulations describing exemption amounts should refer to exceptions from tax under section 4682(d) rather than under section 4682(d)(3). The final regulations adopt the suggested reference.

One commenter suggested that we add an example illustrating the calculation of the exemption amount when a person is both a manufacturer and an

importer. The final regulations provide such an example.

Registration

One commenter suggested that we specify how to register with the IRS. The final regulations explain the registration procedure.

Credit or Refund for Exports

One commenter thought that the wording of the proposed rule relating to a claim for credit or refund of tax paid on ODCs that are exported was ambiguous as to which year's exemption limitation applies to such a claim. The final regulations clarify that the applicable limitation is the limitation for the calendar year during which the ODCs were sold.

The same commenter raised questions about the documentation to be submitted with a claim and suggested that the regulations provide more information. Documentation needs to be submitted with a claim only if specifically required. Neither the proposed nor the final regulations require documentation to be submitted with the claim.

Another commenter suggested that for periods before 1993 we accept export documentation similar to that required by the Environmental Protection Agency. These final regulations provide that such documentation is acceptable.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 52 and 602 are amended as follows:

PART 52—ENVIRONMENTAL TAXES

Paragraph 1. The authority citation for part 52 is amended by adding an entry in numerical order to read in part as follows:

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

Section 52.4682-5 also issued under 26 U.S.C. 4662(e)(4).

§52.4681-0 [Removed]

Par. 2. Section 52.4681-0 is removed.

Par. 3. Section 52.4681-1 is amended by:

- 1. Revising paragraph (a)(3)(ii).
2. Revising paragraph (c)(7)(iii)(A).
3. Revising paragraph (d)(3).

The revisions read as follows:

§52.4681-1 Taxes imposed with respect to ozone-depleting chemicals.

- (a) * * *
(3) * * *

(ii) Dates on which tax imposed. The floor stocks tax is imposed on January 1 of each calendar year after 1989.

* * * * *

- (c) * * *
(7) * * *
(iii) * * *

(A) Section 52.4682-1(b)(2)(iii) (relating to mixture elections), 52.4682-1(b)(2)(iv) (relating to mixtures for export), and 52.4682-1(b)(2)(v) (relating to mixtures for use as a feedstock);

* * * * *

- (d) * * *

(3) Post-1989 ODCs held for sale or for use in further manufacture by any person other than the manufacturer or importer thereof on January 1, 1990, and post-1989 and post-1990 ODCs that are so held on January 1 of each calendar year after 1990.

Par. 4. Section 52.4682-1 is amended by:

- 1. Revising paragraph (a).
2. Revising the introductory text of paragraph (b)(2)(ii).
3. Adding paragraph (b)(2)(iv).
4. Revising paragraphs (f) and (g).
5. Adding paragraph (h).
6. Adding and reserving paragraph (i).
7. Adding paragraph (j).
8. Adding and reserving paragraph (k).

The revisions and additions read as follows:

§52.4682-1 Ozone-depleting chemicals.

(a) Overview. This section provides rules relating to the tax imposed on ozone-depleting chemicals (ODCs) under section 4681, including rules for identifying taxable ODCs and determining when the tax is imposed, and rules prescribing special treatment for certain ODCs. See §52.4681-1(a)(1) and (c) for general rules and definitions relating to the tax on ODCs.

- (b) * * *
(2) * * *

(ii) Mixtures. Except as provided in paragraphs (b)(2)(iii), (iv), and (v) of this section, the creation of a mixture containing two or more ingredients is treated as a taxable use of the ODCs contained in the mixture. For this purpose, a mixture cannot be represented by a chemical formula, and an ODC is contained in a mixture only if the chemical identity of the ODC is not changed. Thus, except as provided in paragraphs (b)(2)(iii), (iv), and (v) of this section—

* * * * *

(iv) Special rule for exports. The creation of a mixture for export is not a taxable use of the ODCs contained in the mixture. If a manufacturer or importer sells a mixture for export, §52.4682-5 applies to the ODCs contained in the mixture. See §52.4682-5(e) for rules relating to liability of a purchaser for tax if the mixture is not exported.

(v) Special rule for use as a feedstock. The creation of a mixture for use as a feedstock (within the meaning of paragraph (c) of this section) is not a taxable use of the ODCs contained in the mixture.

* * * * *

- (f) Methyl chloroform; reduced rate

of tax in 1993. The amount of tax imposed on methyl chloroform is determined under section 4682(g)(5) if the manufacturer or importer of the methyl chloroform sells or uses it during 1993.

(g) ODCs used as medical sterilants—(1) Phase-in of tax. The amount of tax imposed on an ODC is determined under section 4682(g)(4) if the manufacturer or importer of the ODC—

- (i) Uses the ODC during 1993 as a medical sterilant; or
(ii) Sells the ODC in a qualifying sale (within the meaning of paragraph (g)(4) of this section) during 1993.

(2) Excess payments—(i) In general. Under section 4682(g)(4)(B), a credit against income tax (without interest) or a refund of tax (without interest) is allowed to a person if—

- (A) The person uses an ODC during 1993 as a medical sterilant; and
(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 exceeds the amount that would have been determined under section 4682(g)(4).

(ii) Amount of credit or refund. The amount of credit or refund of tax is equal to the excess of—

- (A) The tax that was paid with respect to the ODCs under sections 4681 and 4682; over
(B) The tax that would have been imposed under section 4682(g)(4).

(iii) Procedural rules. (A) The amount determined under section 4682(g)(4)(B) and paragraph (g)(2)(ii) of this section is treated as a credit described in section 34(a) (relating to credits for gasoline and special fuels) unless a claim for refund has been filed.

(B) See section 6402 and the regulations under that section for procedural rules relating to claiming a credit or refund of tax.

(3) Definition of use as a medical sterilant. An ODC is used as a medical sterilant if it is used in the manufacture of sterilant gas.

(4) Qualifying sale. A sale of an ODC for use as a medical sterilant is a qualifying sale if the requirements of §52.4682-2(b)(3) are satisfied with respect to the sale.

(h) ODCs used as propellants in metered-dose inhalers—(1) Reduced rate of tax. The amount of tax imposed on an ODC is determined under section 4682(g)(4) if the manufacturer or importer of the ODC—

(i) Uses the ODC after 1992 as a propellant in a metered-dose inhaler; or

(ii) Sells the ODC in a qualifying sale (within the meaning of paragraph (h)(4) of this section) after 1992.

(2) *Excess payments*—(i) *In general.* Under section 4682(g)(4)(B), a credit against income tax (without interest) or a refund of tax (without interest) is allowed to a person if—

(A) The person uses an ODC after 1992 as a propellant in a metered-dose inhaler; and

(B) The amount of any tax paid with respect to the ODC under section 4681 or 4682 exceeds the amount that would have been determined under section 4682(g)(4).

(ii) *Amount of credit or refund.* The amount of credit or refund of tax is equal to the excess of—

(A) The tax that was paid with respect to the ODCs under sections 4681 and 4682; over

(B) The tax that would have been imposed under section 4682(g)(4).

(iii) *Procedural rules*—(A) The amount determined under section 4682(g)(4)(B) and paragraph (h)(2)(ii) of this section is treated as a credit described in section 34(a) (relating to credits for gasoline and special fuels) unless a claim for refund has been filed.

(B) See section 6402 and the regulations under that section for procedural rules relating to claiming a credit or refund of tax.

(3) *Definition of metered-dose inhaler.* A metered-dose inhaler is an aerosol device that delivers a precisely-measured dose of a therapeutic drug.

(4) *Qualifying sale.* A sale of an ODC for use as a propellant for a metered-dose inhaler is a qualifying sale if the requirements of §52.4682-2(b)(4) are satisfied with respect to the sale.

(i) [Reserved]

(j) *Exports; cross-reference.* For the treatment of exports of ODCs, see §52.4682-5.

(k) *Recycling.* [Reserved]

Par. 5. Section 52.4682-2 is amended by:

1. Adding paragraphs (a)(1)(iii) and (a)(1)(iv).

2. Amending the second sentence of paragraph (a)(2) by:

a. Removing the language “submission of a document to” and adding “registration with” in its place.

b. Removing the language “registration certificates” and adding “certificates” in its place.

3. Removing the language “registration” from paragraphs (b)(1)(i) and (b)(2)(i).

4. Adding paragraphs (b)(3) and (b)(4).

5. Revising the heading for paragraph (d).

6. Revising paragraph (d)(1)(i).

7. Adding paragraphs (d)(4) and (d)(5).

The additions and revisions read as follows:

§52.4682-2 *Qualifying sales.*

(a) * * *

(1) * * *

(iii) Under section 4682(g)(4) and §52.4682-1(g) (relating to ODCs used as medical sterilants), ODCs sold in qualifying sales are taxed at a reduced rate in 1993.

(iv) Under section 4682(g)(4) and §52.4682-1(h) (relating to ODCs used as propellants in metered-dose inhalers), ODCs sold in qualifying sales are taxed at a reduced rate in years after 1992.

* * * * *

(b) * * *

(3) *Use as medical sterilants.* A sale of ODCs is a qualifying sale for purposes of §52.4682-1(g) if the manufacturer or importer of the ODCs—

(i) Obtains a certificate in substantially the form set forth in paragraph (d)(4) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

(4) *Use as propellants in metered-dose inhalers.* A sale of ODCs is a qualifying sale for purposes of §§52.4682-1(h) and 52.4682-4(b)-(2)(vii) if the manufacturer or importer of the ODCs—

(i) Obtains a certificate in substantially the form set forth in paragraph (d)(5) of this section from the purchaser of the ODCs; and

(ii) Relies on the certificate in good faith.

* * * * *

(d) *Certificate*—(1) * * * (i) *Rules relating to all certificates.* This paragraph (d) sets forth certificates that satisfy the requirements of paragraphs (b)(1) through (4) of this section. The certificate shall consist of a statement executed and signed under penalties of perjury by a person with authority to bind the purchaser. A certificate provided under paragraph (d)(2) or (5) of this section may apply to a single purchase or to multiple purchases and need not specify an expiration date. A certificate provided under paragraph (d)(3) or (4) of this section may apply to a single purchase or multiple purchases, and will expire as of December 31, 1993, unless an earlier expiration date is specified in the certificate. A new certificate must be given to the supplier if any information on the current certificate changes. The certificate may be included as part of any business records normally used to document a sale.

* * * * *

(4) *Certificate relating to ODCs used as medical sterilants*—(i) *ODCs that will be resold for use by the second purchaser as medical sterilants.* If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser as medical sterilants, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD
FOR USE BY THE SECOND PURCHASER AS MEDICAL STERILANTS

(To support tax-reduced sales under section
4682(g)(4) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

(not after 12/31/93)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use as medical sterilants (as defined in §52.4682-1(g)(3) of the Environmental Tax Regulations).

PRODUCT

PERCENTAGE

CFC-12

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

(ii) *ODCs that will be used by the purchaser as medical sterilants.* If the purchaser will use the ODCs as medical sterilants, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY
THE PURCHASER AS MEDICAL STERILANTS

(To support tax-reduced sales under section
4682(g)(4) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

(not after 12/31/93)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:
The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

will be used by Purchaser as medical sterilants (as defined in §52.4682-1(g)(3) of the Environmental Tax Regulations).

PRODUCT

PERCENTAGE

CFC-12

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than as medical sterilants may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use as medical sterilants of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

(5) *Certificate relating to ODCs used as propellants in metered-dose inhalers—(i) ODCs that will be resold for use by the second purchaser as propellants in metered-dose inhalers.* If the purchaser will resell the ODCs to a second purchaser for use by such second purchaser as propellants in metered-dose inhalers, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE RESOLD
FOR USE BY THE SECOND PURCHASER AS PROPELLANTS IN
METERED-DOSE INHALERS

(To support tax-reduced sales under section
4682(g)(4) of the Internal Revenue Code.)

Date _____

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are purchasing the ozone-depleting chemicals for use as propellants in metered-dose inhalers (as defined in §52.4682-1(h)(3) of the Environmental Tax Regulations).

| <i>PRODUCT</i> | <i>PERCENTAGE</i> |
|----------------|-------------------|
| CFC-11 | _____ |
| CFC-12 | _____ |
| CFC-114 | _____ |

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than for the purpose set forth in this certificate may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the sales covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn. In addition, the Internal Revenue Service has not notified Purchaser that the right to provide a certificate has been withdrawn from any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

(ii) *ODCs that will be used by the purchaser as propellants in metered-dose inhalers.* If the purchaser will use the ODCs as propellants in metered-dose inhalers, the certificate provided by the purchaser must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS THAT WILL BE USED BY
THE PURCHASER AS PROPELLANTS IN METERED-DOSE INHALERS

(To support tax-reduced sales under section
4682(g)(4) of the Internal Revenue Code.)

Date _____

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:
The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

will be used by Purchaser as propellants in metered-dose inhalers (as defined in §52.4682-1(h)(3) of the Environmental Tax Regulations).

| <i>PRODUCT</i> | <i>PERCENTAGE</i> |
|----------------|-------------------|
| CFC-11 | _____ |
| CFC-12 | _____ |
| CFC-114 | _____ |

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser will not claim a credit or refund under section 4682(g)(4) of the Internal Revenue Code for any ozone-depleting chemicals covered by this certificate.

Purchaser understands that any use by Purchaser of the ozone-depleting chemicals to which this certificate applies other than as propellants in metered-dose inhalers may result in the withdrawal by the Internal Revenue Service of Purchaser's right to provide a certificate.

Purchaser will retain the business records needed to document the use as propellants in metered-dose inhalers of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its right to provide a certificate has been withdrawn.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

Par. 6. Section 52.4682-4 is amended by:

- 1. Removing the introductory text of paragraph (b)(2).
- 2. Revising the first sentence of paragraph (b)(2)(i)(B)(I).
- 3. Adding paragraphs (b)(2)(vi) through (b)(2)(viii).
- 4. Adding a sentence at the end of paragraph (d)(1)(i).
- 5. Revising paragraph (d)(1)(iv)-(A)(I).
- 6. Adding paragraph (d)(4).
- 7. Revising paragraph (e)(4)(i).
- 8. Redesignating paragraph (e)(5) as paragraph (e)(6) and adding a new paragraph (e)(5).
- 9. Revising *Example 5* of newly designated paragraph (e)(6).

The revisions and additions read as follows:

§52.4682-4 Floor stocks tax.

* * * * *

(b) * * *

(2) * * *

(i) * * *

(B) * * * (I) *In general.* In the case of the floor stocks tax imposed on January 1 of a calendar year after 1990, the tax is not imposed on an ODC that has been mixed with any other ingredients, but only if it is established that such ingredients contribute to the accomplishment of the purpose for which the mixture will be used. * * *

* * * * *

(vi) *ODCs to be exported*—(A) *In general.* The floor stocks tax is not imposed on any ODC that was sold in a qualifying sale for export (as defined in §52.4682-5(d)(1)).

(B) *ODCs sold before January 1, 1993.* An ODC that was sold by its manufacturer or importer before January 1, 1993, is treated, for purposes of

this paragraph (b)(2)(vi), as an ODC that was sold in a qualifying sale for export for purposes of §52.4682-5(d)(1) if the ODC will be exported.

(vii) *ODCs used as propellants in metered-dose inhalers; years after 1992*—(A) *In general.* The floor stocks tax is not imposed on January 1 of calendar years after 1992 on any ODC that was sold in a qualifying sale for use as a propellant in a metered-dose inhaler (as defined in §52.4682-1(h)).

(B) *ODCs sold before January 1, 1993.* An ODC that was sold by its manufacturer or importer before January 1, 1993, is treated, for purposes of this paragraph (b)(2)(vii), as an ODC that was sold in a qualifying sale for purposes of §52.4682-1(h) if the ODC will be used as a propellant in a metered-dose inhaler (within the meaning of §52.4682-1(h)).

(viii) *ODCs used as medical sterilants; 1993.* The floor stocks tax is not imposed in 1993 on any ODC held for use as a medical sterilant (as defined in §52.4682-1(g)).

* * * * *

(d) * * *

(1) * * *

(i) * * * The amount of the floor stocks tax imposed on the ODCs contained in a nonexempt mixture is computed on the basis of the weight of the ODCs in that mixture.

* * * * *

(iv) * * *

(A) * * *

(I) The tentative tax amount is determined, except as provided in paragraph (d)(2), (3), or (4) of this section, by reference to the rate of tax prescribed in section 4681(b)(1)(B) and the ozone-depletion factors prescribed in section 4682(b).

* * * * *

(4) *Methyl chloroform; 1993.* In the

case of methyl chloroform, the tentative tax amount is determined under section 4682(g)(5) for purposes of computing the floor stocks tax imposed on January 1, 1993.

(e) * * *

(4) * * *

(i) At least 400 pounds of ODCs that are not described in paragraph (d)(2) or (d)(3) of this section and are otherwise subject to tax;

* * * * *

(5) *Calendar years after 1994.* In the case of the floor stocks tax imposed on January 1 of 1995 and each following calendar year, a person is liable for the tax only if, on such date, the person holds—

(i) At least 400 pounds of ODCs that are not described in paragraph (d)(3) or (d)(4) of this section and are otherwise subject to tax;

(ii) At least 50 pounds of ODCs that are described in paragraph (d)(3) of this section and are otherwise subject to tax; or

(iii) At least 1000 pounds of ODCs that are described in paragraph (d)(4) of this section and are otherwise subject to tax.

(6) * * *

Example 5. (a) On January 1, 1994, D holds for sale 300 pounds of CFC-113 (an ODC not described in paragraph (d)(2) or (d)(3) of this section) and 25 pounds of Halon-1301 (an ODC described in paragraph (d)(3) of this section). D is liable for the floor stocks tax imposed on January 1, 1994, because 25 pounds of Halon-1301 exceeds the de minimis amount specified in paragraph (e)(4)(iii) of this section. The 300 pounds of CFC-113 is less than the amount specified in paragraph (e)(4)(i) of this section. Nevertheless, tax is imposed on both the 25 pounds of Halon-1301 and the 300 pounds of CFC-113.

(b) The amount of the floor stocks tax is determined separately for the 300 pounds of CFC-113 and the 25 pounds of Halon-1301 and is equal to the difference between the tentative tax amount and the amount of tax previously imposed on those ODCs. For Halon-1301, for

example, the tax is determined as follows. The tentative tax amount is \$1,087.50 (\$4.35 (the base tax amount in 1994) × 10 (the ozone-depletion factor for Halon-1301) × 25 (the number of pounds held)). The tax previously imposed on the Halon-1301 is \$6.28 (\$3.35 (the base tax amount in 1993) × 10 (the ozone-depletion factor for Halon-1301) × 0.75 percent (the applicable percentage determined under section 4682(g)(2)(A)) × 25 (the number of pounds held)). Thus, the floor stocks tax imposed on the 25 pounds of Halon-1301 in 1994 is \$1,081.22, the difference between \$1,087.50 (the tentative tax amount) and \$6.28 (the tax previously imposed).

* * * * *

Par. 7. Section 52.4682-5 is added to read as follows:

§52.4682-5 *Exports.*

(a) *Overview.* This section provides rules relating to the tax imposed under section 4681 on ozone-depleting chemicals (ODCs) that are exported. In general, tax is not imposed on ODCs that a manufacturer or importer sells for export, or for resale by the purchaser to a second purchaser for export, if the procedural requirements set forth in paragraph (d) of this section are met. The tax benefit of this exemption is limited, however, to the manufacturer's or importer's exemption amount. Thus, if the tax that would otherwise be imposed under section 4681 on ODCs that a manufacturer or importer sells for export exceeds this exemption amount, a tax equal to the excess is imposed on the ODCs. The exemption amount, which is determined separately for post-1989 ODCs and post-1990 ODCs, is calculated for each calendar year in accordance with the rules of paragraph (c) of this section. This section also provides rules under which a tax imposed under section 4681 on exported ODCs may be credited or refunded, subject to the same limit on tax benefits, if the procedural requirements set forth in paragraph (f) of this section are met. See §52.4681-1(c) for definitions relating to the tax on ODCs.

(b) *Exemption or partial exemption from tax—(1) In general.* Except as provided in paragraph (b)(2) of this section, no tax is imposed on an ODC if the manufacturer or importer of the ODC sells the ODC in a qualifying sale for export (within the meaning of paragraph (d)(1) of this section).

(2) *Tax imposed if exemption amount exceeded—(i) Post-1989 ODCs.* The tax imposed on post-1989 ODCs that a manufacturer or importer

sells in qualifying sales for export during a calendar year is equal to the excess (if any) of—

(A) The tax that would be imposed on the ODCs but for section 4682(d)(3) and this section; over

(B) The post-1989 ODC exemption amount for the calendar year determined under paragraph (c)(1) of this section.

(ii) *Post-1990 ODCs.* The tax imposed on post-1990 ODCs that a manufacturer or importer sells in qualifying sales for export during a calendar year is equal to the excess (if any) of—

(A) The tax that would be imposed on the ODCs but for section 4682(d)(3) and this section; over

(B) The post-1990 ODC exemption amount for the calendar year determined under paragraph (c)(2) of this section.

(iii) *Allocation of tax—(A) Post-1989 ODCs.* The tax (if any) determined under paragraph (b)(2)(i) of this section may be allocated among the post-1989 ODCs on which it is imposed in any manner, provided that the amount allocated to any post-1989 ODC does not exceed the tax that would be imposed on such ODC but for section 4682(d)(3) and this section.

(B) *Post-1990 ODCs.* The tax (if any) determined under paragraph (b)(2)(ii) of this section may be allocated among the post-1990 ODCs on which it is imposed in any manner, provided that the amount allocated to any post-1990 ODC does not exceed the tax that would be imposed on such ODC but for section 4682(d)(3) and this section.

(c) *Exemption amount—(1) Post-1989 ODC exemption amount.* A manufacturer's or importer's post-1989 ODC exemption amount for a calendar year is the sum of the following amounts:

(i) The 1986 export percentage of the aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on the maximum quantity, determined without regard to additional production allowances, of post-1989 ODCs that the person is permitted to manufacture during the calendar year under rules prescribed by the Environmental Protection Agency (40 CFR part 82).

(ii) The aggregate tax that would (but for section 4682(d), section

4682(g), and this section) be imposed under section 4681 on post-1989 ODCs that the person manufactures during the calendar year under any additional production allowance granted by the Environmental Protection Agency.

(iii) The aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on post-1989 ODCs imported by the person during the calendar year.

(2) *Post-1990 ODC exemption amount.* A manufacturer's or importer's post-1990 ODC exemption amount for a calendar year is the sum of the following amounts:

(i) The 1989 export percentage of the aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on the maximum quantity, determined without regard to additional production allowances, of post-1990 ODCs the person is permitted to manufacture during the calendar year under rules prescribed by the Environmental Protection Agency.

(ii) The aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on post-1990 ODCs that the person manufactures during the calendar year under any additional production allowance granted by the Environmental Protection Agency.

(iii) The aggregate tax that would (but for section 4682(d), section 4682(g), and this section) be imposed under section 4681 on post-1990 ODCs imported by the person during the calendar year.

(3) *Definitions—(i) 1986 export percentage.* See section 4682(d)(3)(B)(ii) for the meaning of the term *1986 export percentage*.

(ii) *1989 export percentage.* See section 4682(d)(3)(C) for the meaning of the term *1989 export percentage*.

(d) *Procedural requirements relating to tax-free sales for export—(1) Qualifying sales—(i) In general.* A sale of ODCs is a qualifying sale for export if—

(A) The seller is the manufacturer or importer of the ODCs and the purchaser is a purchaser for export or for resale to a second purchaser for export;

(B) At the time of the sale, the seller and the purchaser are registered with the Internal Revenue Service; and

(C) At the time of the sale, the seller—

(1) Has an unexpired certificate in substantially the form set forth in paragraph (d)(3)(ii) of this section from the purchaser; and

(2) Relies on the certificate in good faith.

(ii) *Qualifying resale.* A sale of ODCs is a qualifying resale for export if—

(A) The seller acquired the ODCs in a qualifying sale for export and the purchaser is a second purchaser for export;

(B) At the time of the sale, the seller and the purchaser are registered with the Internal Revenue Service; and

(C) At the time of the sale, the seller—

(1) Has an unexpired certificate in substantially the form set forth in paragraph (d)(3)(ii)(A) of this section from the purchaser of the ODCs; and

(2) Relies on the certificate in good faith.

(iii) *Special rule relating to sales made before July 1, 1993.* If a sale for export made before July 1, 1993, satisfies all the requirements of paragraph (d)(1)(i) or (ii) of this section other than those relating to registration, the sale will be treated as a qualifying sale (or resale) for export. Thus, a sale

made before July 1, 1993, may be a qualifying sale (or resale) even if the parties to the sale are not registered and the required certificate does not contain statements regarding registration.

(iv) *Registration.* Application for registration is made on Form 637 (or any other form designated for the same use by the Commissioner) according to the instructions applicable to the form. A person is registered only if the district director has issued that person a letter of registration and it has not been revoked or suspended. The effective date of the registration must be no earlier than the date on which the district director signs the letter of registration. Each business unit that has, or is required to have, a separate employer identification number is treated as a separate person.

(2) *Good faith reliance.* The requirements of paragraph (d)(1) of this section are not satisfied with respect to a sale of ODCs and the sale is not a qualifying sale (or resale) if, at the time of the sale—

(i) The seller has reason to believe that the ODCs are not purchased for export; or

(ii) The Internal Revenue Service has notified the seller that the pur-

chaser's registration has been revoked or suspended.

(3) *Certificate—(i) In general.* The certificate required under paragraph (d)(1) of this section consists of a statement executed and signed under penalties of perjury by a person with authority to bind the purchaser, in substantially the same form as model certificates provided in paragraph (d)(3)(ii) of this section, and containing all information necessary to complete such model certificate. A new certificate must be given if any information in the current certificate changes. The certificate may be included as part of any business records normally used to document a sale. The certificate expires on the earliest of the following dates—

(A) The date one year after the effective date of the certificate;

(B) The date the purchaser provides a new certificate to the seller; or

(C) The date the seller is notified by the Internal Revenue Service or the purchaser that the purchaser's registration has been revoked or suspended.

(ii) *Model certificates—(A) ODCs sold for export by the purchaser.* If the purchaser will export the ODCs, the certificate must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS FOR EXPORT BY THE PURCHASER

(To support tax-free sales under section 4682(d)(3) of the Internal Revenue Code.)

Effective Date _____

Expiration Date _____

(not more than one year after effective date)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

Purchaser is registered with the Internal Revenue Service as a purchaser of ozone-depleting chemicals for export under registration number _____. Purchaser's registration has not been suspended or revoked by the Internal Revenue Service.

The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

(Taxpayer identifying number of seller)

are purchased for export by Purchaser.

| <i>PRODUCT</i> | <i>PERCENTAGE</i> |
|----------------------|-------------------|
| CFC-11 | _____ |
| CFC-12 | _____ |
| CFC-113 | _____ |
| CFC-114 | _____ |
| CFC-115 | _____ |
| Halon-1211 | _____ |
| Halon-1301 | _____ |
| Halon-2402 | _____ |
| Carbon tetrachloride | _____ |
| Methyl chloroform | _____ |
| Other (specify) | _____ |

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser understands that Purchaser will be liable for tax imposed under section 4681 if Purchaser does not export the ODCs to which this certificate applies.

Purchaser understands that any use of the ODCs to which this certificate applies other than for export may result in the revocation of Purchaser's registration.

Purchaser will retain the business records needed to document the export of the ozone-depleting chemicals to which this certificate applies and will make such records available for inspection by Government officers.

Purchaser has not been notified by the Internal Revenue Service that its registration has been revoked or suspended.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

 Name of Purchaser

 Address of Purchaser

 Taxpayer Identifying Number of Purchaser

 Title of person signing

Printed or typed name of person signing

Signature

(B) *ODCs sold by the purchaser for resale for export by the second purchaser.* If the purchaser will resell the ODCs to a second purchaser for export by the second purchaser, the certificate must be in substantially the following form:

CERTIFICATE OF PURCHASER OF CHEMICALS FOR RESALE
FOR EXPORT BY THE SECOND PURCHASER
(To support tax-free sales under section 4682(d)(3) of the
Internal Revenue Code.)

Effective Date _____

Expiration Date _____

(not more than one year after effective date)

The undersigned purchaser (Purchaser) certifies the following under penalties of perjury:

Purchaser is registered with the Internal Revenue Service as a purchaser of ozone-depleting chemicals for export under registration number _____. Purchaser's registration has not been suspended or revoked by the Internal Revenue Service.

The following percentage of ozone-depleting chemicals purchased from:

(Name of seller)

(Address of seller)

(Taxpayer identifying number of seller)

will be resold by Purchaser to persons (Second Purchasers) that certify to Purchaser that they are (1) registered with the Internal Revenue Service as purchasers of ozone-depleting chemicals for export and (2) purchasing the ozone-depleting chemicals for export.

| <i>PRODUCT</i> | <i>PERCENTAGE</i> |
|----------------------|-------------------|
| CFC-11 | _____ |
| CFC-12 | _____ |
| CFC-113 | _____ |
| CFC-114 | _____ |
| CFC-115 | _____ |
| Halon-1211 | _____ |
| Halon-1301 | _____ |
| Halon-2402 | _____ |
| Carbon tetrachloride | _____ |
| Methyl chloroform | _____ |
| Other (specify) | _____ |

This certificate applies to (check and complete as applicable):

_____ All shipments to Purchaser at the following location(s):

_____ All shipments to Purchaser under the following Purchaser account number(s):

_____ All shipments to Purchaser under the following purchase order(s):

_____ One or more shipments to Purchaser identified as follows:

Purchaser understands that Purchaser will be liable for tax imposed under section 4681 if Purchaser does not resell the ODCs to which this certificate applies to a Second Purchaser for export or export those ODCs.

Purchaser understands that any use of the ODCs to which this certificate applies other than for resale to Second Purchasers for export may result in the revocation of Purchaser's registration.

Purchaser will retain the business records needed to document the sales to Second Purchasers for export covered by this certificate and will make such records available for inspection by Government officers. Purchaser also will retain and make available for inspection by Government officers the certificates of its Second Purchasers.

Purchaser has not been notified by the Internal Revenue Service that its registration has been revoked or suspended. In addition, the Internal Revenue Service has not notified Purchaser of the revocation or suspension of the registration of any Second Purchaser who will purchase ozone-depleting chemicals to which this certificate applies.

Purchaser understands that the fraudulent use of this certificate may subject Purchaser and all parties making such fraudulent use of this certificate to a fine or imprisonment, or both, together with the costs of prosecution.

Name of Purchaser

Address of Purchaser

Taxpayer Identifying Number of Purchaser

Title of person signing

Printed or typed name of person signing

Signature

(4) *Documentation of export*—(i) *After December 31, 1992.* After December 31, 1992, to document the exportation of any ODCs, a person must have the evidence required by the Environmental Protection Agency as proof that the ODCs were exported.

(ii) *Before January 1, 1993.* Before January 1, 1993, to document the exportation of any ODCs, a person must have evidence substantially similar to that required by the Environmental Protection Agency as proof that the ODCs were exported.

(e) *Purchaser liable for tax*—(1) *Purchaser in qualifying sale.* The pur-

chaser of ODCs in a qualifying sale for export is treated as the manufacturer of the ODC and is liable for any tax imposed under section 4681 (determined without regard to exemptions for qualifying sales under this section or §52.4682-1) when it sells or uses the ODCs if that purchaser does not—

(i) Export the ODCs and document the exportation of the ODCs in accordance with paragraph (d)(4) of this section; or

(ii) Sell the ODCs in a qualifying resale for export.

(2) *Purchaser in qualifying resale.* The purchaser of ODCs in a qualifying

resale for export is treated as the manufacturer of the ODC and is liable for any tax imposed under section 4681 (determined without regard to exemptions for qualifying sales under this section or §52.4682-1) when it sells or uses the ODCs if that purchaser does not export the ODCs and document the exportation of the ODCs in accordance with paragraph (d)(4) of this section.

(f) *Credit or refund*—(1) *In general.* Except as provided in paragraph (f)(2) of this section, a manufacturer or importer that meets the conditions of paragraph (f)(3) of this section is allowed a credit or refund (without

interest) of the tax it paid to the government under section 4681 on ODCs that are exported. Persons other than manufacturers and importers of ODCs cannot file claims for credit or refund of tax imposed under section 4681 on ODCs that are exported.

(2) *Limitation.* The amount of credits or refunds of tax under this paragraph (f) is limited—

(i) In the case of tax paid on post-1989 ODCs sold during a calendar year, to the amount (if any) by which the post-1989 exemption amount for the year exceeds the tax benefit provided to such post-1989 ODCs under paragraph (b) of this section; and

(ii) In the case of tax paid on post-1990 ODCs sold during a calendar year, to the amount (if any) by which the post-1990 exemption amount for the year exceeds the tax benefit provided to such post-1990 ODCs under paragraph (b) of this section.

(3) *Conditions to allowance of credit or refund.* The conditions of this paragraph (f)(3) are met if the manufacturer or importer—

(i) Documents the exportation of the ODCs in accordance with paragraph (d)(4) of this section; and

(ii) Establishes that it has—

(A) Repaid or agreed to repay the amount of the tax to the person that exported the ODC; or

(B) Obtained the written consent of the exporter to the allowance of the credit or the making of the refund.

(4) *Procedural rules.* See section 6402 and the regulations under that section for procedural rules relating to filing a claim for credit or refund of tax.

(g) *Examples.* The following examples illustrate the provisions of this section. In each example, the sales are qualifying sales for export (within the meaning of paragraph (d)(1) of this section), all registration, certification, and documentation requirements of this section are met, and the ODCs sold for export are exported:

Example 1. (i) *Facts.* D, a corporation, manufactures CFC-11, a post-1989 ODC, and does not manufacture or import any other ODCs. In 1993, D manufactures 100,000 pounds of CFC-11, the maximum quantity D is allowed to manufacture in 1993 under EPA regulations. D has no additional production allowance from EPA for 1993. In 1993, the tax on CFC-11 is \$3.35 per pound. D's 1986 export percentage for post-1989 ODCs is 50%. In 1993, D sells 80,000 pounds of CFC-11 in qualifying sales for export. The remainder of D's production is not exported.

(ii) *Components of limit on tax benefit.* Under paragraph (c)(1) of this section, D's exemption amount for 1993 is equal to the sum of—

(A) D's 1986 export percentage multiplied by the aggregate tax that would (but for section 4682(d), section 4682(g), and §52.4682-5) be imposed under section 4681 on the maximum quantity of post-1989 ODCs D is permitted to manufacture during 1993;

(B) The aggregate tax that would (but for section 4682(d), section 4682(g), and §52.4682-5) be imposed under section 4681 on post-1989 ODCs that D manufactures during 1993 under an additional production allowance; and

(C) The aggregate tax that would (but for section 4682(d), section 4682(g), and §52.4682-5) be imposed under section 4681 on post-1989 ODCs imported by D during 1993.

(iii) *Limit on tax benefit.* The amounts described in paragraphs (ii)(B) and (C) of this Example 1 are equal to zero. Thus, D's 1993 exemption amount is \$167,500 (50% of \$335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC-11 in 1993)).

(iv) *Application of limit on tax benefit.* Under paragraph (b)(2) of this section, the tax imposed on the CFC-11 D sells for export is equal to the excess of the tax that would have been imposed on those ODCs but for section 4682(d) and §52.4682-5, over D's 1993 exemption amount. But for §52.4682-5, \$268,000 ($3.35 \times 80,000$) of tax would have been imposed on the CFC-11 sold for export. Thus, \$100,500 ($\$268,000 - \$167,500$) of tax is imposed on the CFC-11 sold for export.

Example 2. (i) *Facts.* E, a corporation, manufactures CFC-11, a post-1989 ODC, and does not manufacture or import any other ODCs. In 1993, E manufactures 100,000 pounds of CFC-11, the maximum quantity E is allowed to manufacture in 1993 under EPA regulations. E has no additional production allowance from EPA for 1993. In 1993, the tax on CFC-11 is \$3.35 per pound. E's 1986 export percentage for post-1989 ODCs is 50%. In 1993, E sells 45,000 pounds of CFC-11 tax free in qualifying sales for export and pays tax under section 4681 on an additional 35,000 pounds of exported CFC-11. The remainder of E's production is not exported.

(ii) *Limit on tax benefit.* E's 1993 exemption amount is \$167,500, (50% of \$335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC-11 in 1993)). The credit or refund allowed to E under paragraph (f) of this section is limited under paragraph (f)(2) of this section to the amount by which E's 1993 exemption amount exceeds E's 1993 tax benefit under paragraph (b) of this section.

(iii) *Application of limit on tax benefit.* Because E sold 45,000 pounds of CFC-11 tax free in qualifying sales for export in 1993, E's 1993 tax benefit under paragraph (b) of this section is \$150,750 ($\$3.35 \times 45,000$). Thus, the credit or refund allowed to E under paragraph (f) of this section is limited to \$16,750 ($\$167,500 - \$150,750$).

Example 3. (i) *Facts.* F, a corporation, manufactures CFC-11, a post-1989 ODC, and does not manufacture any other ODCs. F also imports CFC-11. In 1993, F manufactures 60,000 pounds of CFC-11 (100,000 pounds is the maximum quantity F is allowed to manufacture in 1993 under EPA regulations) and imports 40,000 pounds. F has no additional production allowance from EPA for 1993. In 1993, the tax on CFC-11 is \$3.35 per pound. F's 1986 export percentage for post-1989 ODCs is 50%. In 1993,

F sells 45,000 pounds of CFC-11 tax free in qualifying sales for export and pays tax under section 4681 on an additional 35,000 pounds of exported CFC-11. The remainder of F's production is not exported.

(ii) *Limit on tax benefit.* F's 1993 exemption amount is \$301,500, ($\$167,500$ (50% of \$335,000 (the tax that would otherwise be imposed on 100,000 pounds of CFC-11 in 1993)) plus \$134,000 (the tax that would otherwise be imposed on the 40,000 pounds imported)). The credit or refund allowed to F under paragraph (f) of this section is limited under paragraph (f)(2) of this section to the amount by which F's 1993 exemption amount exceeds F's 1993 tax benefit under paragraph (b) of this section.

(iii) *Application of limit on tax benefit.* Because F sold 45,000 pounds of CFC-11 tax free in qualifying sales for export in 1993, F's 1993 tax benefit under paragraph (b) of this section is \$150,750 ($\$3.35 \times 45,000$). Thus, the credit or refund allowed to F under paragraph (f) of this section is limited to \$150,750 ($\$301,500 - \$150,750$). The limitation does not affect F's credit or refund because the tax F paid on exported ODCs is only \$117,250 ($\$3.35 \times 35,000$).

(h) *Effective date.* This section is effective January 1, 1993.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In §602.101, paragraph (c) is amended by revising the entries for 52.4682-2(b) and 52.4682-2(d) and adding entries in numerical order to the table to read as follows:

§602.601 OMB Control numbers.

| * * * * * | (c) * * * | CFR part or section where identified and described | Current OMB control number |
|-----------|-----------|--|----------------------------|
| * * * * * | | | * * * * * |
| | | 52.4682-2(b) | 1545-1153
1545-1361 |
| | | 52.4682-2(d) | 1545-1153
1545-1361 |
| * * * * * | | | * * * * * |
| | | 52.4682-5(d) | 1545-1361 |
| | | 52.4682-5(f) | 1545-1361 |
| * * * * * | | | * * * * * |

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved August 31, 1995.

Cynthia G. Beerbower,
Deputy Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on October 10, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 11, 1995, 60 F.R. 52848)

Section 4682.—Definitions and Special Rules

Final regulations relating to taxes imposed on exports of ozone-depleting chemicals (ODCs), taxes imposed on ODCs used as medical sterilants or propellants in metered-dose inhalers, and floor taxes on ODCs. See T.D. 8622, page 237.

Chapter 42.—Private Foundations and Certain Other Tax-Exempt Organizations

Subchapter C.—Political Expenditures of Section 501(c)(3) Organizations

Section 4955.—Taxes on Political Expenditures of Section 501(c)(3) Organizations

26 CFR 53.4955-1: Tax on political expenditures.

T.D. 8628

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 53 and 301

Political Expenditures by Section 501(c)(3) Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations regarding excise taxes, accelerated tax assessments, and injunctions imposed for certain political expenditures made by organizations that (without regard to any political expenditure) would be described in section 501(c)(3) and exempt from taxation under section 501(a). These regulations reflect changes to the law that were enacted as part of the Revenue Act of 1987.

EFFECTIVE DATE: These regulations are effective December 5, 1995.

SUPPLEMENTARY INFORMATION:

Background

On December 14, 1994, proposed regulations §§53.4955-1, 301.6852-1, and 301.7409-1 under sections 4955, 6852 and 7409 were published in the Federal Register (59 FR 64359 [EE-48-90, 1995-1 C.B. 847]). In addition, amendments were made to regulations under other sections in order to reflect the effects of sections 4955, 6852, and 7409. Proposed regulation amendments in §§1.6091-2, 53.4963-1, 53.6011-1, 53.6071-1, 53.6091-1, 301.6211-1, 301.6212-1, 301.6213-1, 301.6861-1, 301.6863-1, 301.6863-2, 301.7422-1, and 301.7611-1 were also published in the Federal Register (59 FR 64359). No public hearing was requested or held. The IRS received two comments on the proposed regulations, only one of which offered substantive suggestions. The IRS and the Treasury Department have considered the public comments on the proposed regulations, and the regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

The regulations provide guidance with respect to sections 4955, 6852 and 7409. The sanctions in these sections apply to all organizations described in section 501(c)(3). Before sections 4955, 6852 and 7409 were enacted in 1987, revocation of recognition of exemption was the sole sanction available against political intervention by public charities. Section 4955 was modeled on the section 4945 excise tax on political expenditures (taxable expenditures) by private foundations, while sections 6852 and 7409 provide new sanctions against flagrant political expenditures and flagrant political intervention, respectively.

One comment on the proposed regulations requested that the regulations define in additional detail the term *political expenditure* and provide specific examples of activities that constitute intervention or participation in a political campaign for or against a candidate. Section 53.4955-1(c)(1) of the proposed regulations provides that any expenditure that would cause an organization that makes the expenditure to be classified as an action organization in accordance with §1.501(c)(3)-1(c)(3)(iii) is a political expenditure

within the meaning of section 4955(d)-(1). By referring to the long standing action organization regulations, §53.4955-1(c)(1) of the proposed regulations ties the definition of *political expenditure* in section 4955 to existing IRS and judicial interpretations of when an organization participates or intervenes in a political campaign on behalf of or in opposition to any candidate for public office in violation of the requirements of section 501(c)-(3). The IRS and the Treasury Department believe this direct connection between section 4955 and section 501(c)(3) correctly implements the intent of Congress as expressed in the statute and the legislative history. To the extent that further guidance is needed on the interpretation of the terms political expenditure under section 4955 and intervening in political campaigns under section 501(c)(3), the IRS and the Treasury Department believe such guidance should be given in connection with the requirements for tax exemption under section 501(c)(3). Therefore, the final regulations have not revised §53.4955-1(c)(1).

Another comment suggested that the regulations specify whether there were circumstances under which conduct would result in the imposition of a tax under section 4955 but not in revocation of exemption under section 501(c)(3). According to the statutory language and the legislative history of section 4955, the addition of that section to the Internal Revenue Code did not affect the substantive standards for tax exemption under section 501(c)(3). To be exempt from income tax as an organization described in section 501(c)(3), an organization may not intervene in any political campaign on behalf of any candidate for public office. Consistent with this requirement, section 4955 does not permit a de minimis amount of political intervention. Therefore, the final regulations have not been revised. However, there may be individual cases where, based on the facts and circumstances such as the nature of the political intervention and the measures that have been taken by the organization to prevent a recurrence, the IRS may exercise its discretion to impose a tax under section 4955 but not to seek revocation of the organization's tax-exempt status.

One comment raised questions about the interpretation of section 4955(d)(2), which relates to organizations formed primarily to promote the candidacy of a

particular individual. The comment requested clarification of the standard for determining whether an organization “is formed primarily for purposes of promoting the candidacy (or prospective candidacy) of an individual for public office” under section 4955(d)(2). The comment also requested clarification of the meaning of the phrase “availed of” in the section 4955(d)(2) reference to organizations availed of primarily to promote an individual’s candidacy for public office. The comment further requested examples of expenses which have the primary effect of promoting public recognition or otherwise primarily accruing to the benefit of a candidate or a prospective candidate.

The legislative history of section 4955 provides that the determination of whether an organization’s primary purpose is the promotion of the candidacy or prospective candidacy of an individual for public office is based on all relevant facts and circumstances. The proposed regulations follow the legislative history. The IRS and the Treasury Department believe that, if more detailed guidance is necessary, it would be more appropriate to provide it in a form that allows for the consideration of a fuller range of facts and circumstances. Therefore, the final regulations have not been revised.

The comment also asked whether section 4955(d)(2) adds anything to the range of activities that would already be deemed political expenditures under section 4955(d)(1). The plain language of the statute makes it clear that the expenditures described in section 4955(d)(2) are included within the general category of political expenditures that is described in section 4955(d)(1). Furthermore, the legislative history states that section 4955(d)(2) “enumerates certain expenditures as political expenditures for purposes of the excise tax....” The IRS and the Treasury Department believe that organizations described in section 4955(d)(2) are subject to the same restrictions on political expenditures as all other section 501(c)(3) organizations. Therefore, the final regulations have not been revised.

One comment concluded that §53.4955-1(b) of the proposed regulations, affecting organization managers under section 4955, imposed tax on a larger group of employees and officers than are subject to tax under chapter 42 because the section did not include

language contained in §53.4946-1(f)-(1)(ii) and in §53.4946-1(f)(2). The IRS and the Treasury Department agree that the definition of foundation manager under section 4946(b) should be incorporated into the definition of organization manager when applying section 4955(f)(2). Therefore, we have clarified the final regulations to make them consistent with the interpretation in §53.4946-1(f)(1)(ii) and in §53.4946-1(f)(2) by adding a sentence at the end of §53.4955-1(b)(2)(ii)(B) and at the end of §53.4955-1(b)(2)(iii).

One comment noted that §53.4955-1(b)(7) of the proposed regulations provides that, in certain circumstances, if an organization manager relies on a reasoned legal opinion from legal counsel, the act of the organization manager will not be considered knowing or willful and will be considered due to reasonable cause for purposes of section 4955(a)(2). The commentator requested consideration of whether the same reasoned legal opinion would protect the organization from tax under section 4955(a)(1). Section 53.4955-1(b)(7) interprets whether an act is not willful and is due to reasonable cause for purposes of section 4955(a)(2). Unlike section 4955(a)(2), section 4955(a)(1) taxes an organization without regard to whether its act of making a political expenditure was willful or due to reasonable cause. Therefore, the final regulations have not been revised. A reasoned legal opinion from legal counsel received by the organization prior to making a political expenditure may be a factor that the IRS takes into account in determining what action to take in an individual case. Section 53.4955-1(d) and (e) of the final regulations are also relevant where an organization has corrected a political expenditure that was not willful and flagrant.

One comment requested that the regulations provide more detail on the type of behavior that would be considered flagrant under sections 6852 and 7409. Since a determination of when a specific act or acts by an organization is flagrant depends on the facts and circumstances in individual cases, the IRS and the Treasury Department believe that, to the extent guidance is necessary on this issue, it is better rendered in a form other than through regulations. Therefore, the final regulations do not expand on the definition of flagrant.

One comment suggested that §301.7409-1 of the proposed regula-

tions should be modified to allow the IRS, where appropriate, to provide an organization with less than the 10 days notice required under the proposed regulations before the Commissioner would recommend that a petition for injunctive relief be filed. In light of the important considerations involved when contemplating an injunction of this sort, the IRS and the Treasury Department believe that an organization should be allowed a reasonable amount of time to respond before the IRS takes action. Therefore, the final regulations retain the 10 day notice period.

Special Analysis

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1, 53, and 301 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.6091-2, paragraph (g) is added to read as follows:

§1.6091-2 Place for filing income tax returns.

* * * * *

(g) *Returns of persons subject to a termination assessment.* Notwithstanding paragraph (c) of this section, income tax returns of persons with respect to whom an income tax assess-

ment was made under section 6852(a) with respect to the taxable year must be filed with the district director as provided in paragraphs (a) and (b) of this section.

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Par. 3. The authority citation for part 53 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. Section 53.4955-1 is added to Subpart K to read as follows:

§53.4955-1 *Tax on political expenditures.*

(a) *Relationship between section 4955 excise taxes and substantive standards for exemption under section 501(c)(3).* The excise taxes imposed by section 4955 do not affect the substantive standards for tax exemption under section 501(c)(3), under which an organization is described in section 501(c)(3) only if it does not participate or intervene in any political campaign on behalf of any candidate for public office.

(b) *Imposition of initial taxes on organization managers—(1) In general.* The excise tax under section 4955(a)(2) on the agreement of any organization manager to the making of a political expenditure by a section 501(c)(3) organization is imposed only in cases where—

(i) A tax is imposed by section 4955(a)(1);

(ii) The organization manager knows that the expenditure to which the manager agrees is a political expenditure; and

(iii) The agreement is willful and is not due to reasonable cause.

(2) *Type of organization managers covered—(i) In general.* The tax under section 4955(a)(2) is imposed only on those organization managers who are authorized to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the organization and on those organization managers who are members of a group (such as the organization's board of directors or trustees) which is so authorized.

(ii) *Officer.* For purposes of section 4955(f)(2)(A), a person is an officer of an organization if—

(A) That person is specifically so designated under the certificate of

incorporation, bylaws, or other constitutive documents of the foundation; or

(B) That person regularly exercises general authority to make administrative or policy decisions on behalf of the organization. Independent contractors, acting in a capacity as attorneys, accountants, and investment managers and advisors, are not officers. With respect to any expenditure, any person described in this paragraph (b)(2)(ii)(B) who has authority merely to recommend particular administrative or policy decisions, but not to implement them without approval of a superior, is not an officer.

(iii) *Employee.* For purposes of section 4955(f)(2)(B), an individual rendering services to an organization is an employee of the organization only if that individual is an employee within the meaning of section 3121(d)(2). With respect to any expenditure, an employee (other than an officer, director, or trustee of the organization) is described in section 4955(f)(2)(B) only if he or she has final authority or responsibility (either officially or effectively) with respect to such expenditure.

(3) *Type of agreement required.* An organization manager agrees to the making of a political expenditure if the manager manifests approval of the expenditure which is sufficient to constitute an exercise of the organization manager's authority to approve, or to exercise discretion in recommending approval of, the making of the expenditure by the organization. The manifestation of approval need not be the final or decisive approval on behalf of the organization.

(4) *Knowing—(i) General rule.* For purposes of section 4955, an organization manager is considered to have agreed to an expenditure *knowing* that it is a political expenditure only if—

(A) The manager has actual knowledge of sufficient facts so that, based solely upon these facts, the expenditure would be a political expenditure;

(B) The manager is aware that such an expenditure under these circumstances may violate the provisions of federal tax law governing political expenditures; and

(C) The manager negligently fails to make reasonable attempts to ascertain whether the expenditure is a political expenditure, or the manager is aware that it is a political expenditure.

(ii) *Amplification of general rule.* For purposes of section 4955, knowing does not mean having reason to know. However, evidence tending to show that an organization manager has reason to know of a particular fact or particular rule is relevant in determining whether the manager had actual knowledge of the fact or rule. Thus, for example, evidence tending to show that an organization manager has reason to know of sufficient facts so that, based solely upon those facts, an expenditure would be a political expenditure is relevant in determining whether the manager has actual knowledge of the facts.

(5) *Willful.* An organization manager's agreement to a political expenditure is willful if it is voluntary, conscious, and intentional. No motive to avoid the restrictions of the law or the incurring of any tax is necessary to make an agreement willful. However, an organization manager's agreement to a political expenditure is not willful if the manager does not know that it is a political expenditure.

(6) *Due to reasonable cause.* An organization manager's actions are due to reasonable cause if the manager has exercised his or her responsibility on behalf of the organization with ordinary business care and prudence.

(7) *Advice of counsel.* An organization manager's agreement to an expenditure is ordinarily not considered knowing or willful and is ordinarily considered due to reasonable cause if the manager, after full disclosure of the factual situation to legal counsel (including house counsel), relies on the advice of counsel expressed in a reasoned written legal opinion that an expenditure is not a political expenditure under section 4955 (or that expenditures conforming to certain guidelines are not political expenditures). For this purpose, a written legal opinion is considered reasoned even if it reaches a conclusion which is subsequently determined to be incorrect, so long as the opinion addresses itself to the facts and applicable law. A written legal opinion is not considered reasoned if it does nothing more than recite the facts and express a conclusion. However, the absence of advice of counsel with respect to an expenditure does not, by itself, give rise to any inference that an organization manager agreed to the making of the expenditure knowingly, willfully, or without reasonable cause.

(8) *Cross reference.* For provisions relating to the burden of proof in cases

involving the issue of whether an organization manager has knowingly agreed to the making of a political expenditure, see section 7454(b).

(c) *Amplification of political expenditure definition*—(1) *General rule.* Any expenditure that would cause an organization that makes the expenditure to be classified as an action organization by reason of §1.501(c)(3)–1(c)(3)(iii) of this chapter is a political expenditure within the meaning of section 4955(d)(1).

(2) *Other political expenditures*—(i) For purposes of section 4955(d)(2), an organization is effectively controlled by a candidate or prospective candidate only if the individual has a continuing, substantial involvement in the day-to-day operations or management of the organization. An organization is not effectively controlled by a candidate or a prospective candidate merely because it is affiliated with the candidate, or merely because the candidate knows the directors, officers, or employees of the organization. The effectively controlled test is not met merely because the organization carries on its research, study, or other educational activities with respect to subject matter or issues in which the individual is interested or with which the individual is associated.

(ii) For purposes of section 4955(d)(2), a determination of whether the primary purpose of an organization is promoting the candidacy or prospective candidacy of an individual for public office is made on the basis of all the facts and circumstances. The factors to be considered include whether the surveys, studies, materials, etc. prepared by the organization are made available only to the candidate or are made available to the general public; and whether the organization pays for speeches and travel expenses for only one individual, or for speeches or travel expenses of several persons. The fact that a candidate or prospective candidate utilizes studies, papers, materials, etc., prepared by the organization (such as in a speech by the candidate) is not to be considered as a factor indicating that the organization has a purpose of promoting the candidacy or prospective candidacy of that individual where such studies, papers, materials, etc. are not made available only to that individual.

(iii) Expenditures for voter registration, voter turnout, or voter education constitute other expenses, treated as political expenditures by reason of

section 4955(d)(2)(E), only if the expenditures violate the prohibition on political activity provided in section 501(c)(3).

(d) *Abatement, refund, or no assessment of initial tax.* No initial (first-tier) tax will be imposed under section 4955(a), or the initial tax will be abated or refunded, if the organization or an organization manager establishes to the satisfaction of the IRS that—

(1) The political expenditure was not willful and flagrant; and

(2) The political expenditure was corrected.

(e) *Correction*—(1) *Recovery of Expenditure.* For purposes of section 4955(f)(3) and this section, correction of a political expenditure is accomplished by recovering part or all of the expenditure to the extent recovery is possible, and, where full recovery cannot be accomplished, by any additional corrective action which the Commissioner may prescribe. The organization making the political expenditure is not under any obligation to attempt to recover the expenditure by legal action if the action would in all probability not result in the satisfaction of execution on a judgment.

(2) *Establishing safeguards.* Correction of a political expenditure must also involve the establishment of sufficient safeguards to prevent future political expenditures by the organization. The determination of whether safeguards are sufficient to prevent future political expenditures by the organization is made by the District Director.

(f) *Effective date.* This section is effective December 5, 1995.

§53.4963–1 [Amended]

Par. 5. In §53.4963–1, paragraphs (a), (b), and (c) are amended by adding the reference “4955,” immediately after the reference “4952,” in each place it appears.

§53.6011–1 [Amended]

Par. 6. In §53.6011–1, paragraph (b) is amended as follows:

1. In the first sentence, the language “or 4945(a),” is removed and “, 4945(a) or 4955(a),” is added in its place.

2. In the last sentence, the language “or 4955(a)” is added immediately

following the language “section 4945(a)”.

Par. 7. In §53.6071–1, paragraph (e) is added to read as follows:

§53.6071–1 Time for filing returns.

* * * * *

(e) *Taxes related to political expenditures of organizations described in section 501(c)(3) of the Internal Revenue Code.* A Form 4720 required to be filed by §53.6011–1(b) for an organization liable for tax imposed by section 4955(a) must be filed by the unextended due date for filing its annual information return under section 6033 or, if the organization is exempt from filing, the date the organization would be required to file an annual information return if it was not exempt from filing. The Form 4720 of a person whose taxable year ends on a date other than that on which the taxable year of the organization described in section 501(c)(3) ends must be filed on or before the 15th day of the fifth month following the close of the person’s taxable year.

Par. 8. In §53.6091–1, the section heading is revised and paragraph (d) is added to read as follows:

§53.6091–1 Place for filing chapter 42 tax returns.

* * * * *

(d) *Returns of persons subject to a termination assessment.* Notwithstanding paragraph (c) of this section, income tax returns of persons with respect to whom a chapter 42 tax assessment was made under section 6852(a) with respect to the taxable year must be filed with the district director as provided in paragraphs (a) and (b) of this section.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 9. The authority citation for part 301 continues to read in part as follows:

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

§301.6211–1 [Amended]

Par. 10. In §301.6211–1, the last sentence of paragraph (b) is amended by adding “or 6852” immediately after “section 6851”.

§301.6212-1 [Amended]

Par. 11. In §301.6212-1, the second sentence of paragraph (c) is amended by adding “termination assessments in section 6851 or 6852,” immediately after “section 6213(b)(1),”.

§301.6213-1 [Amended]

Par. 12. Section 301.6213-1 is amended as follows:

1. Paragraph (a)(2), first sentence, is amended by adding “, 6852,” immediately after “section 6851”.

2. Paragraph (e), first sentence, is amended by adding “4955,” immediately after “4952,”.

Par. 13. Section 301.6852-1 is added to read as follows:

§301.6852-1 Termination assessments of tax in the case of flagrant political expenditures of section 501(c)(3) organizations.

(a) *Authority for making.* Any assessment under section 6852 as a result of a flagrant violation by a section 501(c)(3) organization of the prohibition against making political expenditures must be authorized by the District Director.

(b) *Determination of income tax.* An organization shall be subject to an assessment of income tax under section 6852 only if the flagrant violation of the prohibition against making political expenditures results in revocation of the organization’s tax exemption under section 501(a) because it is not described in section 501(c)(3). An organization subject to such an assessment is not liable for income taxes for any period prior to the effective date of the revocation of the organization’s tax exemption.

(c) *Payment.* Where a District Director has made a determination of income tax under paragraph (b) of this section or of section 4955 excise tax, notwithstanding any other provision of law, any tax will become immediately due and payable. The taxpayer is required to pay the amount of the assessment within 10 days after the District Director sends the notice and demand for immediate payment regardless of the filing of an administrative appeal or of a court petition. Regardless of filing an administrative appeal or of petitioning a court, enforced collection action may proceed after the 10-day payment

period unless the taxpayer posts the bond described in section 6863. For purposes of collection procedures such as section 6331 (regarding levy), assessments under the authority of paragraph (a) of this section do not constitute situations in which the collection of such tax is in jeopardy and, therefore, do not suspend normal collection procedures.

(d) *Effective date.* This section is effective December 5, 1995.

§301.6861-1 [Amended]

Par. 14. In §301.6861-1, paragraph (g) is amended by:

1. Adding the language “4955(a),” immediately after “4952(a),”.

2. Adding the language “4955(b),” immediately after “4952(b),”.

§301.6863-1 [Amended]

Par. 15. Section 301.6863-1 is amended as follows:

1. Paragraph (a)(1) is amended by adding the language “, or under section 6852 (referred to as a political assessment for purposes of this section)” immediately after “for purposes of this section”.

2. Paragraphs (a)(3) first sentence, (a)(4) last sentence, and (b) first sentence are amended by adding the language “or political assessment” immediately after “jeopardy assessment” in each place it appears.

3. Paragraph (b) is amended by adding the language “(or political assessment)” immediately after “jeopardy” in the last sentence.

§301.6863-2 [Amended]

Par. 16. In §301.6863-2, paragraph (a) introductory text, the first sentence is amended by adding the language “6852,” immediately after “section 6851,”.

Par. 17. Section 301.7409-1 is added under the undesignated centerheading “Civil Actions by the United States” to read as follows:

§301.7409-1 Action to enjoin flagrant political expenditures of section 501(c)(3) organizations.

(a) *Letter to organization.* When the Assistant Commissioner (Employee Plans and Exempt Organizations) con-

cludes that a section 501(c)(3) organization has engaged in flagrant political intervention and is likely to continue to engage in political intervention that involves political expenditures, the Assistant Commissioner (Employee Plans and Exempt Organizations) shall send a letter to the organization providing it with the facts based on which the Service believes that the organization has been engaging in flagrant political intervention and is likely to continue to engage in political intervention that involves political expenditures. The organization will have 10 calendar days after the letter is sent to respond by establishing that it will immediately cease engaging in political intervention, or by providing the Service with sufficient information to refute the Service’s evidence that it has been engaged in flagrant political intervention. The Internal Revenue Service will not proceed to seek an injunction under section 7409 until after the close of this 10-day response period.

(b) *Determination by Commissioner.* If the organization does not respond within 10 calendar days to the letter under paragraph (a) of this section in a manner sufficient to dissuade the Assistant Commissioner (Employee Plans and Exempt Organizations) of the need for an injunction, the file will be forwarded to the Commissioner of Internal Revenue. The Commissioner of Internal Revenue will personally determine whether to forward to the Department of Justice a recommendation that it immediately bring an action to enjoin the organization from making further political expenditures. The Commissioner may also recommend that the court action include any other action that is appropriate in ensuring that the assets of the section 501(c)(3) organization are preserved for section 501(c)(3) purposes. The authority of the Commissioner to make the determinations described in this paragraph may not be delegated to any other persons.

(c) *Flagrant political intervention.* For purposes of this section, *flagrant political intervention* is defined as participation in, or intervention in (including the publication and distribution of statements), any political campaign by a section 501(c)(3) organization on behalf of (or in opposition to) any candidate for public office in violation of the prohibition on such participation or intervention in section 501(c)(3) and the regulations there-

under if the participation or intervention is flagrant.

(d) *Effective date.* This section is effective December 5, 1995.

§301.7422-1 [Amended]

Par. 18. In §301.7422-1, paragraphs (a) introductory text, (c) introductory text and (d) are amended by adding the language “4955,” immediately after “4952.”

§301.7611-1 [Amended]

Par. 19. In §301.7611-1, A-6, the first sentence is amended by adding the language “or 6852,” immediately after “section 6851”.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved October 26, 1995.

Leslie Samuel,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on December 4, 1995, 8:45 a.m., and published in the issue of the Federal Register for December 5, 1995, 60 F.R. 62209)

Chapter 43.—Qualified Pension, etc., Plans

Section 4972.—Tax On Nondeductible Contributions To Qualified Employer Plans

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 4972 of the Code to certain payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Section 4975.—Tax On Prohibited Transactions

A procedure is provided whereby an employer and a trustee that receive an individual exemption from the prohibited transaction rules from the Department of Labor or meet the criteria of a class exemption from the prohibited transaction rules issued by the Department of Labor may request a closing agreement pertaining to payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Section 4980.—Tax On Reversion Of Qualified Plan Assets To Employer

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 4980 of the Code to the return of certain payments from a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

Subtitle F.—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part II.—Tax Returns or Statements
Subpart A.—General Requirements

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 31.6011(a)-4: Returns of income tax withheld.

T.D. 8624

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 31 and 602

Reporting of Nonpayroll Withheld Tax Liabilities

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the reporting of nonpayroll withheld income taxes under section 6011 of the Internal Revenue Code. The temporary regulations remove the requirement that a person file Form 945, Annual Return of Withheld Federal Income Tax, for each calendar year, whether or not the person is required to withhold the taxes reported on Form 945 in a particular calendar year. The temporary regulations require that a person file Form 945 only for a calendar year in which the person is required to withhold taxes required to be reported on Form 945. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [IA-30-95, page 479, this Bulletin].

EFFECTIVE DATE: These regulations are effective October 16, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are 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 these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545-1413. Responses to this collection of information are required to monitor compliance with the federal tax laws related to the reporting and deposit of nonpayroll withheld taxes.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in *** [IA-30-95, page 479, this Bulletin].

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 23, 1993, the IRS published final regulations (TD 8504 [1994-1 C.B. 276]) in the Federal Register (58 FR 68033) relating to both the reporting and depositing of Federal employment taxes. Those regulations simplify reporting requirements by removing all “nonpayroll” withheld taxes from reporting on Form 941, Employer’s Quarterly Federal Tax Return (or Form 941E, Quarterly Return of Withheld Federal Income Tax and Medicare Tax) and requiring those taxes to be reported on Form 945. Those final regulations were effective December 23, 1993.

Section 31.6011(a)-4(b) of those regulations provides that every person

required to make a return of income tax withheld from nonpayroll payments for calendar year 1994 must make a return for calendar year 1994 and for each subsequent calendar year (whether or not any such tax is required to be withheld that year) until a final return is made in accordance with §31.6011(a)-6. In addition, every person not required to make a return of income tax withheld from nonpayroll payments for calendar year 1994 must make a return for the first calendar year after 1994 in which the person is required to withhold the tax and for each subsequent calendar year until a final return is made in accordance with §31.6011(a)-6.

In the preamble to TD 8504, the IRS stated that it welcomed and would consider comments from the public regarding the requirement to continue filing Form 945 annually, regardless of liability, until a final return is filed in accordance with §31.6011(a)-6. Several commentators responded to that invitation, all opposing the requirement to file a return for a calendar year for which there is no liability. As a result, the IRS has reconsidered the specific requirement.

Explanation of Provisions

These temporary regulations remove the requirement that, once a person files an annual Form 945, the person must file a Form 945 every subsequent year until the person files a final return. Under these temporary regulations, a person must file a Form 945 only for a calendar year in which the person is required to withhold Federal income tax from nonpayroll payments.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business

Administration for comment on their impact on small business.

List of Subjects

26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 31 and 602 are amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 is amended by adding an entry in numerical order to read as follows:

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

Section 31.6011(a)-4T also issued under 26 U.S.C. 6011. * * *

Par. 2. Section 31.6011(a)-4 is amended by revising paragraph (b) to read as follows:

§31.6011(a)-4 Returns of income tax withheld.

* * * * *

(b) [Reserved] For further guidance see §31.6011(a)-4T(b).

* * * * *

Par. 3. Section 31.6011(a)-4T is added to read as follows:

§31.6011(a)-4T Returns of income tax withheld (temporary).

(a) [Reserved] For further guidance see §31.6011(a)-4(a).

(b) *Withheld from nonpayroll payments.* Every person required to withhold tax from nonpayroll payments for calendar year 1994 must make a return

for calendar year 1994 and for any subsequent calendar year in which any such tax is required to be withheld until the person makes a final return in accordance with §31.6011(a)-6. Every person not required to withhold tax from nonpayroll payments for calendar year 1994 must make a return for the first calendar year after 1994 in which the person is required to withhold such tax and for any subsequent calendar year in which the person is required to withhold such tax until the person makes a final return in accordance with §31.6011(a)-6. Form 945, Annual Return of Withheld Federal Income Tax, is the form prescribed for making the return required under this paragraph (b). Nonpayroll payments are—

(1) Certain gambling winnings subject to withholding under section 3402(q);

(2) Retirement pay for services in the Armed Forces of the United States subject to withholding under section 3402;

(3) Certain annuities as described in section 3402(o)(1)(B);

(4) Pensions, annuities, IRAs, and certain other deferred income subject to withholding under section 3405; and

(5) Reportable payments subject to backup withholding under section 3406.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

§602.101 [Amended]

Par. 5. Section 602.101, paragraph (c) is amended in the table by adding the entry “31.6011(a)-4T.... 1545-1413” in numerical order.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved September 22, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 13, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 16, 1995, 60 F.R. 53509)

Section 6012.—Persons Required to Make Returns of Income

26 CFR 1.6012-2: Individuals required to make returns of income.

The Service is providing adjusted tax tables for individuals and trusts and estates for taxable years beginning in 1996 to reflect changes in the cost of living. See Rev. Proc. 95-53, page 445.

26 CFR 1.6012-5: Composite return in lieu of specified form.

An electronically filed Form 1040, U.S. Individual Tax Return, which is a composite return, is described. See Rev. Proc. 95-49 page 419.

Section 6013.—Joint Returns of Income Tax by Husband and Wife

26 CFR 1.6013-1: Joint returns.

The Service is providing adjusted tax tables for individuals for taxable years beginning in 1996 to reflect changes in the cost of living. See Rev. Proc. 95-53, page 445.

Part III.—Information Returns

Subpart A.—Information Concerning Persons Subject to Special Provisions

Section 6033.—Returns by Exempt Organizations

Guidance is provided to organizations exempt from taxation under § 501(a) of the Code on the application of amendments made to §§ 162(e) and 6033(e) by § 13222 of the Omnibus Budget Reconciliation Act of 1993. The procedure identifies certain tax-exempt organizations that will be treated as satisfying the requirements of § 6033(e)(3). Those organizations will not be subject to the reporting and notice requirements of § 6033(e)(1) or the tax imposed by § 6033(e)(2). Procedures for other exempt organizations to establish that they satisfy the requirements of § 6033(e)(3) are also provided. See Rev. Proc. 95-35 page 391.

This procedure exercises the Commissioner's discretionary authority under section 6033(a)-(2)(B) of the Code, by specifying that two additional classes of organizations, governmental units and affiliates of governmental units, which are exempt from federal income tax under section 501(a), are not required to file annual information returns on Form 990, *Return of Organization Exempt From Income Tax*. See Rev. Proc. 95-48, page 418.

The Service is providing inflation adjustments

to the amount of dues certain exempt organizations can charge and still be excepted from the reporting requirements for exempt organizations with nondeductible lobbying expenditures for taxable years beginning in 1996. See Rev. Proc. 95-53, page 445.

Subpart B.—Information Concerning Transactions with Other Persons

Section 6041.—Information at Source

26 CFR 1.6041-1: Return of information as to payments of \$600 or more.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6041-1: Return of information as to payments of winnings from bingo, keno, and slot machines (temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6041A.—Returns Regarding Payments of Remuneration for Services and Direct Sales

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6042.—Returns Regarding Payments of Dividends and Corporate Earnings and Profits

26 CFR 1.6042-2: Returns of information as to dividends paid in calendar years after 1962.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6042-4: Statements to recipients of dividend payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6043.—Liquidating; etc., Transactions

26 CFR 1.6043-2: Return of information respecting distributions in liquidation.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6044.—Returns Regarding Payments of Patronage Dividends

26 CFR 1.6044-2: Returns of information as to payments of patronage dividends with respect to patronage occurring in taxable years beginning after 1962.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6044-5: Statements to recipients of patronage dividends.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6045.—Returns of Brokers

26 CFR 1.6045-1: Returns of information of brokers and barter exchanges.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6045-2: Furnishing statement required with respect to certain substitute payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6045-4: Information reporting on real estate transactions with dates of closing on or after January 1, 1991.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6045-1: Returns of information of brokers and barter exchanges (temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6047.—Information Relating to Certain Trusts and Annuity Plans

26 CFR 1.6047-1: Information to be furnished with regard to employee retirement plan covering an owner-employee.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6049.—Returns Regarding Payments of Interest

26 CFR 1.6049-4: Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6049-6: Statements to recipients of interest payments and holders of obligations as to which there is attributed original issue discount after December 31, 1982.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6049-7: Returns of information with respect to REMIC regular interests and collateralized debt obligations.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050A.—Reporting Requirements of Certain Fishing Boat Operators

26 CFR 1.6050A-1: Reporting requirements of certain fishing boat operators.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050B.—Returns Relating to Unemployment Compensation

26 CFR 1.6050B-1: Information returns by person making unemployment compensation payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050D.—Returns Relating to Energy Grants and Financing

26 CFR 1.6050D-1: Information returns relating to energy grants and financing.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050E.—State and Local Income Tax Refunds

26 CFR 1.6050E-1: Reporting of State and local income tax refunds.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050H.—Returns Relating to Mortgage Interest Received in Trade or Business From Individuals

26 CFR 1.6050H-1: Information reporting of mortgage interest received in a trade or business from an individual.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

26 CFR 1.6050H-2: Time, form, and manner of reporting interest received on qualified mortgage.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050J.—Returns Relating to Foreclosures and Abandonments of Security

26 CFR 1.6050J-1T: Questions and answers concerning information returns relating to foreclosures and abandonments of security (temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050N.—Returns Regarding Payments of Royalties

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Section 6050P.—Returns Relating to the Cancellation of Indebtedness by Certain Financial Entities

26 CFR 1.6050P-1T: Information reporting for discharges of indebtedness by certain financial entities (temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W-2G. See Rev. Proc. 95-30, page 354.

Part IV.—Signing and Verifying of Returns and Other Documents

Section 6061.—Signing of Returns and Other Documents

26 CFR 1.6061-1: Signing of returns and other documents by individuals.

An electronically filed Form 1040, U.S. Individual Tax Return, which is a composite return, is described. See Rev. Proc. 95-49, page 419.

26 CFR 301.6061-1T: Signing of returns and other documents (temporary).

Temporary regulations under section 6061 of the Code relate to this signing of returns, statements, or other documents. See T.D. 8603, page 281.

Part VIII.—Designation of Income Tax Payments to Presidential Election Campaign Fund
Subchapter B.—Miscellaneous Provisions

Section 6109.—Identifying Numbers

26 CFR 301.6109-2: Authority of the Secretary of Agriculture to collect employer identification numbers for purposes of the Food Stamp Act of 1977.

T.D. 8621

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Authority of the Secretary of Agriculture to Share Employer Identification Numbers Collected from Retail Food Stores and Wholesale Food Concerns

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the authority of the Secretary of Agriculture to share employer identification numbers collected from retail food stores and wholesale food concerns with other agencies or instrumentalities of the United States. These regulations reflect changes to the law made by section 316(b) of the Social Security Independence and Program Improvements Act of

1994 and affect retail food stores and wholesale food concerns.

DATES: These regulations are effective October 3, 1995.

For dates of applicability, see the "Effective Dates" section under the "SUPPLEMENTARY INFORMATION" portion of the preamble and the effective date provisions of the new or revised regulations.

SUPPLEMENTARY INFORMATION:

Background

Section 6109(f) of the Internal Revenue Code (Code) was amended by section 316(b) of the Social Security Independence and Program Improvements Act of 1994, Pub. L. 103-296. The amendments to section 6109(f) were effective on August 15, 1994.

On May 10, 1995, a notice of proposed rulemaking (IA-007-95 [1995-22 I.R.B. 953]) under section 6109(f) of the Code relating to the authority of the Secretary of Agriculture to share employer identification numbers collected from retail food stores and wholesale food concerns with other agencies or instrumentalities of the United States was published in the Federal Register (60 FR 24811). Although written comments and requests for a public hearing were solicited, no written or oral comments were received and no public hearing was requested or held. Accordingly, the proposed regulations under section 6109(f) are adopted by this Treasury decision without any revisions.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

Effective Dates

These regulations are effective on February 1, 1992, except that any provisions relating to the sharing of information by the Secretary of Agriculture with any other agency or instrumentality of the United States are effective on August 15, 1994.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.6109-2 is amended by revising paragraphs (c) through (g) and adding paragraph (h) to read as follows:

§301.6109-2 Authority of the Secretary of Agriculture to collect employer identification numbers for purposes of the Food Stamp Act of 1977.

* * * * *

(c) *Sharing of information—(1) Sharing permitted with certain United States agencies and instrumentalities.* The Secretary of Agriculture may share the information contained in the list described in paragraph (b) of this section with any other agency or instrumentality of the United States that otherwise has access to employer identification numbers, but only to the extent the Secretary of Agriculture determines sharing such information will assist in verifying and matching that information against information maintained by the other agency or instrumentality.

(2) *Restrictions on the use of shared information.* The information shared by the Secretary of Agriculture pursuant to this section may be used by any other agency or instrumentality of the United States only for the purpose of effective administration and enforcement of the Food Stamp Act of 1977 or for the purpose of investigation of violations of other Federal laws or enforcement of those laws.

(d) *Safeguards—(1) Restrictions on access to employer identification numbers by individuals—(i) Numbers maintained by the Secretary of Agriculture.* The individuals who are permitted access to employer identification numbers obtained pursuant to paragraph (a) of this section and maintained by the Secretary of Agriculture are officers and employees of the United States whose duties or responsibilities require access to such employer identification numbers for the purpose of effective administration or enforcement of the Food Stamp Act of 1977 or for the purpose of sharing the information in accordance with paragraph (c) of this section.

(ii) *Numbers maintained by any other agency or instrumentality.* The individuals who are permitted access to employer identification numbers obtained pursuant to paragraph (c) of this section and maintained by any agency or instrumentality of the United States other than the Department of Agriculture are officers and employees of the United States whose duties or responsibilities require access to such employer identification numbers for the purpose of effective administration and enforcement of the Food Stamp Act of 1977 or for the purpose of investigation of violations of other Federal laws or enforcement of those laws.

(2) *Other safeguards.* The Secretary of Agriculture, and the head of any other agency or instrumentality referred to in paragraph (c) of this section, must provide for any additional safeguards that the Secretary of the Treasury determines to be necessary or appropriate to protect the confidentiality of the employer identification numbers. The Secretary of Agriculture, and the head of any other agency or instrumentality referred to in paragraph (c) of this section, may also provide for any additional safeguards to protect the confidentiality of employer identification numbers, provided these safeguards are consistent with safeguards determined by the Secretary of the Treasury to be necessary or appropriate.

(e) *Confidentiality and disclosure of employer identification numbers.* Employer identification numbers obtained pursuant to paragraph (a) or (c) of this section are confidential. No officer or employee of the United States who has or had access to any such employer identification number may disclose that number in any manner to an individual

not described in paragraph (d) of this section. For purposes of this paragraph (e), *officer or employee* includes a former officer or employee.

(f) *Sanctions*—(1) *Unauthorized, willful disclosure of employer identification numbers.* Sections 7213(a) (1), (2), and (3) apply with respect to the unauthorized, willful disclosure to any person of employer identification numbers that are maintained pursuant to this section by the Secretary of Agriculture, or any other agency or instrumentality with which information is shared pursuant to paragraph (c) of this section, in the same manner and to the same extent as sections 7213(a) (1), (2), and (3) apply with respect to unauthorized disclosures of returns and return information described in those sections.

(2) *Willful solicitation of employer identification numbers.* Section 7213(a)(4) applies with respect to the willful offer of any item of material value in exchange for any employer identification number maintained pursuant to this section by the Secretary of Agriculture, or any other agency or instrumentality with which information is shared pursuant to paragraph (c) of this section, in the same manner and to the same extent as section 7213(a)(4) applies with respect to offers (in exchange for any return or return information) described in that section.

(g) *Delegation.* All references in this section to the Secretary of Agriculture are references to the Secretary of Agriculture or his or her delegate.

(h) *Effective date.* Except as provided in the following sentence, this section is effective on February 1, 1992. Any provisions relating to the sharing of information by the Secretary of Agriculture with any other agency or instrumentality of the United States are effective on August 15, 1994.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved September 7, 1995.

Cynthia G. Beerbower,
*Deputy Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on October 2, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 3, 1995, 60 F.R. 51724)

Section 6302.—Mode or Time of Collection

26 CFR 31.6302-1T: Federal Tax Deposit Rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA)—Deposits required to be made by electronic funds transfer after December 31, 1994 (temporary).

Application of tax failure-to-deposit penalty imposed by section 6656 to taxpayers that are required to deposit by electronic funds transfer (EFT) and also taxpayers that deposit voluntarily by EFT. See Rev. Rul. 95-68, page 272.

26 CFR 40.6302(c)-5T: Use of Government depositaries; rules under sections 6302(e) and (f) (temporary).

T.D. 8616

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 40

Deposits of Excise Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to deposits of excise taxes. These temporary regulations reflect changes to the law made by the Uruguay Round Agreements Act and affect persons required to make deposits of excise taxes. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [PS-8-95, page 506, this Bulletin].

EFFECTIVE DATE: These regulations are effective August 1, 1995.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Excise Tax Procedural Regulations (26 CFR part 40) relating to deposits of excise taxes. Effective January 1, 1995, the Uruguay Round Agreements Act of 1994 (the Act)

amended sections 6302(e) and (f) (relating to deposits of excise taxes). As amended, these provisions require an additional deposit of all excise taxes except air transportation taxes in September of each year. Beginning in 1997, the amendments also apply to air transportation taxes. These temporary regulations provide safe harbor rules for that additional deposit of tax.

Under existing rules, deposits of excise taxes for a semimonthly period generally must equal the amount of tax liability incurred (or in the case of collected taxes, the amount of tax collected) during that semimonthly period unless a safe harbor applies. Sections 40.6302(c)-1(c) and 40.6302(c)-2(b)(2) and (3) provide two safe harbor rules for computing the amount of tax required to be deposited; the look-back quarter safe harbor rule and the current liability safe harbor rule.

These temporary regulations modify the safe harbor rules to reflect the amendments made by the Act.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 40 is amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 continues to read in part as follows:

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

not described in paragraph (d) of this section. For purposes of this paragraph (e), *officer or employee* includes a former officer or employee.

(f) *Sanctions*—(1) *Unauthorized, willful disclosure of employer identification numbers.* Sections 7213(a) (1), (2), and (3) apply with respect to the unauthorized, willful disclosure to any person of employer identification numbers that are maintained pursuant to this section by the Secretary of Agriculture, or any other agency or instrumentality with which information is shared pursuant to paragraph (c) of this section, in the same manner and to the same extent as sections 7213(a) (1), (2), and (3) apply with respect to unauthorized disclosures of returns and return information described in those sections.

(2) *Willful solicitation of employer identification numbers.* Section 7213(a)(4) applies with respect to the willful offer of any item of material value in exchange for any employer identification number maintained pursuant to this section by the Secretary of Agriculture, or any other agency or instrumentality with which information is shared pursuant to paragraph (c) of this section, in the same manner and to the same extent as section 7213(a)(4) applies with respect to offers (in exchange for any return or return information) described in that section.

(g) *Delegation.* All references in this section to the Secretary of Agriculture are references to the Secretary of Agriculture or his or her delegate.

(h) *Effective date.* Except as provided in the following sentence, this section is effective on February 1, 1992. Any provisions relating to the sharing of information by the Secretary of Agriculture with any other agency or instrumentality of the United States are effective on August 15, 1994.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved September 7, 1995.

Cynthia G. Beerbower,
*Deputy Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on October 2, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 3, 1995, 60 F.R. 51724)

Section 6302.—Mode or Time of Collection

26 CFR 31.6302-1T: Federal Tax Deposit Rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA)—Deposits required to be made by electronic funds transfer after December 31, 1994 (temporary).

Application of tax failure-to-deposit penalty imposed by section 6656 to taxpayers that are required to deposit by electronic funds transfer (EFT) and also taxpayers that deposit voluntarily by EFT. See Rev. Rul. 95-68, page 272.

26 CFR 40.6302(c)-5T: Use of Government depositaries; rules under sections 6302(e) and (f) (temporary).

T.D. 8616

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 40

Deposits of Excise Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to deposits of excise taxes. These temporary regulations reflect changes to the law made by the Uruguay Round Agreements Act and affect persons required to make deposits of excise taxes. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [PS-8-95, page 506, this Bulletin].

EFFECTIVE DATE: These regulations are effective August 1, 1995.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Excise Tax Procedural Regulations (26 CFR part 40) relating to deposits of excise taxes. Effective January 1, 1995, the Uruguay Round Agreements Act of 1994 (the Act)

amended sections 6302(e) and (f) (relating to deposits of excise taxes). As amended, these provisions require an additional deposit of all excise taxes except air transportation taxes in September of each year. Beginning in 1997, the amendments also apply to air transportation taxes. These temporary regulations provide safe harbor rules for that additional deposit of tax.

Under existing rules, deposits of excise taxes for a semimonthly period generally must equal the amount of tax liability incurred (or in the case of collected taxes, the amount of tax collected) during that semimonthly period unless a safe harbor applies. Sections 40.6302(c)-1(c) and 40.6302(c)-2(b)(2) and (3) provide two safe harbor rules for computing the amount of tax required to be deposited; the look-back quarter safe harbor rule and the current liability safe harbor rule.

These temporary regulations modify the safe harbor rules to reflect the amendments made by the Act.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 40 is amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 continues to read in part as follows:

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

Par. 2. Section 40.6302(c)-5T is added to read as follows:

§40.6302(c)-5T Use of Government depositaries; rules under sections 6302(e) and (f) (temporary).

(a) *Applicability; meaning of terms.* This section sets forth rules relating to the excise tax deposits required under sections 6302(e)(2) and (f). Terms used both in this section and in any other provision of §40.6302(c)-1, 40.6302(c)-2, 40.6302(c)-3, or 40.6302(c)-4 have the same meaning for purposes of this section as when used in such other provision.

(b) *Nine-day rule and 14-day rule taxes*—(1) *Deposits required.* In the case of deposits of 9-day rule taxes and 14-day rule taxes for the second semimonthly period in September, separate deposits are required for the period September 16th-26th and the period September 27th-30th.

(2) *Amount of deposit; in general.* Each deposit of a class of tax (that is, 9-day rule taxes or 14-day rule taxes) required under this paragraph (b) for the periods September 16th-26th and September 27th-30th must be not less than the amount of net tax liability incurred for the class of tax during the period. The net tax liability incurred for a class of tax during these periods may be computed by—

(i) Determining the amount of net tax liability reasonably expected to be incurred for the class of tax during the second semimonthly period in September;

(ii) Treating 11/15 (73.34 percent) of such amount as the net tax liability incurred during the period September 16th-26th; and

(iii) Treating the remainder of the amount determined under paragraph (b)(2)(i) of this section (adjusted to reflect net tax liability actually incurred through the end of September) as the net tax liability incurred during the period September 27th-30th.

(3) *Amount of deposit; safe harbor rules.* In the case of a class of tax for which an additional September deposit is required under this paragraph (b), the safe harbor rules of §40.6302(c)-1(c) are modified as follows:

(i) *Safe harbor rule based on look-back quarter liability.* The safe harbor rule of §40.6302(c)-1(c)(2)(i) does not apply for the third calendar quarter unless—

(A) The deposit of taxes in that class for the period September 16th-26th is not less than 11/90 (12.23 percent) of the net tax liability reported for the class of tax for the look-back quarter; and

(B) The total deposit of taxes in that class for the second semimonthly period in September is not less than 1/6 (16.67 percent) of the net tax liability reported for the class of tax for the look-back quarter.

(ii) *Safe harbor rule based on current liability.* The safe harbor rule of §40.6302(c)-1(c)(3)(i) does not apply for the third calendar quarter unless—

(A) The deposit of taxes in that class for the period September 16th-26th is not less than 69.67 percent of the net tax liability for the class of tax for the second semimonthly period in September; and

(B) The total deposit of taxes in that class for the second semimonthly period in September is not less than 95 percent of the net tax liability for the class of tax for that semimonthly period.

(4) *Time to deposit.* The deposit required under this paragraph (b) for the period beginning September 16th must be made on or before September 29. The deposit required under this paragraph (b) for the period ending September 30th must be made at the time prescribed in §40.6302(c)-1(b)-(6)(i) (or, to the extent applicable, at the time prescribed in §40.6302(c)-4(b)) for making deposits for the second semimonthly period in September.

(c) *30-day rule taxes*—(1) *Deposits required.* In the case of deposits of 30-day rule taxes for the first semimonthly period in September, separate deposits are required for the period September 1st-11th and the period September 12th-15th.

(2) *Amount of deposit; in general.* Each deposit of 30-day rule taxes required under this paragraph (c) for the periods September 1st-11th and September 12th-15th must be not less than the amount of net tax liability incurred for 30-day rule taxes during the period. The net tax liability incurred during these periods may be computed by—

(i) Determining the amount of net tax liability incurred during the first semimonthly period in September (or, if semimonthly liability is computed by dividing monthly liability by two, the

amount reasonably expected to be incurred);

(ii) Treating 11/15 (73.34 percent) of such amount as the net tax liability incurred during the period September 1st-11th; and

(iii) Treating the remainder of the amount determined under paragraph (c)(2)(i) of this section (adjusted, if such amount is based on reasonable expectations, to reflect net tax liability actually incurred through the end of September) as the net tax liability incurred during the period September 12th-15th.

(3) *Amount of deposit; safe harbor rules.* In the case of 30-day rule taxes for which an additional September deposit is required under this paragraph (c), the safe harbor rules of §40.6302(c)-2(b) are modified as follows:

(i) *Safe harbor rule based on look-back quarter liability.* The safe harbor rule of §40.6302(c)-2(b)(2) does not apply for the third calendar quarter unless—

(A) The deposit of 30-day rule taxes for the period September 1st-11th is not less than 11/90 (12.23 percent) of the net tax liability reported for 30-day rule taxes for the look-back quarter; and

(B) The total deposit of 30-day rule taxes for the first semimonthly period in September is not less than 1/6 (16.67 percent) of the net tax liability reported for 30-day rule taxes for the look-back quarter.

(ii) *Safe harbor rule based on current liability.* The safe harbor rule of §40.6302(c)-2(b)(3) does not apply for the third calendar quarter unless—

(A) The deposit of 30-day rule taxes for the period September 1st-11th is not less than 69.67 percent of the net tax liability for 30-day rule taxes for the first semimonthly period in September; and

(B) The total deposit of 30-day rule taxes for the first semimonthly period in September is not less than 95 percent of the net tax liability for 30-day rule taxes for that semimonthly period.

(4) *Time to deposit.* The deposit required under this paragraph (c) for the period beginning September 1st and the deposit of 30-day rule taxes for the second semimonthly period in August must be made on or before September 29. The deposit required under this paragraph (c) for the period ending September 15th must be made at the time prescribed in §40.6302(c)-2(b)(1)

for making deposits for the first semi-monthly period in September.

(d) *Alternative method taxes*—(1) *Deposits required.* In the case of alternative method taxes charged (that is, included in amounts billed or tickets sold) during the first semi-monthly period in September, separate deposits are required for the taxes charged during the period September 1st-11th and the period September 12th-15th.

(2) *Amount of deposit; in general.* Each deposit of alternative method taxes required under this paragraph (d) for the periods September 1st-11th and September 12th-15th must be not less than the amount of alternative method taxes charged during the period. The amount of alternative method taxes charged during these periods may be computed by—

(i) Determining the net amount of alternative method taxes reflected in the separate account for the first semi-monthly period in September (or one-half of the net amount of alternative method taxes reasonably expected to be reflected in the separate account for the month of September);

(ii) Treating 11/15 (73.34 percent) of such amount as the amount charged during the period September 1st-11th; and

(iii) Treating the remainder of the amount determined under paragraph (d)(2)(i) of this section (adjusted, if such amount is based on reasonable expectations, to reflect actual charges through the end of September) as the amount charged during the period September 12th-15th.

(3) *Amount of deposit; safe harbor rules.* In the case of alternative method

taxes for which an additional September deposit is required under this paragraph (d), the safe harbor rules of §40.6302(c)–1(c) are modified as follows:

(i) *Safe harbor rule based on look-back quarter liability.* The safe harbor rule of §40.6302(c)–1(c)(2)(i) does not apply for the fourth calendar quarter unless—

(A) The deposit for alternative method taxes charged during the period September 1st-11th is not less than 11/90 (12.23 percent) of the net tax liability reported for alternative method taxes for the look-back quarter; and

(B) The total deposit for alternative method taxes charged during the first semi-monthly period in September is not less than 1/6 (16.67 percent) of the net tax liability reported for alternative method taxes for the look-back quarter.

(ii) *Safe harbor rule based on current liability.* The safe harbor rule of §40.6302(c)–1(c)(3)(i) does not apply for the fourth calendar quarter unless—

(A) The deposit for alternative method taxes charged during the period September 1st-11th is not less than 69.67 percent of the alternative method taxes charged during the first semi-monthly period in September; and

(B) The total deposit for alternative method taxes charged during the first semi-monthly period in September is not less than 95 percent of the alternative method taxes charged during that semi-monthly period.

(4) *Time to deposit.* The deposit required under this paragraph (d) for taxes charged during the period beginning September 1st must be made on or before September 29. The deposit of

alternative method taxes required under this paragraph (d) for taxes charged during the period ending September 15th must be made at the time prescribed in §40.6302(c)–3(c) for making deposits for the first semi-monthly period in October.

(e) *Modifications for persons not required to use electronic funds transfer.* In the case of a person that is not required to deposit excise taxes by electronic funds transfer (a non-EFT depositor), the rules of paragraphs (b), (c), and (d) apply with the following modifications:

(1) The periods for which separate deposits must be made under paragraph (b) of this section are September 16th-25th and September 26th-30th. In addition, the deposit required for the period beginning September 16th must be made on or before September 28.

(2) The periods for which separate deposits must be made under paragraph (c) of this section are September 1st-10th and September 11th-15th. In addition, the deposit required for the period beginning September 1st and the deposit of 30-day rule taxes for the second semi-monthly period in August must be made on or before September 28.

(3) The taxes for which separate deposits must be made under paragraph (d) of this section are those charged during the periods September 1st-10th and September 11th-15th. In addition, the deposit required for taxes charged during the period beginning September 1st must be made on or before September 28.

(4) The generally applicable fractions and percentages are modified to reflect the different deposit periods in accordance with the following table:

| Generally applicable fractions and percentages | Modification for non-EFT depositors |
|--|-------------------------------------|
| 11/15 (73.34 percent) | 10/15 (66.67 percent) |
| 11/90 (12.23 percent) | 10/90 (11.12 percent) |
| 69.67 percent | 63.34 percent |

(f) *Due date on Saturday or Sunday*—(1) *EFT depositors.* A deposit that, under the rules of this section, would otherwise be due on September 29 must be made on or before September 28 if September 29 is a Saturday and on or before September 30 if September 29 is a Sunday.

(2) *Non-EFT depositors.* A deposit

that, under the rules of this section, would otherwise be due on September 28 must be made on or before September 27 if September 28 is a Saturday and on or before September 29 if September 28 is a Sunday.

(g) *Special rules for section 4081 taxes superseded.* Deposits for the second semi-monthly period in Septem-

ber of taxes imposed by section 4081 must be made under the rules of this section and without regard to the special rules for such deposits under §40.6302(c)–1.

(h) *Effective date*—(1) *In general.* Except as provided in paragraph (h)(2) of this section, this section is effective August 1, 1995.

(2) *Air transportation taxes.* For air transportation taxes, this section is effective January 1, 1997.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved August 3, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 28, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 29, 1995, 60 F.R. 44758)

Chapter 67.—Interest

Subchapter C.—Determination of Interest Rate;
Compounding of Interest

Section 6621.— Determination of Rate of Interest

26 CFR 301.6621-1: *Interest rate.*

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1995, will remain at 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporation overpayment exceeding \$10,000 will remain at 6.5 percent.

Rev. Rul. 95-59

Section 6621 of the Internal Revenue

Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) shall be applied by substituting “5 percentage points” for “3 percentage points.” See § 6621(c) and § 301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621-3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary shall determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month shall apply during the first calendar quarter beginning after such month.

Section 6621(b)(3) provides that the federal short-term rate for any month shall be the federal short-term rate determined during such month by the

Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of ½ of 1 percent, the rate shall be increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 1995 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning October 1, 1995. The overpayment rate for the portion of corporate overpayments exceeding \$10,000 for the calendar quarter beginning October 1, 1995, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning October 1, 1995, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 18, 21, 23, and 27 of Rev. Proc. 95-17, 1995-1 C.B. 556.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the accompanying tables.

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

| PERIOD | RATE | DAILY RATE
TABLE IN
1995-9 I.R.B. |
|----------------------------|------|---|
| Before Jul. 1, 1975 | 6% | Table 2, pg. 14 |
| Jul. 1, 1975—Jan. 31, 1976 | 9% | Table 4, pg. 16 |
| Feb. 1, 1976—Jan. 31, 1978 | 7% | Table 3, pg. 15 |
| Feb. 1, 1978—Jan. 31, 1980 | 6% | Table 2, pg. 14 |
| Feb. 1, 1980—Jan. 31, 1982 | 12% | Table 5, pg. 16 |
| Feb. 1, 1982—Dec. 31, 1982 | 20% | Table 6, pg. 16 |
| Jan. 1, 1983—Jun. 30, 1983 | 16% | Table 37, pg. 47 |
| Jul. 1, 1983—Dec. 31, 1983 | 11% | Table 27, pg. 37 |
| Jan. 1, 1984—Jun. 30, 1984 | 11% | Table 75, pg. 85 |
| Jul. 1, 1984—Dec. 31, 1984 | 11% | Table 75, pg. 85 |
| Jan. 1, 1985—Jun. 30, 1985 | 13% | Table 31, pg. 41 |
| Jul. 1, 1985—Dec. 31, 1985 | 11% | Table 27, pg. 37 |
| Jan. 1, 1986—Jun. 30, 1986 | 10% | Table 25 pg. 35 |
| Jul. 1, 1986—Dec. 31, 1986 | 9% | Table 23, pg. 33 |

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 — PRESENT

| | OVERPAYMENTS | | | UNDERPAYMENTS | | |
|----------------------------|---------------|-------|-----|---------------|-------|-----|
| | RATE | TABLE | PG. | RATE | TABLE | PG. |
| | 1995-9 I.R.B. | | | 1995-9 I.R.B. | | |
| Jan. 1, 1987—Mar. 31, 1987 | 8% | 221 | 31 | 9% | 23 | 33 |
| Apr. 1, 1987—Jun. 30, 1987 | 8% | 21 | 31 | 9% | 23 | 33 |
| Jul. 1, 1987—Sep. 30, 1987 | 8% | 21 | 31 | 9% | 23 | 33 |
| Oct. 1, 1987—Dec. 31, 1987 | 9% | 23 | 33 | 10% | 25 | 35 |
| Jan. 1, 1988—Mar. 31, 1988 | 10% | 73 | 83 | 11% | 75 | 85 |
| Apr. 1, 1988—Jun. 30, 1988 | 9% | 71 | 81 | 10% | 73 | 83 |
| Jul. 1, 1988—Sep. 30, 1988 | 9% | 71 | 81 | 10% | 73 | 83 |
| Oct. 1, 1988—Dec. 31, 1988 | 10% | 73 | 83 | 11% | 75 | 85 |
| Jan. 1, 1989—Mar. 31, 1989 | 10% | 25 | 35 | 11% | 27 | 37 |
| Apr. 1, 1989—Jun. 30, 1989 | 11% | 27 | 37 | 12% | 29 | 39 |
| Jul. 1, 1989—Sep. 30, 1989 | 11% | 27 | 37 | 12% | 29 | 39 |
| Oct. 1, 1989—Dec. 31, 1989 | 10% | 25 | 35 | 11% | 27 | 37 |
| Jan. 1, 1990—Mar. 31, 1990 | 10% | 25 | 35 | 11% | 27 | 37 |
| Apr. 1, 1990—Jun. 30, 1990 | 10% | 25 | 35 | 11% | 27 | 37 |
| Jul. 1, 1990—Sep. 30, 1990 | 10% | 25 | 35 | 11% | 27 | 37 |
| Oct. 1, 1990—Dec. 31, 1990 | 10% | 25 | 35 | 11% | 27 | 37 |
| Jan. 1, 1991—Mar. 31, 1991 | 10% | 25 | 35 | 11% | 27 | 37 |
| Apr. 1, 1991—Jun. 30, 1991 | 9% | 23 | 33 | 10% | 25 | 35 |
| Jul. 1, 1991—Sep. 30, 1991 | 9% | 23 | 33 | 10% | 25 | 35 |
| Oct. 1, 1991—Dec. 31, 1991 | 9% | 23 | 33 | 10% | 25 | 35 |
| Jan. 1, 1992—Mar. 31, 1992 | 8% | 69 | 79 | 9% | 71 | 81 |
| Apr. 1, 1992—Jun. 30, 1992 | 7% | 67 | 77 | 8% | 69 | 79 |
| Jul. 1, 1992—Sep. 30, 1992 | 7% | 67 | 77 | 8% | 69 | 79 |
| Oct. 1, 1992—Dec. 31, 1992 | 6% | 65 | 75 | 7% | 67 | 77 |
| Jan. 1, 1993—Mar. 31, 1993 | 6% | 17 | 27 | 7% | 19 | 29 |
| Apr. 1, 1993—Jun. 30, 1993 | 6% | 17 | 27 | 7% | 19 | 29 |
| Jul. 1, 1993—Sep. 30, 1993 | 6% | 17 | 27 | 7% | 19 | 29 |
| Oct. 1, 1993—Dec. 31, 1993 | 6% | 17 | 27 | 7% | 19 | 29 |
| Jan. 1, 1994—Mar. 31, 1994 | 6% | 17 | 27 | 7% | 19 | 29 |
| Apr. 1, 1994—Jun. 30, 1994 | 6% | 17 | 27 | 7% | 19 | 29 |
| Jul. 1, 1994—Sep. 30, 1994 | 7% | 19 | 29 | 8% | 21 | 31 |
| Oct. 1, 1994—Dec. 31, 1994 | 8% | 21 | 31 | 9% | 23 | 33 |
| Jan. 1, 1995—Mar. 31, 1995 | 8% | 21 | 31 | 9% | 23 | 33 |
| Apr. 1, 1995—Jun. 30, 1995 | 9% | 23 | 33 | 10% | 25 | 35 |
| Jul. 1, 1995—Sep. 30, 1995 | 8% | 21 | 31 | 9% | 23 | 33 |
| Oct. 1, 1995—Dec. 31, 1995 | 8% | 21 | 31 | 9% | 23 | 33 |

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991 — PRESENT

| | RATE | TABLE
1995-9 I.R.B. | PG. |
|----------------------------|------|------------------------|-----|
| Jan. 1, 1991—Mar. 31, 1991 | 13% | 31 | 41 |
| Apr. 1, 1991—Jun. 30, 1991 | 12% | 29 | 39 |
| Jul. 1, 1991—Sep. 30, 1991 | 12% | 29 | 39 |
| Oct. 1, 1991—Dec. 31, 1991 | 12% | 29 | 39 |
| Jan. 1, 1992—Mar. 31, 1992 | 11% | 75 | 85 |
| Apr. 1, 1992—Jun. 30, 1992 | 10% | 73 | 83 |
| Jul. 1, 1992—Sep. 30, 1992 | 10% | 73 | 83 |
| Oct. 1, 1992—Dec. 31, 1992 | 9% | 71 | 81 |
| Jan. 1, 1993—Mar. 31, 1993 | 9% | 23 | 33 |
| Apr. 1, 1993—Jun. 30, 1993 | 9% | 23 | 33 |
| Jul. 1, 1993—Sep. 30, 1993 | 9% | 23 | 33 |
| Oct. 1, 1993—Dec. 31, 1993 | 9% | 23 | 33 |
| Jan. 1, 1994—Mar. 31, 1994 | 9% | 23 | 33 |
| Apr. 1, 1994—Jun. 30, 1994 | 9% | 23 | 33 |
| Jul. 1, 1994—Sep. 30, 1994 | 10% | 25 | 35 |
| Oct. 1, 1994—Dec. 31, 1994 | 11% | 27 | 37 |
| Jan. 1, 1995—Mar. 31, 1995 | 11% | 27 | 37 |
| Apr. 1, 1995—Jun. 30, 1995 | 12% | 29 | 39 |
| Jul. 1, 1995—Sep. 30, 1995 | 11% | 27 | 37 |
| Oct. 1, 1995—Dec. 31, 1995 | 11% | 27 | 37 |

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000

FROM JANUARY 1, 1995 — PRESENT

| | RATE | TABLE
1995-9 I.R.B. | PG. |
|----------------------------|------|------------------------|-----|
| Jan. 1, 1995—Mar. 31, 1995 | 6.5% | 18 | 28 |
| Apr. 1, 1995—Jun. 30, 1995 | 7.5% | 20 | 30 |
| Jul. 1, 1995—Sep. 30, 1995 | 6.5% | 18 | 28 |
| Oct. 1, 1995—Dec. 31, 1995 | 6.5% | 18 | 28 |

26 CFR 301.6621-1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning January 1, 1996, is 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding \$10,000 is 6.5 percent.

Rev. Rul. 95-78

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding \$10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computa-

tions made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621-3 of the Regulations on Procedure and Administration for the definition of a large corporate under-

payment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621-3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) provides that in determining the addition to tax under § 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following such taxable year also applies during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) provides that the federal short-term rate for any month is

the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of ½ of 1 percent, the rate is increased to the next highest full percent).

Notice 88-59, 1988-1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of October 1995 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning January 1,

1996. The overpayment rate for the portion of corporate overpayments exceeding \$10,000 for the calendar quarter beginning January 1, 1996, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning January 1, 1996, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

The 9 percent rate also applies to estimated tax underpayments for the first calendar quarter in 1996 and for the first 15 days in April 1996.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 66, 69, 71, and 75 of Rev. Proc. 95-17, 1995-1 C.B. 556, 620, 623, 625 and 629.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

TABLE OF INTEREST RATES
PERIODS BEFORE JUL. 1, 1975—PERIODS ENDING DEC. 31, 1986
OVERPAYMENTS AND UNDERPAYMENTS

| PERIOD | RATE | DAILY RATE TABLE
IN 1995-1 C.B. |
|----------------------------|------|------------------------------------|
| Before Jul. 1, 1975 | 6% | Table 2, pg. 557 |
| Jul. 1, 1975—Jan. 31, 1976 | 9% | Table 4, pg. 559 |
| Feb. 1, 1976—Jan. 31, 1978 | 7% | Table 3, pg. 558 |
| Feb. 1, 1978—Jan. 31, 1980 | 6% | Table 2, pg. 557 |
| Feb. 1, 1980—Jan. 31, 1982 | 12% | Table 5, pg. 560 |
| Feb. 1, 1982—Dec. 31, 1982 | 20% | Table 6, pg. 560 |
| Jan. 1, 1983—Jun. 30, 1983 | 16% | Table 37, pg. 591 |
| Jul. 1, 1983—Dec. 31, 1983 | 11% | Table 27, pg. 581 |
| Jan. 1, 1984—Jun. 30, 1984 | 11% | Table 75, pg. 629 |
| Jul. 1, 1984—Dec. 31, 1984 | 11% | Table 75, pg. 629 |
| Jan. 1, 1985—Jun. 30, 1985 | 13% | Table 31, pg. 585 |
| Jul. 1, 1985—Dec. 31, 1985 | 11% | Table 27, pg. 581 |
| Jan. 1, 1986—Jun. 30, 1986 | 10% | Table 25 pg. 579 |
| Jul. 1, 1986—Dec. 31, 1986 | 9% | Table 23, pg. 577 |

TABLE OF INTEREST RATES
FROM JAN. 1, 1987 — PRESENT

| | OVERPAYMENTS | | | UNDERPAYMENTS | | |
|----------------------------|--------------|-------|-----|---------------|-------|-----|
| | RATE | TABLE | PG | RATE | TABLE | PG |
| | 1995-1 C.B. | | | 1995-1 C.B. | | |
| Jan. 1, 1987—Mar. 31, 1987 | 8% | 21 | 575 | 9% | 2 | 577 |
| Apr. 1, 1987—Jun. 30, 1987 | 8% | 21 | 575 | 9% | 23 | 577 |
| Jul. 1, 1987—Sep. 30, 1987 | 8% | 21 | 575 | 9% | 23 | 577 |
| Oct. 1, 1987—Dec. 31, 1987 | 9% | 23 | 577 | 10% | 25 | 579 |
| Jan. 1, 1988—Mar. 31, 1988 | 10% | 73 | 627 | 11% | 75 | 629 |
| Apr. 1, 1988—Jun. 30, 1988 | 9% | 71 | 625 | 10% | 73 | 627 |
| Jul. 1, 1988—Sep. 30, 1988 | 9% | 71 | 625 | 10% | 73 | 627 |
| Oct. 1, 1988—Dec. 31, 1988 | 10% | 73 | 627 | 11% | 75 | 629 |
| Jan. 1, 1989—Mar. 31, 1989 | 10% | 25 | 579 | 11% | 27 | 581 |
| Apr. 1, 1989—Jun. 30, 1989 | 11% | 27 | 581 | 12% | 29 | 583 |
| Jul. 1, 1989—Sep. 30, 1989 | 11% | 27 | 581 | 12% | 29 | 583 |
| Oct. 1, 1989—Dec. 31, 1989 | 10% | 25 | 579 | 11% | 27 | 581 |
| Jan. 1, 1990—Mar. 31, 1990 | 10% | 25 | 579 | 11% | 27 | 581 |
| Apr. 1, 1990—Jun. 30, 1990 | 10% | 25 | 579 | 11% | 27 | 581 |
| Jul. 1, 1990—Sep. 30, 1990 | 10% | 25 | 579 | 11% | 27 | 581 |
| Oct. 1, 1990—Dec. 31, 1990 | 10% | 25 | 579 | 11% | 27 | 581 |
| Jan. 1, 1991—Mar. 31, 1991 | 10% | 25 | 579 | 11% | 27 | 581 |
| Apr. 1, 1991—Jun. 30, 1991 | 9% | 23 | 577 | 10% | 25 | 579 |
| Jul. 1, 1991—Sep. 30, 1991 | 9% | 23 | 577 | 10% | 25 | 579 |
| Oct. 1, 1991—Dec. 31, 1991 | 9% | 23 | 577 | 10% | 25 | 579 |
| Jan. 1, 1992—Mar. 31, 1992 | 8% | 69 | 623 | 9% | 71 | 625 |
| Apr. 1, 1992—Jun. 30, 1992 | 7% | 67 | 621 | 8% | 69 | 623 |
| Jul. 1, 1992—Sep. 30, 1992 | 7% | 67 | 621 | 8% | 69 | 623 |
| Oct. 1, 1992—Dec. 31, 1992 | 6% | 65 | 619 | 7% | 67 | 621 |
| Jan. 1, 1993—Mar. 31, 1993 | 6% | 17 | 571 | 7% | 19 | 573 |
| Apr. 1, 1993—Jun. 30, 1993 | 6% | 17 | 571 | 7% | 19 | 573 |
| Jul. 1, 1993—Sep. 30, 1993 | 6% | 17 | 571 | 7% | 19 | 573 |
| Oct. 1, 1993—Dec. 31, 1993 | 6% | 17 | 571 | 7% | 19 | 573 |
| Jan. 1, 1994—Mar. 31, 1994 | 6% | 17 | 571 | 7% | 19 | 573 |
| Apr. 1, 1994—Jun. 30, 1994 | 6% | 17 | 571 | 7% | 19 | 573 |
| Jul. 1, 1994—Sep. 30, 1994 | 7% | 19 | 573 | 8% | 21 | 575 |
| Oct. 1, 1994—Dec. 31, 1994 | 8% | 21 | 575 | 9% | 23 | 577 |
| Jan. 1, 1995—Mar. 31, 1995 | 8% | 21 | 575 | 9% | 23 | 577 |
| Apr. 1, 1995—Jun. 30, 1995 | 9% | 23 | 577 | 10% | 25 | 579 |
| Jul. 1, 1995—Sep. 30, 1995 | 8% | 21 | 575 | 9% | 23 | 577 |
| Oct. 1, 1995—Dec. 31, 1995 | 8% | 21 | 575 | 9% | 23 | 577 |
| Jan. 1, 1996—Mar. 31, 1996 | 8% | 69 | 623 | 9% | 71 | 625 |

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS
FROM JANUARY 1, 1991 — PRESENT

| | RATE | TABLE
1995-1 C.B. | PG |
|----------------------------|------|----------------------|-----|
| Jan. 1, 1991—Mar. 31, 1991 | 13% | 31 | 585 |
| Apr. 1, 1991—Jun. 30, 1991 | 12% | 29 | 583 |
| Jul. 1, 1991—Sep. 30, 1991 | 12% | 29 | 583 |
| Oct. 1, 1991—Dec. 31, 1991 | 12% | 29 | 583 |
| Jan. 1, 1992—Mar. 31, 1992 | 11% | 75 | 629 |
| Apr. 1, 1992—Jun. 30, 1992 | 10% | 73 | 627 |
| Jul. 1, 1992—Sep. 30, 1992 | 10% | 73 | 627 |
| Oct. 1, 1992—Dec. 31, 1992 | 9% | 71 | 625 |
| Jan. 1, 1993—Mar. 31, 1993 | 9% | 23 | 577 |
| Apr. 1, 1993—Jun. 30, 1993 | 9% | 23 | 577 |
| Jul. 1, 1993—Sep. 30, 1993 | 9% | 23 | 577 |
| Oct. 1, 1993—Dec. 31, 1993 | 9% | 23 | 577 |
| Jan. 1, 1994—Mar. 31, 1994 | 9% | 23 | 577 |
| Apr. 1, 1994—Jun. 30, 1994 | 9% | 23 | 577 |
| Jul. 1, 1994—Sep. 30, 1994 | 10% | 25 | 579 |
| Oct. 1, 1994—Dec. 31, 1994 | 11% | 27 | 581 |
| Jan. 1, 1995—Mar. 31, 1995 | 11% | 27 | 581 |
| Apr. 1, 1995—Jun. 30, 1995 | 12% | 29 | 583 |
| Jul. 1, 1995—Sep. 30, 1995 | 11% | 27 | 581 |
| Oct. 1, 1995—Dec. 31, 1995 | 11% | 27 | 581 |
| Jan. 1, 1996—Mar. 31, 1996 | 11% | 75 | 629 |

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING \$10,000
FROM JANUARY 1, 1995 — PRESENT

| | RATE | TABLE
1995-1 C.B. | PG |
|----------------------------|------|----------------------|-----|
| Jan. 1, 1995—Mar. 31, 1995 | 6.5% | 18 | 572 |
| Apr. 1, 1995—Jun. 30, 1995 | 7.5% | 20 | 574 |
| Jul. 1, 1995—Sep. 30, 1995 | 6.5% | 18 | 572 |
| Oct. 1, 1995—Dec. 31, 1995 | 6.5% | 18 | 572 |
| Jan. 1, 1996—Mar. 31, 1996 | 6.5% | 66 | 620 |

Chapter 68.—Additions to the Tax, Additional Amounts, and Assessable Penalties
Subchapter A.—Additions to the Tax and Additional Amounts
Part I.—General Rule

Section 6656.—Failure to Make Deposit of Taxes

26 CFR 301.6656-1: Penalty for underpayment of deposits.
(Also Part I, § 6302; 31.6302-1T.)

Failure to deposit by electronic funds transfer. Applicability of the

failure-to-deposit penalty imposed by section 6656 of the Code to taxpayers that are required to deposit by electronic funds transfer (EFT) and also to taxpayers that deposit voluntarily by EFT.

Rev. Rul. 95-68

ISSUES

(1) Is a taxpayer that is required to deposit federal taxes by electronic funds transfer (EFT) subject to the failure-to-deposit penalty imposed by

§ 6656 of the Internal Revenue Code if the taxpayer deposits the taxes by means other than EFT, or by EFT after the date on which the taxes are due?

(2) Is a taxpayer that is not required to deposit taxes by EFT, but has done so on a voluntary basis, subject to the failure-to-deposit penalty imposed by § 6656 if the taxpayer instead timely deposits the taxes at an authorized depository?

FACTS

Situation 1. A was required to make a federal tax deposit of \$100x by EFT

on or before January 5, in accordance with § 6302(h) and § 31.6302-1T of the Employment Taxes and Collection of Income Tax at Source Regulations. A did not make the \$100x deposit by EFT. Instead, A used a Form 8109, Federal Tax Deposit Coupon, to make the \$100x deposit on January 5 at Bank Z, an authorized depository for deposits made with that form.

Situation 2. The facts are the same as in *Situation 1* except that A made the \$100x deposit by EFT on January 6.

Situation 3. B was not required to make deposits by EFT but has done so voluntarily in accordance with Rev. Proc. 94-48, 1994-2 C.B. 694. B was required to make a federal tax deposit of \$100x on or before January 5. B did not make the \$100x deposit by EFT. Instead, B used a Form 8109 to make the \$100x deposit on January 5 at Bank Z.

LAW AND ANALYSIS

Section 6656(a) provides that in the case of any failure by any person to deposit (as required by the Code or by regulations of the Secretary under the Code) on the date prescribed therefor any amount of tax imposed by the Code in the government depository authorized under section 6302(c) to receive such deposit, a penalty is imposed on such person equal to the applicable percentage of the amount of the underpayment, unless it is shown that such failure is due to reasonable cause and not due to willful neglect.

Under § 6656(b)(1)(A), the “applicable percentage” is 2 percent of the underpayment if the failure to deposit is for not more than 5 days, 5 percent of the underpayment if the failure is for more than 5 days but not more than 15 days, and 10 percent of the underpayment if the failure is for more than 15 days.

Under § 6656(b)(1)(B), the applicable percentage is 15 percent of the underpayment if the tax is not deposited on or before the earlier of (i) the day 10 days after the date of the first delinquency notice to the taxpayer under § 6303, or (ii) the day on which notice and demand for immediate payment is given under § 6861, 6862, or 6331(a) (last sentence).

Section 6656(b)(2) defines the term “underpayment” as the excess of the amount of the tax required to be

deposited over the amount, if any, of the tax deposited on or before the date prescribed therefor.

Section 6302(c) provides that the Secretary may authorize Federal Reserve banks, and incorporated banks, trust companies, domestic building and loan associations, or credit unions which are depositories or financial agents of the United States, to receive any tax imposed under the internal revenue laws, in such manner, at such times, and under such conditions as the Secretary may prescribe.

Section 6302(h), as added by the North American Free Trade Agreement Implementation Act (NAFTA), Pub. L. No. 103-182, § 523, 107 Stat. 2057 (1993), provides that the Secretary shall prescribe such regulations as may be necessary for the development and implementation of an EFT system for the collection of depository taxes. The section provides further that the system must be designed in such manner as may be necessary to ensure that such taxes are credited to the general account of the Treasury on the date on which such taxes would otherwise have been required to be deposited under the federal tax deposit system.

Section 31.6302-1T(h)(1) describes those taxpayers required to make deposits by means of EFT and when they must commence making such deposits. Section 31.6302-1T(h)(3) defines an EFT as any transfer of depository taxes made in accordance with Rev. Proc. 94-48, or in accordance with procedures subsequently published by the Commissioner.

Rev. Proc. 94-48 describes TAXLINK, an electronic remittance processing system that the Internal Revenue Service uses to accept deposits of federal taxes by EFT, and informs taxpayers and financial institutions that participate in TAXLINK of their obligations to each other and to the Service. Rev. Proc. 94-48 has applicability both to taxpayers required to make deposits by EFT and to taxpayers who choose to participate voluntarily in the EFT program. Section 2.05 of Rev. Proc. 94-48 provides that a taxpayer required by regulations to use an EFT to make a deposit cannot revert to the paper coupon system to make a deposit. However, a taxpayer that voluntarily participates in the EFT program may revert to the paper coupon system (using Form 8109) to make a deposit so long as the deposit and the paper coupon are received by an authorized

depository bank before the close of business on the deposit due date.

Rev. Proc. 90-58, 1990-2 C.B. 642, describes how a deposit will be credited to a taxpayer’s account in determining whether the failure-to-deposit penalty imposed by § 6656 will apply. In *Example 5* of Rev. Proc. 90-58, an employer timely hand-delivered a check to the local Internal Revenue Service office to satisfy a deposit obligation rather than depositing the check in an authorized government depository as required by regulations under § 6302. Rev. Proc. 90-58 holds that because the amount due was not deposited as required by the regulations, the § 6656 failure-to-deposit penalty will apply.

In *Situation 1*, A was required to make a \$100x federal tax deposit using EFT. Instead of using EFT, however, A made the deposit at Bank Z using a Form 8109. Thus, A’s deposit was not made *in the manner* required by § 6302 and the underlying regulations. Accordingly, absent reasonable cause, A is subject to the 10 percent failure-to-deposit penalty under § 6656(b)(1)(A) because A failed for more than 15 days to make the \$100x federal tax deposit *in the manner* required by § 6302 and the underlying regulations. However, A is not subject to the 15 percent failure-to-deposit penalty under § 6656(b)(1)(B) because the \$100x is credited to A’s account as of January 5 and, thus, the Internal Revenue Service will not subsequently demand the payment of that amount under a provision specified in § 6656(b)(1)(B).

In *Situation 2*, A properly made the required \$100x deposit by EFT, but the deposit was made one day late. Therefore, absent reasonable cause, A is subject to the 2 percent failure-to-deposit penalty under § 6656(b)(1)(A) because A’s deposit was not more than 5 days late.

In *Situation 3*, B is not subject to any failure-to-deposit penalty under § 6656 because B’s participation in the EFT program was on a voluntary basis, and B timely made the required \$100x deposit at Bank Z, an authorized depository, using Form 8109 (which EFT volunteers are permitted to do under Rev. Proc. 94-48).

HOLDINGS

(1) Absent reasonable cause, a taxpayer that is required to deposit federal

taxes by EFT is subject to the failure-to-deposit penalty imposed by § 6656 if the taxpayer deposits the taxes by means other than EFT, or by EFT after the date on which the taxes are due.

(2) A taxpayer that is not required to deposit taxes by EFT, but has done so on a voluntary basis, is not subject to the failure-to-deposit penalty imposed by § 6656 if the taxpayer instead timely deposits the taxes at an authorized depository using Form 8109.

Part II.—Accuracy-Related and Fraud Penalties

Section 6662.—Imposition of Accuracy-Related Penalty

26 CFR 1.6662-0: Table of contents.
(Also Section 6664.)

T.D. 8617

**DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1**

Accuracy-related Penalty

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations implementing changes to the accuracy-related penalty under section 6662 of the Internal Revenue Code of 1986 that were made by section 13251 of the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) and Title VII of the Uruguay Round Agreements Act, implementing the Uruguay Round of the General Agreement on Tariffs and Trade (the GATT Act). The final regulations also provide guidance as to when a taxpayer may rely upon the advice of others as evidence of reasonable cause and good faith within the meaning of section 6664(c) for purposes of avoiding the accuracy-related penalty of section 6662, and as to what constitutes reasonable cause and good faith within the meaning of section 6664(c) as applicable to the substantial understatement penalty of section 6662(b)(2) with respect to tax shelter items of a corporation. These regulations affect taxpayers subject to the accuracy-related penalty.

EFFECTIVE DATE: These regulations are effective September 1, 1995.

SUPPLEMENTARY INFORMATION:

Background

As part of OBRA 1993, Congress made certain changes to the accuracy-related penalty. These changes eliminated the disclosure exception for the negligence penalty (section 6662(b)(1) of the Internal Revenue Code (Code)) and raised the disclosure standard for purposes of the penalties for disregard of rules or regulations (section 6662(b)(1) of the Code) and substantial understatement of income tax (section 6662(b)(2) of the Code) from “not frivolous” to “reasonable basis.”

On March 17, 1994, temporary regulations (TD 8533 [1994-1 C.B. 307]) reflecting changes to the accuracy-related penalty made by OBRA 1993 were published in the Federal Register (59 FR 12547). A notice of proposed rulemaking (IA-78-93 [1994-1 C.B. 805]) relating to the temporary regulations was published in the Federal Register for the same day (59 FR 12563). On March 30, 1994, a correction to the temporary regulations was published in the Federal Register (59 FR 14749) clarifying language in §1.6662-7T(a)(2) of the temporary regulations. The same day a correction to the notice of proposed rulemaking was published in the Federal Register (59 FR 14810) correcting “RIN 1545-AS58” to read “RIN 1545-AS62” and other administrative matters and clarifying language in §§1.6662-2(d)(2) and 1.6662-7(a)(2) of the proposed regulations.

Section 744 of the GATT Act made further changes to the accuracy-related penalty. For corporate taxpayers, the GATT Act amended section 6662(d) of the Code to eliminate the exception to the substantial understatement penalty regarding tax shelter items for which the taxpayer had substantial authority and reasonably believed that its treatment was more likely than not the proper treatment. The legislative history of the GATT Act states that “the standards applicable to corporate tax shelters are tightened” and “in no instance [will] this modification result in a penalty not being imposed where a penalty would have been imposed under prior law.” S. Rep. No. 412, 103d Cong., 2d Sess. 165 (1994); H.R. Rep. No. 826, 103d Cong., 2d Sess. 198-99 (1994).

On January 4, 1995, a notice of proposed rulemaking (IA-55-94

[1995-1 C.B. 947]) was published in the Federal Register (60 FR 406) implementing the changes made by the GATT Act and providing guidance with regard to reliance upon the advice of others as evidence of reasonable cause and good faith within the meaning of section 6664(c) of the Code for purposes of avoiding the accuracy-related penalty of section 6662, and what constitutes reasonable cause and good faith within the meaning of section 6664(c) as it applies to the substantial understatement penalty of section 6662(b)(2) with respect to tax shelter items of a corporation.

Written comments responding to these notices were received. A public hearing on the notices regarding changes made by OBRA 1993 was held on July 12, 1994. A public hearing on the notice regarding changes made by the GATT Act was held on April 28, 1995. After consideration of all the comments, the proposed regulations under sections 6662 and 6664 of the Code are adopted as revised by this Treasury decision.

Explanation of Provisions

Reasonable Basis Standard for Disclosure

With respect to the reasonable basis standard, the final regulations adopt the proposed regulations without substantive change. The regulations provide that the reasonable basis standard is “significantly higher than the not frivolous standard applicable to preparers under section 6694.” In the preamble to the proposed regulations, Treasury requested comments on any additional guidance as to the reasonable basis standard for purposes of the negligence, disregard of rules or regulations, and substantial understatement penalties. Several commentators recommended adopting as the definition of reasonable basis the description that existed in §1.6662-4(d)(2) of the regulations prior to amendment by these final regulations. Other commentators recommended equating the reasonable basis standard with the negligence standard and the realistic possibility of success standard, taking into account the relative knowledge and experience of the taxpayer. The IRS and Treasury are continuing to consider these comments in connection with a separate project to publish a notice of proposed rulemaking providing further guidance

as to the reasonable basis standard. Treasury and the IRS invite additional comments and suggestions regarding this project.

Reliance on Tax Advisor

Under sections 6662 and 6664, and applicable regulations, a taxpayer's good faith reliance on the advice (including an opinion) of a professional tax advisor will generally be taken into account for purposes of determining whether the taxpayer will be subject to an accuracy-related penalty. See, e.g., §§1.6662-4(g)(4)(ii) and 1.6664-4(b). The proposed regulations clarify when a taxpayer may be considered to have reasonably relied in good faith upon advice (including an opinion provided by a professional tax advisor), for purposes of sections 6662 and 6664. In general, §1.6664-4(c) of the proposed regulations requires advice to be based on all material facts (including, for example, the taxpayer's purposes for entering into a transaction) and to relate applicable law to such facts in reaching its conclusion. The advice must not be based upon unreasonable factual or legal assumptions (including assumptions as to future events), nor unreasonably rely on the representations, findings or agreements of the taxpayer or any other person. The proposed regulations also indicate that reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

Several commentators recommended changes to these provisions of the proposed regulations. For example, one commentator suggested eliminating language in §1.6664-4(c)(1) of the proposed regulations that reliance on advice may not be reasonable and in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

The final regulations do not adopt this suggestion. In requiring that reliance on advice must be reasonable in light of all of the facts and circumstances, the final regulations do not depart from prior law. In most situations it will generally be reasonable for a taxpayer to conclude that an attorney, an accountant, or an enrolled agent is qualified to give advice on Federal tax law.

Another commentator suggested eliminating the requirements that advice must be based on all material facts and reasonable factual and legal assumptions. The commentator stated that taxpayers are not in a position to determine what facts are material, particularly in complex transactions, nor are they in a position to determine whether the advisor based the opinion on material facts and reasonable factual and legal assumptions. An additional commentator requested guidance to distinguish the term *pertinent* as it is used throughout the regulations and the term *material* as it is used in §1.6664-4(c) of the proposed regulations.

In response to these comments, and in order to resolve confusion, the final regulations provide that advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. As used in this context, *pertinent* is intended to have the same meaning as it has in §1.6662-4(g)(4)(ii), which provides that a taxpayer may satisfy the reasonable belief requirement of section 6662(d)(2)(C)(i) through reliance on an advisor's analysis of pertinent facts and authorities. To clarify that separate rules apply to taxpayers and advisors, the final regulations have also been revised to include a cross-reference to the preparer penalties under §§1.6694-1 through 1.6694-3 and Circular 230 (contained in 31 CFR part 10).

Another commentator recommended eliminating, or in the alternative revising and clarifying, the requirement that advice take into account the taxpayer's purposes for entering into a transaction or structuring a transaction in a particular manner. The final regulations do not adopt this recommendation. It is appropriate to consider a taxpayer's reasons for structuring a transaction in a particular manner in determining whether the taxpayer acted in good faith in its tax return treatment of items from the transaction.

Reasonable Cause for Tax Shelter Items of a Corporation

The proposed regulations provide that a corporation's legal justification may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item only if there is substantial authority for the treatment of the item and the corporation reasonably believes

in good faith that such treatment is more likely than not the proper treatment. Under the proposed regulations, satisfaction of the substantial authority and reasonable belief criteria is an important factor to be considered in determining whether the taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. The proposed regulations also provide that facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether it acted with reasonable cause and in good faith, regardless of whether the substantial authority and reasonable belief requirements are satisfied.

One commentator urged removal of the special reasonable cause standard for corporate tax shelter items under the proposed regulations. According to the commentator, there is no authority in section 6664 or its legislative history for a reasonable cause standard for tax shelter items of corporate taxpayers that differs from the standard for noncorporate taxpayers.

Other commentators recommended revising the legal justification test for determining reasonable cause. Particularly, these commentators recommended removing the objective requirement that substantial authority be present for the taxpayer's position (the authority requirement). Alternatively, one commentator suggested making the legal justification test a "safe harbor." Under this alternative, a taxpayer that satisfies the authority requirement and the belief requirement under proposed §1.6664-4(e)(2) would be treated as having acted with reasonable cause and in good faith.

The final regulations do not adopt these suggestions. Treasury and the IRS continue to believe that the regulations, including the authority requirement, properly implement the statute and Congressional intent.

Satisfaction of the minimum requirements under the legal justification test is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's

investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter. In addition, a taxpayer that does not satisfy the authority requirement may nonetheless demonstrate that it acted with reasonable cause and in good faith based on facts and circumstances unrelated to its legal justification (the other factors test).

Although several commentators requested additional guidance with regard to the other factors test, they provided no examples of factors (other than factors related to legal justification) that they would like to be included in the final regulations. The suggested factors were not adopted because legal justification is not relevant to the other factors test. While the final regulations do not provide additional guidance in this area, Treasury and the IRS continue to welcome comments on the issue.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notices of proposed rulemaking preceding these regulations were submitted to the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6662-0 is amended by:

1. Revising the introductory language.
2. Revising the entry for §1.6662-2(d) and adding entries for (d)(1), (2), and (3).
3. Revising the entries for §§1.6662-3(b)(3) and 1.6662-4(g).
4. Adding an entry for §1.6662-7.
5. Removing the entry for §1.6662-7T.

The additions and revisions read as follows:

§1.6662-0 Table of contents.

This section lists the captions that appear in §§1.6662-1 through 1.6662-7.

* * * * *

§1.6662-2 Accuracy related penalty.

* * * * *

- (d) Effective dates.
 - (1) Returns due before January 1, 1994.
 - (2) Returns due after December 31, 1993.
 - (3) Special rules for tax shelter items.

* * * * *

§1.6662- Negligence or disregard of rules or regulations.

* * * * *

- (b) * * *
- (3) Reasonable basis.
 - (i) In general [Reserved].
 - (ii) Relationship to other standards.

* * * * *

§1.6662-4 Substantial understatement of income tax.

* * * * *

- (g) Items relating to tax shelters.
 - (1) In general.
 - (i) Noncorporate taxpayers.
 - (ii) Corporate taxpayers.
 - (A) In general.
 - (B) Special rule for transactions occurring prior to December 9, 1994.
 - (iii) Disclosure irrelevant.
 - (iv) Cross-reference.
 - (2) Tax shelter.
 - (i) In general.
 - (ii) Principal purpose.
 - (3) Tax shelter item.
 - (4) Reasonable belief.
 - (i) In general.
 - (ii) Facts and circumstances; reliance on professional tax advisor.

- (5) Pass-through entities.

* * * * *

§1.6662-7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

- (a) Scope.
- (b) No disclosure exception for negligence penalty.
- (c) Disclosure standard for other penalties is reasonable basis.
- (d) Definition of reasonable basis.
 - (1) In general [Reserved].
 - (2) Relationship to other standards.

Par. 3. In §1.6662-1, the second and third sentences of the concluding text are revised to read as follows:

§1.6662-1 Overview of the accuracy-related penalty.

* * * * *

* * * The penalties for disregard of rules or regulations and for a substantial understatement of income tax may be avoided by adequately disclosing certain information as provided in §1.6662-3(c) and §§1.6662-4(e) and (f), respectively. The penalties for negligence and for a substantial (or gross) valuation misstatement under chapter 1 may not be avoided by disclosure. * * *

Par. 4. Section 1.6662-2 is amended by:

1. Revising the heading of paragraph (d), redesignating the text of paragraph (d) following the heading as paragraph (d)(1), adding a new heading for newly designated paragraph (d)(1), and revising the first and second sentences of newly redesignated paragraph (d)(1).
2. Adding new paragraphs (d)(2) and (3).

The additions and revisions read as follows:

§1.6662-2 Accuracy-related penalty.

* * * * *

(d) *Effective dates*—(1) *Returns due before January 1, 1994.* Section 1.6662-3(c) and §§1.6662-4(e) and (f) (relating to methods of making adequate disclosure) (as contained in 26 CFR part 1 revised April 1, 1995) apply to returns the due date of which (determined without regard to extensions of time for filing) is after

December 31, 1991, but before January 1, 1994. Except as provided in the preceding sentence and in paragraphs (d)(2) and (3) of this section, §§1.6662-1 through 1.6662-5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989, but before January 1, 1994. * * *

(2) *Returns due after December 31, 1993.* Except as provided in paragraph (d)(3) and the last sentence of this paragraph (d)(2), the provisions of §§1.6662-1 through 1.6662-4 and §1.6662-7 (as revised to reflect the changes made to the accuracy-related penalty by the Omnibus Budget Reconciliation Act of 1993) and of §1.6662-5 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1993. These changes include raising the disclosure standard for the penalties for disregarding rules or regulations and for a substantial understatement of income tax from not frivolous to reasonable basis, eliminating the disclosure exception for the negligence penalty, and providing guidance on the meaning of reasonable basis. The Omnibus Budget Reconciliation Act of 1993 changes relating to the penalties for negligence or disregard of rules or regulations will not apply to returns (including qualified amended returns) that are filed on or before March 14, 1994, but the provisions of §§1.6662-1 through 1.6662-3 (as contained in 26 CFR part 1 revised April 1, 1995) relating to those penalties will apply to such returns.

(3) *Special rules for tax shelter items.* Sections 1.6662-4(g)(1) and 1.6662-4(g)(4) apply to returns the due date of which (determined without regard to extensions of time for filing) is after September 1, 1995. Except as provided in the last sentence of this paragraph (d)(3), §§1.6662-4(g)(1) and 1.6662-4(g)(4) (as contained in 26 CFR part 1 revised April 1, 1995) apply to returns the due date of which (determined without regard to extensions of time for filing) is on or before September 1, 1995, and after December 31, 1989. For transactions occurring after December 8, 1994, §§1.6662-4(g)(1) and 1.6662-4(g)(2) (as contained in 26 CFR part 1 revised April 1, 1995) are applied taking into account the changes made to section 6662(d)-(2)(C) (relating to the substantial understatement penalty for tax shelter items of corporations) by section 744

of Title VII of the Uruguay Round Agreements Act, Pub. L. 103-465 (108 Stat. 4809).

Par. 5. Section 1.6662-3 is amended by:

1. Revising the second sentence of paragraph (a).
2. Revising paragraph (b)(3).
3. Revising paragraphs (c)(1) and (2).

The revisions read as follows:

§1.6662-3 Negligence or disregard of rules or regulations.

(a) * * * The penalty for disregarding rules or regulations does not apply, however, if the requirements of §1.6662-3(c)(1) are satisfied and the position in question is adequately disclosed as provided in §1.6662-3(c)(2), or to the extent that the reasonable cause and good faith exception to this penalty set forth in §1.6664-4 applies. * * *

(b) * * *

(3) *Reasonable basis*—(i) *In general.* [Reserved].

(ii) *Relationship to other standards.* The reasonable basis standard is significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in §1.6694-2(c)(2).

(c) * * * (1) *In general.* No penalty under section 6662(b)(1) may be imposed on any portion of an underpayment that is attributable to a position contrary to a rule or regulation if the position is disclosed in accordance with the rules of paragraph (c)(2) of this section and, in case of a position contrary to a regulation, the position represents a good faith challenge to the validity of the regulation. This disclosure exception does not apply, however, in the case of a position that does not have a reasonable basis or where the taxpayer fails to keep adequate books and records or to substantiate items properly.

(2) *Method of disclosure.* Disclosure is adequate for purposes of the penalty for disregarding rules or regulations if made in accordance with the provisions of §§1.6662-4(f)(1), (3), (4), and (5), which permit disclosure on a properly completed and filed Form 8275 or 8275-R, as appropriate. In addition, the statutory or regulatory provision or ruling in question must be adequately identified on the Form 8275 or 8275-

R, as appropriate. The provisions of §1.6662-4(f)(2), which permit disclosure in accordance with an annual revenue procedure for purposes of the substantial understatement penalty, do not apply for purposes of this section.

* * * * *

Par. 6. Section 1.6662-4 is amended by:

1. Removing the third sentence in paragraph (d)(2).
2. Revising paragraph (e)(2).
3. Revising paragraphs (g)(1), (g)(4), and (g)(5).

The revisions read as follows:

§1.6662-4 Substantial understatement of income tax.

* * * * *

(e) * * *

(2) *Circumstances where disclosure will not have an effect.* The rules of paragraph (e)(1) of this section do not apply where the item or position on the return—

(i) Does not have a reasonable basis (as defined in §1.6662-3(b)(3));

(ii) Is attributable to a tax shelter (as defined in section 6662(d)(2)(C)(iii) and paragraph (g)(2) of this section); or

(iii) Is not properly substantiated, or the taxpayer failed to keep adequate books and records with respect to the item or position.

* * * * *

(g) *Items relating to tax shelters*—

(1) *In general*—(i) *Noncorporate taxpayers.* Tax shelter items (as defined in paragraph (g)(3) of this section) of a taxpayer other than a corporation are treated for purposes of this section as if such items were shown properly on the return for a taxable year in computing the amount of tax shown on the return, and thus the tax attributable to such items is not included in the understatement for the year, if—

(A) There is substantial authority (as provided in paragraph (d) of this section) for the tax treatment of that item; and

(B) The taxpayer reasonably believed at the time the return was filed that the tax treatment of that item was more likely than not the proper treatment.

(ii) *Corporate taxpayers*—(A) *In general.* Except as provided in para-

graph (g)(1)(ii)(B) of this section, all tax shelter items (as defined in paragraph (g)(3) of this section) of a corporation are taken into account in computing the amount of any understatement.

(B) *Special rule for transactions occurring prior to December 9, 1994.* The tax shelter items of a corporation arising in connection with transactions occurring prior to December 9, 1994 are treated for purposes of this section as if such items were shown properly on the return if the requirements of paragraph (g)(1)(i) are satisfied with respect to such items.

(iii) *Disclosure irrelevant.* Disclosure made with respect to a tax shelter item of either a corporate or noncorporate taxpayer does not affect the amount of an understatement.

(iv) *Cross-reference.* See §1.6664-4(e) for certain rules regarding the availability of the reasonable cause and good faith exception to the substantial understatement penalty with respect to tax shelter items of corporations.

* * * * *

(4) *Reasonable belief*—(i) *In general.* For purposes of section 6662(d) and paragraph (g)(1)(i)(B) of this section (pertaining to tax shelter items of noncorporate taxpayers), a taxpayer is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(A) The taxpayer analyzes the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section, and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(B) The taxpayer reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in paragraph (d)(3)(ii) of this section and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service.

(ii) *Facts and circumstances; reliance on professional tax advisor.* All facts and circumstances must be taken into account in determining whether a taxpayer satisfies the requirements of paragraph (g)(4)(i) of this section. However, in no event will a taxpayer be considered to have reasonably relied in good faith on the opinion of a professional tax advisor for purposes of paragraph (g)(4)(i)(B) of this section unless the requirements of §1.6664-4(c)(1) are met. The fact that the requirements of §1.6664-4(c)(1) are satisfied will not necessarily establish that the taxpayer reasonably relied on the opinion in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(5) *Pass-through entities.* In the case of tax shelter items attributable to a pass-through entity, the actions described in paragraphs (g)(4)(i)(A) and (B) of this section, if taken by the entity, are deemed to have been taken by the taxpayer and are considered in determining whether the taxpayer reasonably believed that the tax treatment of an item was more likely than not the proper tax treatment.

Par. 7. Section 1.6662-7 is added to read as follows:

§1.6662-7 Omnibus Budget Reconciliation Act of 1993 changes to the accuracy-related penalty.

(a) *Scope.* The Omnibus Budget Reconciliation Act of 1993 made certain changes to the accuracy-related penalty in section 6662. This section provides rules reflecting those changes.

(b) *No disclosure exception for negligence penalty.* The penalty for negligence in section 6662(b)(1) may not be avoided by disclosure of a return position.

(c) *Disclosure standard for other penalties is reasonable basis.* The penalties for disregarding rules or regulations in section 6662(b)(1) and for a substantial understatement of income tax in section 6662(b)(2) may be avoided by adequate disclosure of a return position only if the position has at least a reasonable basis. See §1.6662-3(c) and §§1.6662-4(e) and (f) for other applicable disclosure rules.

(d) *Definition of reasonable basis*—(1) *In general.* [Reserved].

(2) *Relationship to other standards.* The reasonable basis standard is significantly higher than the not frivolous standard applicable to preparers under section 6694 and defined in §1.6694-2(c)(2).

§1.6662-7T [Removed]

Par. 8. Section 1.6662-7T is removed.

Par. 9. Section 1.6664-0 is amended by revising the entries for §§1.6664-1(b) and 1.6664-4 to read as follows:

§1.6664-0 Table of contents.

* * * * *

§1.6664-1 Accuracy-related and fraud penalties; definitions and special rules.

* * * * *

- (b) Effective date.
 - (1) In general.
 - (2) Reasonable cause and good faith exception to section 6662 penalties.

* * * * *

§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

- (a) In general.
- (b) Facts and circumstances taken into account.
 - (1) In general.
 - (2) Examples.
 - (c) Reliance on opinion or advice.
 - (1) Fact and circumstances; minimum requirements.
 - (i) All facts and circumstances considered.
 - (ii) No unreasonable assumptions.
 - (iii) Law is related to actual facts.
 - (2) Definitions.
 - (i) Advice.
 - (ii) Material.
 - (3) Cross-reference.
 - (d) Pass-through items.
 - (e) Special rules for substantial understatement penalty attributable to tax shelter items of corporations.
 - (1) In general; facts and circumstances.
 - (2) Reasonable cause based on legal justification.
 - (i) Minimum requirements.
 - (A) Authority requirement.
 - (B) Belief requirement.
 - (ii) Legal justification defined.

- (3) Minimum requirements not dispositive.
- (4) Other factors.
- (f) Transactions between persons described in section 482 and net section 482 transfer price adjustments. [Reserved]
- (g) Valuation misstatements of charitable deduction property.
 - (1) In general.
 - (2) Definitions.
 - (i) Charitable deduction property.
 - (ii) Qualified appraisal.
 - (iii) Qualified appraiser.

* * * * *

Par. 10. Section 1.6664-1 is amended by revising paragraph (b) to read as follows:

§1.6664-1 Accuracy-related and fraud penalties; definitions and special rules.

* * * * *

(b) *Effective date*—(1) *In general.* Sections 1.6664-1 through 1.6664-3 apply to returns the due date of which (determined without regard to extensions of time for filing) is after December 31, 1989.

(2) *Reasonable cause and good faith exception to section 6662 penalties.* Section 1.6664-4 applies to returns the due date of which (determined without regard to extensions of time for filing) is after September 1, 1995. Except as provided in the last sentence of this paragraph (b)(2), §1.6664-4 (as contained in 26 CFR part 1 revised April 1, 1995) applies to returns the due date of which (determined without regard to extensions of time for filing) is on or before September 1, 1995, and after December 31, 1989. For transactions occurring after December 8, 1994, §1.6664-4 (as contained in 26 CFR part 1 revised April 1, 1995) is applied taking into account the changes made to section 6662(d)(2)(C) (relating to the substantial understatement penalty for tax shelter items of corporations) by section 744 of Title VII of the Uruguay Round Agreements Act, Pub. L. 103-465 (108 Stat. 4809).

Par. 11. Section 1.6664-4 is amended by:

- 1. Revising the last sentence of paragraph (a).
- 2. Revising paragraph (b)(1).
- 3. Revising the introductory language of paragraph (b)(2) and *Example 1.*

4. Redesignating paragraphs (c), (d), and (e) as paragraphs (d), (f), and (g), respectively.

5. Revising newly designated paragraph (d).

6. Adding new paragraphs (c) and (e).

The additions and revisions read as follows:

§1.6664-4 Reasonable cause and good faith exception to section 6662 penalties.

(a) * * * Rules for determining whether the reasonable cause and good faith exception applies are set forth in paragraphs (b) through (g) of this section.

(b) *Facts and circumstances taken into account*—(1) *In general.* The determination of whether a taxpayer acted with reasonable cause and in good faith is made on a case-by-case basis, taking into account all pertinent facts and circumstances. (See paragraph (e) of this section for certain rules relating to a substantial understatement penalty attributable to tax shelter items of corporations.) Generally, the most important factor is the extent of the taxpayer's effort to assess the taxpayer's proper tax liability. Circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer. An isolated computational or transcriptional error generally is not inconsistent with reasonable cause and good faith. Reliance on an information return or on the advice of a professional tax advisor or an appraiser does not necessarily demonstrate reasonable cause and good faith. Similarly, reasonable cause and good faith is not necessarily indicated by reliance on facts that, unknown to the taxpayer, are incorrect. Reliance on an information return, professional advice, or other facts, however, constitutes reasonable cause and good faith if, under all the circumstances, such reliance was reasonable and the taxpayer acted in good faith. (See paragraph (c) of this section for certain rules relating to reliance on the advice of others.) For example, reliance on erroneous information (such as an error relating to the cost or adjusted basis of property, the date property was placed in service, or the amount of opening or closing inven-

tory) inadvertently included in data compiled by the various divisions of a multidivisional corporation or in financial books and records prepared by those divisions generally indicates reasonable cause and good faith, provided the corporation employed internal controls and procedures, reasonable under the circumstances, that were designed to identify such factual errors. Reasonable cause and good faith ordinarily is not indicated by the mere fact that there is an appraisal of the value of property. Other factors to consider include the methodology and assumptions underlying the appraisal, the appraised value, the relationship between appraised value and purchase price, the circumstances under which the appraisal was obtained, and the appraiser's relationship to the taxpayer or to the activity in which the property is used. (See paragraph (g) of this section for certain rules relating to appraisals for charitable deduction property.) A taxpayer's reliance on erroneous information reported on a Form W-2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not know or have reason to know that the information was incorrect. Generally, a taxpayer knows, or has reason to know, that the information on an information return is incorrect if such information is inconsistent with other information reported or otherwise furnished to the taxpayer, or with the taxpayer's knowledge of the transaction. This knowledge includes, for example, the taxpayer's knowledge of the terms of his employment relationship or of the rate of return on a payor's obligation.

(2) *Examples.* The following examples illustrate this paragraph (b). They do not involve tax shelter items. (See paragraph (e) of this section for certain rules relating to the substantial understatement penalty attributable to the tax shelter items of corporations.)

Example 1. A, an individual calendar year taxpayer, engages B, a professional tax advisor, to give A advice concerning the deductibility of certain state and local taxes. A provides B with full details concerning the taxes at issue. B advises A that the taxes are fully deductible. A, in preparing his own tax return, claims a deduction for the taxes. Absent other facts, and assuming the facts and circumstances surrounding B's advice and A's reliance on such advice satisfy the requirements of paragraph (c) of this section, A is considered to have demonstrated good faith by seeking the advice of a professional tax advisor, and to have shown reasonable cause for any underpayment attributable to the

deduction claimed for the taxes. However, if A had sought advice from someone that A knew, or should have known, lacked knowledge in the relevant aspects of Federal tax law, or if other facts demonstrate that A failed to act reasonably or in good faith, A would not be considered to have shown reasonable cause or to have acted in good faith.

* * * * *

(c) *Reliance on opinion or advice*—

(1) *Facts and circumstances; minimum requirements.* All facts and circumstances must be taken into account in determining whether a taxpayer has reasonably relied in good faith on advice (including the opinion of a professional tax advisor) as to the treatment of the taxpayer (or any entity, plan, or arrangement) under Federal tax law. However, in no event will a taxpayer be considered to have reasonably relied in good faith on advice unless the requirements of this paragraph (c)(1) are satisfied. The fact that these requirements are satisfied will not necessarily establish that the taxpayer reasonably relied on the advice (including the opinion of a professional tax advisor) in good faith. For example, reliance may not be reasonable or in good faith if the taxpayer knew, or should have known, that the advisor lacked knowledge in the relevant aspects of Federal tax law.

(i) *All facts and circumstances considered.* The advice must be based upon all pertinent facts and circumstances and the law as it relates to those facts and circumstances. For example, the advice must take into account the taxpayer's purposes (and the relative weight of such purposes) for entering into a transaction and for structuring a transaction in a particular manner. In addition, the requirements of this paragraph (c)(1) are not satisfied if the taxpayer fails to disclose a fact that it knows, or should know, to be relevant to the proper tax treatment of an item.

(ii) *No unreasonable assumptions.* The advice must not be based on unreasonable factual or legal assumptions (including assumptions as to future events) and must not unreasonably rely on the representations, statements, findings, or agreements of the taxpayer or any other person. For example, the advice must not be based upon a representation or assumption which the taxpayer knows, or has reason to know, is unlikely to be true, such as an inaccurate representation or

assumption as to the taxpayer's purposes for entering into a transaction or for structuring a transaction in a particular manner.

(2) *Advice defined.* Advice is any communication, including the opinion of a professional tax advisor, setting forth the analysis or conclusion of a person, other than the taxpayer, provided to (or for the benefit of) the taxpayer and on which the taxpayer relies, directly or indirectly, with respect to the imposition of the section 6662 accuracy-related penalty. Advice does not have to be in any particular form.

(3) *Cross-reference.* For rules applicable to advisors, see *e.g.*, §§1.6694–1 through 1.6694–3 (regarding preparer penalties), 31 CFR 10.22 (regarding diligence as to accuracy), 31 CFR 10.33 (regarding tax shelter opinions), and 31 CFR 10.34 (regarding standards for advising with respect to tax return positions and for preparing or signing returns).

(d) *Pass-through items.* The determination of whether a taxpayer acted with reasonable cause and in good faith with respect to an underpayment that is related to an item reflected on the return of a pass-through entity is made on the basis of all pertinent facts and circumstances, including the taxpayer's own actions, as well as the actions of the pass-through entity.

(e) *Special rules for substantial understatement penalty attributable to tax shelter items of corporations*—(1) *In general; facts and circumstances.* The determination of whether a corporation acted with reasonable cause and in good faith in its treatment of a tax shelter item (as defined in §1.6662–4(g)(3)) is based on all pertinent facts and circumstances. Paragraphs (e)(2), (3), and (4) of this section set forth rules that apply, in the case of a penalty attributable to a substantial understatement of income tax (within the meaning of section 6662(d)), in determining whether a corporation acted with reasonable cause and in good faith with respect to a tax shelter item.

(2) *Reasonable cause based on legal justification*—(i) *Minimum requirements.* A corporation's legal justification (as defined in paragraph (e)(2)(ii) of this section) may be taken into account, as appropriate, in establishing that the corporation acted with reasonable cause and in good faith in its

treatment of a tax shelter item only if the authority requirement of paragraph (e)(2)(i)(A) of this section and the belief requirement of paragraph (e)(2)(i)(B) of this section are satisfied (the minimum requirements). Thus, a failure to satisfy the minimum requirements will preclude a finding of reasonable cause and good faith based (in whole or in part) on the corporation's legal justification.

(A) *Authority requirement.* The authority requirement is satisfied only if there is substantial authority (within the meaning of §1.6662–4(d)) for the tax treatment of the item.

(B) *Belief requirement.* The belief requirement is satisfied only if, based on all facts and circumstances, the corporation reasonably believed, at the time the return was filed, that the tax treatment of the item was more likely than not the proper treatment. For purposes of the preceding sentence, a corporation is considered reasonably to believe that the tax treatment of an item is more likely than not the proper tax treatment if (without taking into account the possibility that a return will not be audited, that an issue will not be raised on audit, or that an issue will be settled)—

(1) The corporation analyzes the pertinent facts and authorities in the manner described in §1.6662–4(d)(3)(ii), and in reliance upon that analysis, reasonably concludes in good faith that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service; or

(2) The corporation reasonably relies in good faith on the opinion of a professional tax advisor, if the opinion is based on the tax advisor's analysis of the pertinent facts and authorities in the manner described in §1.6662–4(d)(3)(ii) and unambiguously states that the tax advisor concludes that there is a greater than 50-percent likelihood that the tax treatment of the item will be upheld if challenged by the Internal Revenue Service. (For this purpose, the requirements of paragraph (c) of this section must be met with respect to the opinion of a professional tax advisor.)

(ii) *Legal justification defined.* For purposes of this paragraph (e), *legal justification* includes any justification relating to the treatment or characterization under the Federal tax law of the tax shelter item or of the entity, plan, or arrangement that gave rise to the

item. Thus, a taxpayer's belief (whether independently formed or based on the advice of others) as to the merits of the taxpayer's underlying position is a legal justification.

(3) *Minimum requirements not dispositive.* Satisfaction of the minimum requirements of paragraph (e)(2) of this section is an important factor to be considered in determining whether a corporate taxpayer acted with reasonable cause and in good faith, but is not necessarily dispositive. For example, depending on the circumstances, satisfaction of the minimum requirements may not be dispositive if the taxpayer's participation in the tax shelter lacked significant business purpose, if the taxpayer claimed tax benefits that are unreasonable in comparison to the taxpayer's investment in the tax shelter, or if the taxpayer agreed with the organizer or promoter of the tax shelter that the taxpayer would protect the confidentiality of the tax aspects of the structure of the tax shelter.

(4) *Other factors.* Facts and circumstances other than a corporation's legal justification may be taken into account, as appropriate, in determining whether the corporation acted with reasonable cause and in good faith with respect to a tax shelter item regardless of whether the minimum requirements of paragraph (e)(2) of this section are satisfied.

* * * * *

Michael P. Dolan,
*Acting Commissioner of
Internal Revenue.*

Approved August 18, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 31, 1995, 8:45 a.m., and published in the issue of the Federal Register for September 1, 1995, 60 F.R. 45661)

Section 6664.—Definitions and Special Rules

Final regulations implementing changes to the accuracy-related penalty. See T.D. 8617, page 274.

Section 6695.—Other Assessable Penalties With Respect to the Preparation of Income Tax Returns for Other Persons

26 CFR 1.6695-1T: Other assessable penalties with respect to the preparation of income tax returns for other persons (temporary). (Also Sec. 6061; 301.6061-1T.)

T.D. 8603

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 301

Methods of Signing

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to the signing of returns, statements, or other documents. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in *** [IA-10-95, page 478, this Bulletin].

DATES: These regulations are effective on July 21, 1995.

SUPPLEMENTARY INFORMATION:
Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) and the Procedure and Administration Regulations (26 CFR part 301) that relate to signing returns, statements, and other documents.

Explanation of provisions

Section 6061 provides in part that "... any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Secretary." Traditionally, the IRS has accepted pen-to-paper signatures. The Service will

prescribe additional methods of signing to be used when electronically filing returns and other documents.

The temporary regulations clarify that the IRS may prescribe the specific method of signing any return, statement, or other document. The temporary regulations also provide that the IRS may require a return preparer to use a method of signing other than a pen-to-paper signature or a facsimile signature stamp of the person filing a return, statement, or other document.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6695-1T is added to read as follows:

§1.6695-1T Other assessable penalties with respect to the preparation of income tax returns for other persons (temporary).

(a) [Reserved].

(b) Unless the Secretary has prescribed another method of signing pursuant to §301.6061-1T(b) on or after July 21, 1995, an individual who is an income tax return preparer with

respect to a return of tax under subtitle A of the Internal Revenue Code (Code) or claim for refund of tax under subtitle A of the Code shall manually sign the return or claim for refund (which may be a photocopy) in the appropriate space provided on the return or claim for refund after it is completed and before it is presented to the taxpayer (or nontaxable entity) for signature.

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

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

Section 301.6061-1T also issued under 26 U.S.C. 6061.

Par. 2. Section 301.6061-1T is added to read as follows:

§301.6061-1T Signing of returns and other documents (temporary).

(a) [Reserved].

(b) *Method of signing.* The Secretary may prescribe in forms, instructions, or other appropriate guidance the method of signing any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations.

(c) *Effective date.* This section is effective on July 21, 1995.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved July 5, 1995.

Leslie Samuels,
*Assistant Secretary
of the Treasury.*

(Filed by the Office of the Federal Register on July 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 21, 1995, 60 F.R. 37589)

Chapter 70.—Jeopardy, Receiverships, Etc.
Subchapter A.—Jeopardy
Part III.—Special Rules With Respect To Certain Cash

Section 6867.—Presumptions Where Owner of Large Amount of Cash is not Identified

26 CFR 301.6867-1: Presumptions where owner of large amount of cash is not identified.

T.D. 8605

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 301

Presumptions Where Owner of Large Amount of Cash is not Identified

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and Temporary Regulations.

SUMMARY: This document contains final regulations regarding the presumptions that arise where the owner of a large amount of cash or its equivalent is not identified. The final regulations reflect changes to the law made by the Tax Equity and Fiscal Responsibility Act of 1982 and the Technical and Miscellaneous Revenue Act of 1988, and incorporate the rules of current §301.6867-1T, relating to cash, cash equivalents, specific cash equivalents and the value of cash equivalents. In addition, several new items have been added to the list of specific cash equivalents. The final regulations affect individuals who are found in possession of a large amount of cash or its equivalent and the true owners of that cash or its equivalent.

EFFECTIVE DATE: August 3, 1995.

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations amending the Procedure and Administration Regulations (26 CFR part 301) under section 6867 of the Internal Revenue Code of 1986 (Code). The regulations reflect the enactment of section 6867 by section 330(a) of the Tax Equity and Fiscal Responsibility Act of 1982 (Pub. L. 97-248), and the amendment made by section 1001(a)(1) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647).

The IRS published a notice of proposed rulemaking in the Federal Register on September 29, 1994, (59 FR 49613 [GL-548-87, 1994-2 C.B. 867]) providing proposed rules under section 6867 of the Code. No written comments were received. No public

hearing was requested or held. In most respects, the final regulations are identical to the proposed regulations. The final regulations, however, do not contain those provisions of the proposed regulations that had permitted a possessor of cash, solely in that person's capacity as possessor of cash, to bring a suit for refund in the district court after the deficiency had been collected.

Explanation of Provisions

Section 330(a) of the Tax Equity and Fiscal Responsibility Act of 1982 amended the Code by adding section 6867, designed to be used in making jeopardy or termination assessments, as appropriate, when there is no known owner of large amounts of cash. Section 6867 provides that if an individual in physical possession of cash in excess of \$10,000 does not claim the cash as belonging to that individual or as belonging to another person whose identity is readily ascertainable and who acknowledges ownership of the cash to the IRS, it is presumed that the cash represents gross income of a single individual for the taxable year in which the possession occurs and that the collection of tax will be jeopardized by delay. Section 6867, as originally enacted, made the entire amount of the cash subject to a 50 percent tax rate. Section 1001(a)(1) of the Technical and Miscellaneous Revenue Act of 1988 amended section 6867, effective for taxable years beginning after December 31, 1986, to provide that the tax rate is to be the highest rate of tax for an individual specified in section 1.

Under section 6867, the possessor of cash is treated (solely with respect to the cash) as the taxpayer for the purposes of chapters 63 and 64 of the Code, relating to assessment and collection, and for the purposes of section 7429(a)(1), entitling that individual to a written statement of information concerning the assessment provided for by that section. Because section 6867 does not treat the possessor as the taxpayer for the purposes of sections 7429(a)(2) and 7429(b), relating to administrative and judicial review of termination and jeopardy assessments, the proposed regulations do not permit the possessor of cash to maintain an action under section 7429 for such review. In addition, because section 7422, relating to civil actions for refund, is in chapter

76B and other provisions dealing with refunds are contained in chapter 65 and not chapters 63 or 64 of the Code, a possessor of cash, solely in that person's capacity as possessor of cash, may not institute a suit for refund in district court after the deficiency has been collected. This in no way diminishes the right of the possessor of cash to petition the United States Tax Court to challenge the notice of deficiency issued to the possessor solely in that person's capacity as possessor of cash.

The true owner of cash may maintain an action under section 7429 for administrative and judicial review of the deficiency notice issued to the possessor. However, the true owner may only institute the section 7429 action concerning the notice of deficiency issued to the possessor by making a request for review within 30 days from the date the possessor is given the written statement of information required under section 7429(a)(1). After the deficiency asserted against the possessor of cash has been levied upon, the true owner of cash may bring an action in federal district court, within the time frame specified in section 6532(c), to recover the cash, as provided in section 7426, relating to civil actions by persons other than taxpayers. In addition, the true owner of cash, with the permission of the court, may appear before the United States Tax Court in any proceeding that may be filed by the possessor of the cash challenging the notice of deficiency issued to the possessor as possessor of the cash.

Section 301.6867-1(f) of the final regulations incorporates the definitions contained in §301.6867-1T, relating to cash, cash equivalents, specific cash equivalents and the value of cash equivalents. In addition, several other items have been identified and added to the list of specific cash equivalents. Section 301.6867-1T will be removed on August 3, 1995.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has 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, there-

fore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.6867-1 is added to read as follows:

§301.6867-1 Presumptions where owner of large amount of cash is not identified.

(a) *General rule.* For purposes of section 6851 (relating to termination assessments) and section 6861 (relating to jeopardy assessments), if cash in excess of \$10,000 is found in the physical possession of an individual who does not claim either ownership of that cash or ownership by some other person whose identity the Commissioner can readily ascertain and who acknowledges ownership of that cash as of the date the cash was found, then, it shall be presumed that—

- (1) The cash represents gross income of an unknown single individual; and
- (2) That the collection of tax on that income will be jeopardized by delay.

(b) *Rules for assessment.* The Commissioner may make an assessment pursuant to section 6851 or section 6861, as appropriate, using the rules for assessment specified in this paragraph. In the case of any assessment resulting from the application of paragraph (a) of this section—

- (1) The entire amount of cash is treated as taxable income for the taxable year in which the cash is found;
- (2) The income is treated as taxable at the highest rate of tax specified in section 1 of the Internal Revenue Code; and

(3) Except as provided in paragraph (c), the possessor of the cash is treated (solely with respect to that cash) as the taxpayer for purposes of chapters 63 and 64 and section 7429(a)(1) of the Internal Revenue Code.

(c) *Effect of later substitution of true owner—*(1) *In general.* If an assessment resulting from the application of paragraph (a) of this section is later abated and replaced by an assessment against the true owner of the cash, the later assessment is treated for purposes of all laws relating to lien, levy, and collection as relating back to the date of the original assessment. Notwithstanding the preceding sentence, any notice and review provided for by section 7429 and the notice of deficiency issued to the true owner relative to the later assessment are to be made within the prescribed time limits, using the actual date of the later assessment against the true owner.

(2) *Example.* The provisions of paragraph (c)(1) of this section may be illustrated by the following example:

Example. On June 5, 1994, A is found in possession of a bag, containing \$200,000, which A claims he was holding for a friend whose name A cannot remember. Because A does not claim ownership of the cash and does not provide the name of the true owner so that the Commissioner can identify the true owner and have that person acknowledge ownership of the cash, it is presumed that the cash represents gross income of an individual for calendar year 1994, and that the collection of tax on that gross income will be jeopardized by delay. Accordingly, on June 17, 1994, a termination assessment under section 6851 is made against A, in his capacity as possessor of the cash. On June 21, 1994, the written statement of information provided for by section 7429(a)(1) is given to A. No request for review under section 7429(a)(2) is made by the true owner within 30 days after the day on which A was furnished the written statement provided for in section 7429(a)(1). Subsequently, individual B comes to the Service and states that he is the owner of the cash. On September 2, 1994, the Service determines that B was the true owner of the cash on June 5, 1994. On September 9, 1994, the Service abates the termination assessment made against A solely as possessor of cash and, after determining that jeopardy exists, replaces it with a termination assessment under section 6851 against B. The lien against B that arises under section 6321 is treated as arising on June 17, 1994. However, within 5 days after September 9, 1994, the Service must give B the written statement of information required by section 7429(a)(1) so that B can make a request for review under section 7429(a)(2). In addition, a notice of deficiency must be sent to B within 60 days after the later of the due date or the actual filing of B's tax return for 1994, as required by section 6851(b).

(d) *Rights of possessor of cash—*(1) *Action permitted.* Section 6867 pro-

vides that the possessor of cash is treated as the taxpayer for purposes of chapter 63 (relating to assessment) and chapter 64 (relating to collection) of the Internal Revenue Code. Accordingly, the possessor of cash may file a petition with the United States Tax Court, within the applicable time limits, challenging the notice of deficiency issued to the possessor solely in that person's capacity as possessor of cash.

(2) *Actions not permitted.* Section 6867 provides that the possessor of cash is treated as the taxpayer solely for purposes of section 7429(a)(1), and is entitled to the written statement of information provided for by that section. The possessor of cash is not treated as the taxpayer for purposes of sections 7429(a)(2) and 7429(b), relating to administrative and judicial review of termination and jeopardy assessments, and may not maintain an action under section 7429 for such review. The possessor of cash is not treated as the taxpayer for purposes of section 7422, relating to civil actions for refund, or chapter 65 of the Internal Revenue Code, relating to abatements, credits, and refunds, and may not institute a suit for refund in district court after the deficiency has been collected.

(e) *Rights of true owner of cash—*
(1) *Actions permitted.* The true owner of cash may request administrative review under section 7429(a)(2) and may maintain a civil action under section 7429(b) for judicial review of an assessment under section 6851 or section 6861 made against the possessor solely in that person's capacity as possessor of cash. Such an action, however, must be preceded by a request for review under section 7429(a)(2) made by the true owner within 30 days after the day on which the possessor is furnished the written statement provided for in section 7429(a)(1). In addition, after the deficiency asserted against the possessor of cash has been levied upon, the true owner of cash may bring an action in federal district court to recover the cash, as provided in section 7426, relating to civil actions by persons other than taxpayers. See, however, section 6532(c), relating to the 9-month statute of limitations for suits under section 7426. In addition, the true owner of cash, with the permission of the court, may appear before the United States Tax Court in any proceeding that may be filed by the possessor of the cash challenging the notice of defi-

ciency issued to the possessor solely in that person's capacity as possessor of the cash.

(2) *Actions not permitted.* The true owner of cash may not file a petition with the United States Tax Court challenging the notice of deficiency issued to the possessor solely in that person's capacity as possessor of cash. Notwithstanding the preceding sentence, the true owner of cash may file a petition with the United States Tax Court challenging any notice of deficiency issued to the true owner following the abatement of the assessment made against the possessor of cash.

(f) *Definitions.* For the purposes of this section and section 6867—

(1) *Cash.* The term *cash* includes any cash equivalents.

(2) *Cash equivalent—*(i) *In general.* The term *cash equivalent* includes foreign currency, any bearer obligation, and any medium of exchange that is of a type that has been frequently used in illegal activities, as listed in paragraph (f)(2)(ii) of this section.

(ii) *Specific cash equivalents.* For purposes of paragraph (f)(2)(i), the following are also cash equivalents—

- (A) Coins;
- (B) Precious metals;
- (C) Jewelry;
- (D) Precious stones;
- (E) Postage stamps;
- (F) Traveler's checks in any form;
- (G) Negotiable instruments (including personal checks, business checks, official bank checks, cashier's checks, notes, and money orders) that are either in bearer form, endorsed without restriction, made out to a fictitious payee, or otherwise in such form that title thereto passes upon delivery;

(H) Incomplete instruments (including personal checks, business checks, official bank checks, cashier's checks, notes, and money orders) signed but with the payee's name omitted; and

(I) Securities or stock in bearer form or otherwise in such form that title thereto passes upon delivery.

(iii) *Value of cash equivalents.* A cash equivalent is taken into account at its fair market value except in the case of a bearer obligation, in which case it is taken into account at its face value.

(3) *Possessor of cash.* An individual is considered to be the possessor of cash if the cash is found on that individual's person or in that individ-

ual's possession or is found in any object, container, vehicle, or area under that individual's custody or control.

(4) *True owner of the cash.* The true owner of cash is the individual who beneficially owns the cash on the date such cash is found in the physical possession of the individual described in paragraph (f)(3) of this section. An agent, bailee, or other custodian of the cash is not the true owner of cash. A true owner of cash does not include an individual who, subsequent to the date on which the cash is found in the physical possession of the individual described in paragraph (f)(3) of this section, obtains ownership of the cash by purchase, subrogation, descent, or other means.

(g) *Effective date.* This section is effective with respect to cash found in the physical possession of an individual on or after August 3, 1995.

§301.6867-1T [Removed]

Par. 3. Section 301.6867-1T is removed.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved June 29, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 2, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 3, 1995, 60 F.R. 39652)

Chapter 77.—Miscellaneous Provisions

Section 7514.—Authority to Prescribe or Modify Seals

26 CFR 301.7514-1: Seals of office.

T.D. 8625

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Seals of Office

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the authority contained within section 7514 of the Internal Revenue Code to prescribe or modify seals of office. These regulations provide an additional or alternative uniform seal for use by internal revenue offices throughout the country. In addition this regulation publishes what will be the newly reorganized regional and district offices, computing centers, submission processing centers, and customer service centers of the IRS.

EFFECTIVE DATE: October 27, 1995.

SUPPLEMENTARY INFORMATION:

Background

These final regulations amend the Procedure and Administration Regulations (26 CFR part 301) under section 7514 of the Internal Revenue Code (Code) and are issued under the authority contained in section 7805 (68A Stat. 917; 26 U.S.C. 7805). Section 7514 was enacted by section 91 of the Technical Amendments Act of 1958 (Public Law 85-866, 72 Stat. 1667) and amended by section 1906(b)-(13)(A), (M) of the Tax Reform Act of 1976 (Public Law 94-455, 90 Stat. 1834, 1835). The IRS published a notice of proposed rulemaking in the Federal Register on January 3, 1995, (60 FR 83 [GL-38-93, 1995-1 C.B. 937]) providing proposed rules under section 7514 of the Code. No public comments were received. Subsequent to publication of the notice of proposed rulemaking, the IRS announced that it was reorganizing its offices as a streamlining measure, and, beginning October 1, 1995, would be eliminating some offices and adding others. These final regulations list the IRS offices that will result from the full implementation of the reorganization, and indicates that the Commissioner can designate other offices that are authorized to use the uniform seal.

Explanation of Provisions

Section 301.7514-1 currently provides for several different seals of office for various offices of internal revenue throughout the country. These

final regulations permit internal revenue offices to keep the official seal currently in use, but provide for a uniform Internal Revenue Service seal for use when replacement of the current seal becomes necessary, or for other reasons such as the establishment of a new office or the relocation of an office to a new geographic area. The uniform seal can be used by all internal revenue offices throughout the country that are currently authorized by the Commissioner to use a seal, the new internal revenue offices created as the result of the impending reorganization of the IRS that is to be implemented starting October 1, 1995, and any other internal revenue office authorized by the Commissioner to use a seal.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7514-1 is amended as follows:

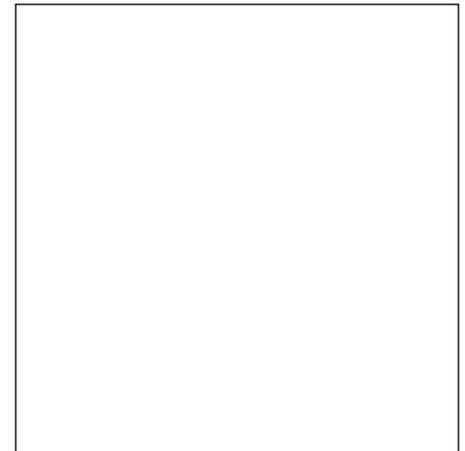
a. Paragraphs (a)(2) through (a)(7) are redesignated as (a)(3) through (a)(8).

b. New paragraph (a)(2) is added. The addition reads as follows:

§ 301.7514-1 *Seals of office.*

(a) * * *

(2) *Establishment of uniform seal.* (i) In addition to the seals of office prescribed for those offices set forth in paragraphs (a)(3) through (8) of this section, a uniform seal for use by any office of internal revenue is established. The uniform seal is described as follows, and is illustrated in this paragraph (a)(2)(i). A circle within which shall appear that part of the seal of the Treasury Department represented by the shield with a dark background. Exterior to this circle and within a circumscribed circle forming the exterior of the seal shall appear words describing the specific office of internal revenue authorized to use the seal under this section. This paragraph (a)(2) is effective on October 27, 1995. The uniform seal is as follows:



(ii) The uniform seal may be used by any office of internal revenue set forth in paragraphs (a)(3) through (8) of this section, and any other office designated by the Commissioner to use a seal, including the following internal revenue offices resulting from a reorganization of the IRS that will be implemented beginning October 1, 1995:

- Office of Regional Commissioner for:
 - Midstates Region (Dallas)
 - Northeast Region (Manhattan)
 - Southeast Region (Atlanta)
 - Western Region (San Francisco)
- Office of District Director for:
 - Arkansas-Oklahoma District (Oklahoma City)
 - Brooklyn District
 - Central California District (San Jose)

Connecticut-Rhode Island District (Hartford)
 Delaware-Maryland District (Baltimore)
 Georgia District (Atlanta)
 Gulf Coast District (New Orleans)
 Houston District
 Illinois District (Chicago)
 Indiana District (Indianapolis)
 Kansas-Missouri District (St. Louis)
 Kentucky-Tennessee District (Nashville)
 Los Angeles District
 Manhattan District
 Michigan District (Detroit)
 Midwest District (Milwaukee)
 New Jersey District (Newark)
 New England District (Boston)
 North Central District (St. Paul)
 North Florida District (Jacksonville)
 North-South Carolina District (Greensboro)
 North Texas District (Dallas)
 Northern California District (Oakland)
 Ohio District (Cincinnati)
 Pacific-Northwest District (Seattle)
 Pennsylvania District (Philadelphia)
 Rocky Mountain District (Denver)
 South Florida District (Fort Lauderdale)
 South Texas District (Austin)
 Southern California District (Laguna Niguel)
 Southwest District (Phoenix)
 Upstate New York District (Buffalo)
 Virginia-West Virginia District (Richmond)

Buffalo
 Cincinnati
 Cleveland
 Dallas
 Denver
 Fresno
 Indianapolis
 Jacksonville
 Kansas City
 Memphis
 Nashville
 Ogden
 Philadelphia
 Pittsburgh
 Portland, OR
 Richmond
 St. Louis
 Seattle.

* * * * *

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved October 10, 1995.

Leslie Samuels,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 26, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 27, 1995, 60 F.R. 54944)

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for

the month of December 1995. See Rev. Rul. 95-79, page 134.

Chapter 79.—Definitions

Section 7701.—Definitions

Rev. Rul. 84-152, 1984-2 C.B. 381; Rev. Rul. 84-153, 1984-2 C.B. 383; Rev. Rul. 85-163, 1985-2 C.B. 349; and Rev. Rul. 87-89, Situations (1) and (2), 1987-2 C.B. 195, are rendered obsolete for payments made after September 10, 1995, that are subject to the final regulations under section 7701(1). See Rev. Rul. 95-56, page 322.

26 CFR 1.7701(l)-1: Conduit financing arrangements.

T.D. 8611

**DEPARTMENT OF THE TREASURY
 Internal Revenue Service
 26 CFR Parts 1 and 602**

Conduit Arrangements Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to conduit financing arrangements issued under the authority granted by section 7701(1). The final regulations apply to persons engaging in multiple-party financing arrangements. The final regulations are necessary to determine whether such arrangements should be recharacterized under section 7701(1).

EFFECTIVE DATE: The regulations are effective September 11, 1995.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1545-1440. The estimated annual burden per recordkeeper is 10 hours.

Comments concerning the accuracy of this burden estimate and suggestions

Office of Director of Computing Centers in:

- Detroit
- Memphis
- Martinsburg

Office of Director of Submission Processing Centers in:

- Austin
- Cincinnati
- Memphis
- Kansas City
- Ogden

Office of Director of Customer Service Centers in:

- Andover
- Atlanta
- Austin
- Baltimore
- Brookhaven

for reducing this burden should be sent to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

On August 10, 1993, Congress enacted section 7701(l) of the Internal Revenue Code (Code), which authorizes the Secretary to “prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more parties where such recharacterization is necessary to prevent avoidance of any tax imposed by [title 26].” The legislative history to section 7701(l) noted with approval a series of tax court and IRS pronouncements that used “substance over form” principles to recharacterize conduit financing arrangements, but stated that the Secretary was not bound by the principles of these pronouncements in developing regulations.

On October 14, 1994, the IRS published a notice of proposed rulemaking in the Federal Register (59 FR 52110 [INTL-64-93, 1994-2 C.B. 880]) under section 7701(l) of the Code. These proposed regulations permit the district director to disregard the participation of one or more intermediate entities in a conduit financing arrangement for purposes of sections 871, 881, 1441, and 1442.

Written comments responding to the notice were received, and a public hearing was held on December 16, 1994. After considering the written comments received and the statements made at the hearing, the IRS and Treasury adopt the proposed regulation as revised by this Treasury decision.

Explanation of Provisions and Summary of Significant Comments

A. Overview of Provisions

The final regulations make few substantive changes to the proposed regulations. Most changes are in the nature of refinements to, and clarifications of, the principles in the proposed regulations. It should be noted that the IRS and Treasury will continue to monitor conduit financing arrangements in the

context of sections 871, 881, 1441 and 1442 after the publication of these final regulations. If the rules announced herein do not sufficiently address the avoidance of these taxes, the IRS and Treasury will consider modifying or supplementing these rules as they find necessary.

Section 1.881-3(a)(2) of the final regulations provides definitions of certain terms used throughout the regulations. A *financing arrangement* is defined as a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or the right to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. The final regulations supplement this basic rule with an anti-abuse rule that allows the IRS to treat related persons as a single entity where a taxpayer interposes a related person in an arrangement that would otherwise qualify as a *financing arrangement* to circumvent the application of the conduit rules.

A *financing transaction* includes a debt instrument, lease or license. In addition, an equity instrument may qualify as a *financing transaction* if the equity has certain debt-like characteristics. The term *financing transaction* also includes any other advance of money or property pursuant to which the transferee is obligated to repay or return a substantial portion of the money or other property advanced or the equivalent in value.

Section 1.881-3(a)(3)(i) authorizes the district director to determine that an intermediate entity is a conduit entity under the rules set forth in §1.881-3(a)(4). Section 1.881-3(a)(3)(ii) describes the effects of conduit treatment. Section 1.881-3(a)(3)(ii)(B) generally provides that the character of the payments made under the recharacterized transaction (*i.e.* interest, rents, etc.) is determined by reference to the character of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a party gives rise to a type of payment that would not be deductible if paid by the financed entity (*e.g.*, dividends, as determined under U.S. tax principles), the character

of the payments is not affected by the recharacterization.

Section 1.881-3(a)(3)(ii)(E) provides that a financing entity that is unrelated to both the intermediate entity and the financed entity is not liable for the tax imposed by section 881 unless it knows or has reason to know of a conduit financing arrangement. Moreover, the final regulations create a presumption that an unrelated financing entity does not know or have reason to know of a conduit financing arrangement where the intermediate entity that is a party to the financing transaction with the financing entity is engaged in a substantial trade or business.

Section 1.881-3(a)(4) provides the standards for determining whether an intermediate entity is a conduit entity for purposes of section 881. If an intermediate entity is related to either the financing entity or the financed entity, the intermediate entity will be a conduit entity only if (i) the participation of the intermediate entity in the financing arrangement reduces the U.S. withholding tax that otherwise would have been imposed, and (ii) the participation of the intermediate entity in the financing arrangement is pursuant to a plan one of the principal purposes of which is the avoidance of the withholding tax.

If a financing arrangement involves multiple intermediate entities, §1.881-3(a)(4)(ii)(A) provides that the district director will determine whether each of the intermediate entities is a conduit entity. The factors, presumptions, and other rules in the regulations generally state how they should be applied in the case of multiple intermediate entities. The regulations state that, if no such rule is provided, the district director should apply principles consistent with the standards described above. Section 1.881-3(a)(4)(ii)(B) provides a general anti-abuse rule that allows the district director to treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent the provisions of this section. The district director's determination is to be based upon all of the facts and circumstances, including, but not limited to, the factors indicating whether the

intermediate entity's participation in a financing arrangement is pursuant to a tax avoidance plan.

Section 1.881-3(b) provides that the district director will weigh all available evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. Moreover, §1.881-3(b)(3) provides a presumption that a tax avoidance plan does not exist where an intermediate entity that is related to either the financing entity or the financed entity performs significant financing activities with respect to the financing transactions making up the financing arrangement.

In the case of an intermediate entity that is not related to either the financing entity or the financed entity, the intermediate entity will not be a conduit entity unless the requirements applicable to related parties are met (that is, there is a reduction in the tax imposed by section 881 and a tax avoidance plan) and, in addition, the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity advanced money or property to (or entered into a lease or license with) the intermediate entity. See §1.881-3(a)-(4)(i)(C). Under §1.881-3(c)(2), the district director may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity if another person has provided a guarantee of the financed entity's obligation to the intermediate entity. The term *guarantee* includes, but is not limited to, a right of offset between the two financing transactions to which the intermediate entity is a party.

Once the district director has disregarded the participation of a conduit entity in a conduit financing arrangement, §1.881-3(d)(1)(i) provides that a portion of each payment made by the financed entity is recharacterized as a payment directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment by the financed entity shall be recharacterized. If the aggregate princi-

pal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party.

Under §1.881-3(d)(1)(ii)(A), the principal amount of a financing transaction generally equals the amount of money, or the fair market value of other property, advanced, or subject to a lease or license, valued at the time of the financing transaction. However, in the case of a financing arrangement where the same property is advanced, or rights granted from the financing entity through the intermediate entity (or entities) to the financed entity, the property is valued on the date of the last financing arrangement. This rule is intended to minimize the distortive effect of currency or other market fluctuations when there is a time lag between financing transactions. In addition, the principal amount of certain types of financing transactions is subject to adjustment. Sections 1.881-3(d)(1)(ii)(B) through (D) provide more detailed guidance regarding how these general rules are applied to different types of financing transactions.

Section 1.881-4 uses the general recordkeeping requirements under section 6001 to require a financed entity or any other person to keep records relevant to determining whether such person is a party to a financing arrangement and whether that financing arrangement may be recharacterized under §1.881-3. Corporations that otherwise would report certain information on total annual payments to related parties pursuant to sections 6038(a) and 6038A(a) must also maintain such records where the corporation knows or has reason to know that such transactions are part of a financing arrangement. Specifically, the final regulations require the entity to retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements, including minutes of board of

directors meetings and board resolutions and materials from investment advisors regarding the structuring of the transaction.

Under §1.1441-7(d), any person that is a withholding agent for purposes of section 1441 with respect to the transaction (whether the financed entity or an intermediate entity that is treated as an agent of the financing entity) must withhold in accordance with the recharacterization if it knows or has reason to know that the financing arrangement is a conduit financing arrangement. The final regulations provide examples of how the "knows or has reason to know" standard, which generally applies to all withholding agents, is to be applied in this context.

B. Discussion of Significant Comments

Significant comments that relate to the application of the proposed regulation and the responses to them, including an explanation of the revisions made to the final regulation, are summarized below. Technical or drafting comments that have been reflected in the final regulations generally are not discussed.

1. General Approach

As described above, the final regulations adopt the general "tax avoidance" standard of the proposed regulations. Several commentators criticized the proposed regulations for setting forth new standards for the recharacterization of conduit transactions. They argued that the rulings that preceded these regulations required matching cash flows from the financed entity to the conduit entity and from the conduit entity to the financing entity. Some commentators argued that, because in their view the regulations adopt new standards, the regulations should only be effective for transactions entered into after the enactment of section 7701(l), while others argued that the regulations should only apply to transactions entered into after the publication of the final regulations. Finally, some commentators suggested that the regulations constituted an override of our treaty obligations and might therefore be invalid.

The IRS and Treasury believe that pre-section 7701(l) conduit rulings

rested on a taxpayer having a tax avoidance purpose for structuring its transactions. The fact that an intermediate entity received and paid matching, or nearly matching, cash flows was evidence that the participation of the intermediate entity in the transaction did not serve a business purpose. Nevertheless, the fact that cash flows were not matched did not mean that the transaction had a business purpose.

The final regulations generally apply to payments made by financed entities after the date which is 30 days after the date of publication of the regulations because the IRS and Treasury believe that the regulations reflect existing conduit principles. Moreover, even if the regulations had adopted a new standard, it would be inappropriate to grandfather transactions that admittedly had a tax avoidance purpose. The final regulations do not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation). Prior law continues to apply with respect to payments on any such debt instruments.

As noted in the preamble to the proposed regulations, the IRS and Treasury believe that these regulations supplement, but do not conflict with, the limitation on benefits articles in tax treaties. They do so by determining which person is the beneficial owner of income with respect to a particular financing arrangement. Because the financing entity is the beneficial owner of the income, it is entitled to claim the benefits of any income tax treaty to which it is entitled to reduce the amount of tax imposed by section 881 on that income. The conduit entity, as an agent of the financing entity, cannot claim the benefits of a treaty to reduce the amount of tax due under section 881 with respect to payments made pursuant to the financing arrangement.

2. Discretion given to District Director

a. Determination of whether conduit entity's participation will be disregarded

Because the proposed regulations utilize a tax avoidance test that depends on the facts and circumstances, discre-

tion is given to the district director to determine whether the participation of an intermediate entity had as one of its principal purposes the avoidance of U.S. withholding tax. Among other things, the district director may determine the composition of the financing arrangement and the number of parties to the financing arrangement.

Some commentators criticized this grant of discretion because they claimed that the regulations provide insufficient guidance regarding what factors the district director should take into account. Several commentators proposed adding presumptions, making certain existing presumptions irrebuttable or otherwise providing bright-line tests. One commentator suggested that the district director's discretion to determine the parties to a financing arrangement should be limited to the extent necessary to ensure that a taxpayer could prove that a different party that was entitled to treaty benefits was the real financing entity. Finally, another commentator suggested that the determination whether an intermediate entity's participation will be disregarded should be subject to review by a central control board in the National Office of the IRS.

Because the final regulations retain the facts and circumstances test used in the proposed regulations, the final regulations do not significantly reduce the district director's discretion. As discussed below, it was not considered necessary to add additional factors because the objective list of factors is not exclusive. The final regulations do, however, provide more guidance regarding the tax avoidance purpose test by adding several more examples. In addition, the final regulations modify the factor relating to whether there has been a significant reduction in tax to allow the taxpayer to produce evidence that there was not a reduction in tax because the entity that was the ultimate source of funds also was entitled to treaty benefits. See §1.881-3(b)(2)(i).

The final regulations do not adopt the suggestion that the district director's discretion be subject to review at the National Office level. The final regulations, like the proposed regulations, provide that the determination of whether a tax avoidance plan exists is based on all of the facts and circumstances surrounding the intermediate entity's participation in the financing arrangement. The IRS and Treasury believe that such a determination would best be made at the local level.

b. Judicial standard of review

Because the district director is granted discretion by the regulations, his determinations generally will be reviewed by the court under an abuse of discretion standard. Commentators suggested that the district director's determination that an intermediate entity's participation should be disregarded should be reviewed by the court under this standard. One commentator instead suggested that courts review a district director's determination using a *de novo* standard of review. Another suggested that the IRS should be afforded only its normal presumption of correctness. The final regulations do not adopt these suggestions because they are fundamentally inconsistent with the grant of discretion to the district director.

3. Definitions

a. Financing transaction, in general

Commentators pointed out that the definition of *financing transaction* in the proposed regulations encompassed transactions that clearly were not meant to be covered by the proposed regulations. For example, under the proposed regulations, a foreign parent that contributed an existing note from its domestic subsidiary to a foreign subsidiary in exchange for common stock of the subsidiary that did not have any debt-like features nevertheless would be treated as a financing entity because the foreign parent had made an advance of property (the note) pursuant to which the foreign subsidiary had "become a party to an existing financing transaction".

The definitions of *financing transaction* and *financing arrangement* have been redrafted to address these concerns. See §1.881-3(a)(2)(i) and (ii). The effect of the new definitions is to take a "snapshot" after all the transactions are in place to determine whether there is a *financing arrangement*.

b. Equity

Commentators noted that the proposed regulations were inconsistent in their treatment of how a controlling interest in a corporation, either before or after a default, affected whether an equity arrangement was a financing transaction. In addition, commentators

requested that the final regulations explicitly exempt “common stock” and “ordinary preferred stock” from treatment as financing transactions.

In response to the first of these comments and in a general attempt to clarify the types of equity instruments that are financing transactions, the final regulations revise the definition of *financing transaction* with respect to equity. See §1.881-3(a)(2)(ii)(A)(2) and (B). The new definition provides that the right to elect the majority of the board of directors will not, in and of itself, cause an equity instrument to be a financing arrangement. See §1.881-3(a)(2)(ii)(B)(2)(i).

As to the second suggestion, the final regulations do not create a separate exception from the definition of financing transaction for “common stock” or “ordinary perpetual preferred stock.” Whether a transaction constitutes a financing transaction depends upon the terms of the transaction, not simply on the label attached to the transaction. Moreover, because these terms are not themselves well-defined in either the Code or common law, the IRS and Treasury believe that excluding these categories of instruments would lead to disputes as to whether a particular instrument is “common stock” or, if not, whether it is “ordinary” perpetual preferred stock.

c. Guarantees

Commentators asked that final regulations explicitly provide that guarantees are exempted from treatment as financing transactions. The IRS and Treasury believe that the new definition of financing transaction, which does *not* treat becoming a party to a financing transaction as itself a financing transaction, clarifies that a guarantee is not a financing transaction. Moreover, the final regulations add an example to eliminate any doubt in this regard. See §1.881-3(e) *Example 1*.

d. Leases and licenses

The proposed regulations provide that leases and licenses are financing transactions. Some commentators suggested that the regulations not include leases and licenses in the definition of financing transaction or that the IRS reserve on the subject of leases until it had more time to study the matter.

Other commentators proposed that certain types of leases, for instance

short-term leases and leveraged leases, be excluded from the definition of financing transaction. The commentators pointed out that certain leveraged leases would be subject to recharacterization under the proposed regulations even though, in substance, the financing arrangement is the equivalent of a loan from a financing entity entitled to a zero rate of withholding on interest. Under section §1.881-3(d)(2) of the proposed regulations, which provides that the nature of the recharacterized payments is determined by reference to the transaction to which the financed entity is a party, the participation of the intermediate entity in a leveraged lease would substantially reduce the tax imposed under section 881 if the treaty between the United States and the country in which the lender was organized allowed withholding on rental payments. Because all of the negative factors of §1.881-3(c)(2) and the “but-for” test of §1.881-3(b) of the proposed regulations are met in a standard leveraged lease, this reduction in tax would allow the district director to recharacterize the financing arrangement as a conduit financing arrangement.

The IRS and Treasury believe that all leases and licenses, of whatever duration, can be used by taxpayers to structure a conduit financing arrangement. Accordingly, the final regulations continue to include leases and licenses in the definition of financing transaction. See §1.881-3(a)(2)(ii)(A)(3). However, the final regulations change the character rule in the case of deductible payments. In those cases, the character of the payments under the recharacterized transaction is determined by reference to the financing transaction to which the financing entity is a party. As a result, under the final regulations, a leveraged lease generally will not be recharacterized as a conduit arrangement if the ultimate lender would be entitled to an exemption from withholding tax on interest received from the financed entity, even if rental payments made by the financed entity to the financing entity would have been subject to withholding tax.

e. Related

As noted above, it is more difficult for an intermediate entity to be a conduit entity if it is not related to either the financing entity or the

financed entity. The definition of persons who are *related* to another person generally follows the definition used in section 6038A. One commentator suggested that the final regulations eliminate the constructive ownership rule of section 267(c)(3) from the definition of related. The same commentator further suggested that a person under common control within the meaning of section 482 should not be a related person for purposes of this regulation.

The IRS and Treasury believe that the term *related* should be broadly defined to ensure that the additional protection from recharacterization provided by the so-called “but for” test flows only to those entities that are not under the effective control of either the financing or the financed entity. Accordingly, the final regulations retain the definition of related provided in the proposed regulations. See §1.881-3(a)(2)(v).

4. Factors indicating the presence or absence of a tax avoidance plan

a. In general

The proposed regulations provide that whether the participation of the intermediary in the financing arrangement is pursuant to a tax avoidance plan is determined based on all the relevant facts and circumstances. In addition, the proposed regulations provide a list of some of the factors that will be taken into account: the extent of the reduction in tax; the liquidity of the intermediate entity; the timing of the transactions; and, in the case of related entities, the nature of the business(es) of such entities.

Commentators asked that the final regulations adopt a number of additional factors. For example, commentators asked that the dissimilarity of cash flows or of financing transactions making up the financing arrangement constitute a positive factor (*i.e.*, a factor that evidences the absence of a tax avoidance plan). Commentators also suggested that the positive factors include the fact that income was subject to net tax in the United States or in a foreign jurisdiction or, alternatively, that the transaction reduced other U.S. or foreign taxes more than it reduced the U.S. withholding tax (indicating that the purpose of the transaction was to avoid taxes other than the tax imposed by section 881).

The factors proposed by commentators generally relate to the issue of whether there were purposes, other than the avoidance of the tax imposed by section 881, for the participation of the intermediate entity in the financing arrangement. The final regulations do not add factors relating to purposes for the participation of an intermediate entity in a financing arrangement. However, §1.881-3(b)(1) of the final regulations addresses the issue by clarifying that the district director will consider all available evidence regarding the purposes for the participation of the intermediate entity.

b. Factor relating to a complementary or integrated business

One of the factors listed in the proposed regulations is whether, if the intermediate entity is related to the financed entity, the two parties enter into a financing transaction to finance a trade or business actively engaged in by the financed entity that forms a part of, or is complementary to, a substantial trade or business actively engaged in by the intermediate entity. One commentator expressed uncertainty as to the policy behind this factor.

The intent of this factor was to take into account the fact that related corporations engaged in integrated businesses may enter into many financing transactions in the course of conducting those businesses, the vast majority of which have no tax avoidance purpose. Accordingly, §1.881-3(b)(2)(iv) of the final regulations clarifies that the district director will take into account whether a transaction is entered into in the ordinary course of integrated or complementary trades or businesses in determining whether there is a tax avoidance plan. In addition, the factor is broadened so as to apply not only to transactions between the intermediate entity and the financed entity but to transactions between any two parties to the financing arrangement that are related to each other.

5. Presumption regarding significant financing activities

The proposed regulations provide that, in the case of an intermediate entity that is related to either the financing entity or the financed entity, a presumption of no tax avoidance arises where the intermediate entity

performs significant financing activities for such entities. Among other things, the provision required employees of the intermediate entity (other than an intermediate entity that earned “active rents” or “active royalties”) to manage “business risks” arising from the transaction on an ongoing basis. The proposed regulations provide an example showing that, if there are no such business risks because the intermediate entity has hedged itself fully at the time it entered into the financing transactions, the entity is not described in the provision.

One commentator criticized the articulation of the significant financing activities presumption in the proposed regulations on the grounds that the test should be solely whether the participation of the intermediate entity produces (or could be expected to produce) efficiency savings through a reduction in overhead costs and the ability to hedge the group’s positions on a net basis. Another commentator proposed extending the presumption for significant financing activities to intermediate entities that are unrelated to both the financed entity and the financing entity.

As to the first comment, the IRS and Treasury agree that there is not a sufficient business purpose for the centralization of financing activities of a group of related corporations in a single corporation unless the taxpayer anticipates efficiency savings. Although the prospect of such savings in general may establish a business purpose for the establishment of the subsidiary, it does not prevent the subsidiary from acting as a conduit with respect to any particular financing arrangement. This is demonstrated by the hedging example described above, the rationale for which is that either the financed entity or the financing entity could have entered into the long-term hedge so there is no economic justification for the participation of the intermediate entity in the particular financing arrangement. The IRS and Treasury believe that an affiliate that is not taking a continuing active role in coordinating and managing a financing transaction should not be entitled to the presumption that its participation is not pursuant to a tax avoidance plan.

As to the suggestion of extending the significant financing activities presumption to unrelated parties, the IRS and Treasury believe that this extension would be inconsistent with the purpose of the presumption. The significant

financing presumption recognizes that there are legitimate business reasons for conducting financing activities through a centralized financing and hedging subsidiary. The decision to have an unrelated intermediate entity participate in a financing transaction is based on different considerations, including the regulatory effects of such transactions and the interests of the shareholders of the unrelated intermediary. These considerations are addressed by providing that such entities will not be conduit entities unless they satisfy the “but for” test. The final regulations do not extend the significant financing activities presumption to unrelated parties.

Accordingly, the requirements for the significant financing activities presumption in §1.881-3(b)(3) of the final regulations are generally the same as those in the proposed regulations. However, the final regulations do add a requirement that the participation of the intermediate entity generate efficiency savings, and change the term *business risks to market risks* (to differentiate the risks of currency and interest rate movements from other, primarily credit, risks). In addition, one of the examples that illustrates the significant financing activities presumption has been revised to indicate that a finance subsidiary may be managing market risks even in the case of a fully-hedged transaction if the intermediate entity routinely terminates such long term arrangements when it finds cheaper hedging alternatives. See §1.881-3(e) *Example 22*.

6. “But for” Test

a. In general

Under the proposed regulations, if the intermediate entity is not related to either the financing entity or the financed entity, the financing arrangement will not be recharacterized unless the intermediate entity would not have participated in the financing arrangement on substantially the same terms “but for” the fact that the financing entity advanced money or property to (or entered into a lease or license with) the intermediate entity.

Commentators asked for clarification regarding what it means for terms to be not substantially the same. One commentator proposed using the standards for material modifications under section 1001.

The IRS and Treasury believe that an attempt to set forth a comprehensive

system of bright-line rules like those suggested by commentators would add unnecessary complexity to the regulation, given its anti-abuse purpose. Accordingly, the final regulations make no change to the proposed regulations in this regard.

b. Presumption where financing entity guarantees the liability of the financed entity.

Under the proposed regulations, it is presumed that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if, in addition to entering into a financing transaction with the intermediate entity, the financing entity guarantees the financed entity's liabilities under its financing transaction with the intermediate entity. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing arrangement on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity.

Several commentators asked for clarification of this presumption. Some commentators suggested that the existence of a guarantee makes the existence of the financing transaction between the financing entity and the intermediate entity irrelevant to the determination of whether the intermediate entity would have participated in the financing arrangement on substantially the same terms. Another commentator proposed eliminating the "clear and convincing evidence" standard on the grounds that it is too difficult an evidentiary burden for the taxpayer to overcome.

The presumption regarding guarantees originated in Rev. Rul. 87-89 (1987-2 C.B. 195), which articulated the "but for" test in substantially the same terms as adopted in the final regulations. Rev. Rul. 87-89 provided that a statutory or contractual right of offset is presumptive evidence that the unrelated intermediary would not have participated in the financing arrangement on substantially the same terms without the financing transaction from the financing entity. The proposed regulations extend the presumption to all guarantees in order to prevent taxpayers from using forms of credit support other than the right of offset to avoid this presumption. The final reg-

ulations retain this rule. See §1.881-3(c)(2).

The final regulations also retain the "clear and convincing evidence" standard. The taxpayer always must overcome the presumption of correctness in favor of the government by a preponderance of the evidence. Therefore, in order for this additional presumption to have any effect, it is necessary to raise the evidentiary standard. In addition, this standard of proof is not unreasonable, because an intermediate entity that is unrelated to the financing entity and the financed entity and that proves, by clear and convincing evidence, that it would have entered into the financing arrangement on substantially the same terms will avoid recharacterization as a conduit entity *even though* its participation in the financing arrangement is pursuant to a tax avoidance plan.

7. Multiple Intermediate Entities

a. In general

The proposed regulations provide guidance as to how some but not all of the operative provisions and presumptions apply to multiple intermediate entities. Several commentators asked that the final regulations clarify the manner in which the operative rules apply in the case of multiple intermediate entities. The final regulations provide additional guidance in the relevant operative rules and presumptions. In addition, the final regulations modify the example in the proposed regulations relating to multiple intermediate entities to clarify how some of these provisions and presumptions apply. See §1.881-3(e) *Example 8*.

b. Special rule for related persons

Section 1.881-3(a)(4)(ii)(B) of the proposed regulations allows the district director to treat related persons as a single intermediate entity if he determines that one of the principal purposes for the structuring of a transaction was the avoidance of the application of the conduit financing arrangement rules. Several commentators suggested that the final regulations eliminate this section. One commentator suggested that the rule be limited to situations where one related corporation made an equity investment in another. Another believed that the IRS and

Treasury should "wait and see" whether such a rule was really necessary to prevent taxpayers from circumventing the conduit financing arrangement rules.

The IRS and Treasury believe that an anti-abuse rule is necessary to prevent the circumvention of these rules through manipulation of the definition of financing arrangement. Accordingly, §1.881-3(a)(2)(i)(B) of the final regulations retains the related party anti-abuse rule. Moreover, the final regulations include another more general anti-abuse rule that allows the district director to treat related intermediate entities as a single intermediate entity if he determines that one of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an entity as a conduit, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent any other provision of this section. See §1.881-3(a)(4)(ii)(B). This rule prevents a taxpayer from structuring a financing transaction with a small principal amount to reduce the amount of the recharacterized payment, and thus replaces the second half of the rule set forth in proposed regulation §1.881-3(a)(4)(ii)(B). This rule is illustrated in §1.881-3(e) *Example 7*.

8. Principal amount

The proposed regulations provide that the principal amount of a financing transaction shall be determined on the basis of all of the facts and circumstances. Under the proposed regulations, the principal amount generally equals the amount of money, or the fair market value of other property (determined as of the time that the financing transaction is entered into), advanced in the financing transaction. The principal amount of a financing transaction is subject to adjustments, as appropriate.

Some commentators asked for clarification regarding whether adjustments would be made to the principal amount of a financing transaction to take account of amortization or depreciation. Another commentator suggested that the final regulations provide that calculations be performed in the functional currency of the intermediate entity in order to isolate currency fluctuations.

The final regulations provide that adjustments for depreciation and amor-

tization are made when calculating the principal amount of a leasing or licensing financing transaction. See §1.881-3(d)(1)(ii)(A).

Although the IRS and Treasury agree that the effect of currency fluctuations should be minimized, they believe that determining the principal amount in the functional currency of the intermediate entity would not always yield the correct result. Accordingly, the final regulations eliminate currency and market fluctuations to the extent possible by providing that, when the same property has been advanced by the financing entity and received by the financed entity, the determination of the principal amount is made as of the date the last financing transaction is entered into. See §1.881-3(d)(1)(ii)(A). An example has been added to demonstrate how this rule applies to transactions in currencies other than the U.S. dollar. See §1.881-3(e) *Example 25*.

9. Correlative Adjustments

The proposed regulations do not provide for correlative adjustments in the case of the district director's recharacterization of a financing arrangement as a transaction directly between a financing entity and a financed entity.

Commentators have requested that taxpayers be allowed to make correlative adjustments if their transactions are recharacterized. Commentators generally would not, however, allow the IRS to make correlative adjustments where such adjustments would result in greater tax liability.

The final regulations, like the proposed regulations, do not provide for correlative adjustments. The IRS and Treasury agree with commentators that it is not appropriate to use regulations that are intended to prevent the avoidance of tax under section 881 to recharacterize transactions for purposes of other code sections. Accordingly, taxpayers should not be able to use these regulations to make correlative adjustments to their tax returns.

10. Recordkeeping and Reporting Requirements

The proposed regulations require corporations that would otherwise report certain information on total annual payments to related parties pursuant to sections 6038(a) and 6038A(a) to re-

port such information on a transaction-by-transaction basis where the corporation knows or has reason to know that such transactions are part of a financing arrangement. In addition, the proposed regulations require a financed entity or any other person to keep records relevant to determining whether such person is a party to a financing arrangement that is subject to recharacterization as part of their general recordkeeping requirements under section 6001.

Commentators criticized the reporting requirements imposed by the proposed regulation as unduly burdensome in that they would require reporting of all financing arrangements and not simply those subject to recharacterization as conduit financing arrangements. Moreover, they pointed out that, because the regulations only would require reporting of those transactions to which the financed entity is a party, the information reported would not be of significant value. The reported information would not be sufficient to allow the IRS to connect the reported financing transaction to the other financing transactions making up a financing arrangement.

The final regulations eliminate the reporting requirements provided in the proposed regulations and provide more specific guidance as to the type of records affected entities must retain. The recordkeeping requirements of §1.881-4 have been revised to incorporate all of the information that entities would have had to report under the proposed regulations. In addition, the final regulations require the entity to retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrangements, including minutes of board of directors meetings and board resolutions and materials from investment advisors regarding the structuring of the transaction. See §1.881-4(c)(2).

11. Withholding obligations

Under the proposed regulations, a person that is otherwise a withholding agent is required to withhold tax under section 1441 or section 1442 in accordance with the recharacterization of a financing arrangement if the person knows or has reason to know that the financing arrangement is subject to recharacterization under sections 871 or 881. Commentators asked for additional guidance regarding the application of

the "know or have reason to know" standard in the context of conduit financing arrangements. The final regulations include several examples regarding the circumstances in which a financed entity does and does not have reason to know of the existence of a conduit financing arrangement.

C. Status of Revenue Rulings

The proposed regulations did not address the status of the existing revenue rulings relating to conduit arrangements. Commentators have asked for guidance regarding their status.

Concurrent with the publication of these regulations, the IRS is issuing a revenue ruling modifying the existing rulings. The revenue ruling limits the application of the old revenue rulings in the context of withholding tax to payments made before the effective date of the final regulations and to other provisions not covered by the conduit regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. These regulations affect entities engaged in cross-border multiple-party financing arrangements. It is assumed that a substantial number of small entities will not engage in such financing arrangements. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small businesses.

* * * * *

Adoption of Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the

entry for “Sections 1.6038A–1 through 1.6038A–7” and adding entries in numerical order to read as follows:

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

Section 1.871–1 also issued under 26 U.S.C. 7701(l). * * *

Section 1.881–3 also issued under 26 U.S.C. 7701(l).

Section 1.881–4 also issued under 26 U.S.C. 7701(l). * * *

Section 1.1441–3 also issued under 26 U.S.C. 7701(l). * * *

Section 1.1441–7 also issued under 26 U.S.C. 7701(l). * * *

Section 1.6038A–1 also issued under 26 U.S.C. 6038A.

Section 1.6038A–2 also issued under 26 U.S.C. 6038A.

Section 1.6038A–3 also issued under 26 U.S.C. 6038A and 7701(l).

Section 1.6038A–4 also issued under 26 U.S.C. 6038A.

Section 1.6038A–5 also issued under 26 U.S.C. 6038A.

Section 1.6038A–6 also issued under 26 U.S.C. 6038A.

Section 1.6038A–7 also issued under 26 U.S.C. 6038A. * * *

Section 1.7701(l)–1 also issued under 26 U.S.C. 7701(l). * * *

Par. 2. In §1.871–1, paragraph (b)(7) is added to read as follows:

§1.871–1 Classification and manner of taxing alien individuals.

* * * * *

(b) * * *

(7) *Conduit financing arrangements.*

For rules regarding conduit financing arrangements, see §§1.881–3 and 1.881–4.

* * * * *

Par. 3. Sections 1.881–0, 1.881–3 and 1.881–4 are added to read as follows:

§1.881–0 Table of contents.

This section lists the major headings for §§1.881–1 through 1.881–4.

§1.881–1 Manner of taxing foreign corporations.

- (a) Classes of foreign corporations.
- (b) Manner of taxing.
- (1) Foreign corporations not engaged in U.S. business.

- (2) Foreign corporations engaged in U.S. business.
- (c) Meaning of terms.
- (d) Rules applicable to foreign insurance companies.
- (1) Corporations qualifying under subchapter L.
- (2) Corporations not qualifying under subchapter L.
- (e) Other provisions applicable to foreign corporations.
- (1) Accumulated earnings tax.
- (2) Personal holding company tax.
- (3) Foreign personal holding companies.
- (4) Controlled foreign corporations.
- (i) Subpart F income and increase of earnings invested in U.S. property.
- (ii) Certain accumulations of earnings and profits.
- (5) Changes in tax rate.
- (6) Consolidated returns.
- (7) Adjustment of tax of certain foreign corporations.
- (f) Effective date.

§1.881–2 Taxation of foreign corporations not engaged in U.S. business.

- (a) Imposition of tax.
- (b) Fixed or determinable annual or periodical income.
- (c) Other income and gains.
- (1) Items subject to tax.
- (2) Determination of amount of gain.
- (d) Credits against tax.
- (e) Effective date.

§1.881–3 Conduit financing arrangements.

- (a) General rules and definitions.
- (1) Purpose and scope.
- (2) Definitions.
- (i) Financing arrangement.
- (A) In general.
- (B) Special rule for related parties.
- (ii) Financing transaction.
- (A) In general.
- (B) Limitation on inclusion of stock or similar interests.
- (iii) Conduit entity.
- (iv) Conduit financing arrangement.
- (v) Related.
- (3) Disregard of participation of conduit entity.
- (i) Authority of district director.
- (ii) Effect of disregarding conduit entity.
- (A) In general.
- (B) Character of payments made by the financed entity.

- (C) Effect of income tax treaties.
- (D) Effect on withholding tax.
- (E) Special rule for a financing entity that is unrelated to both intermediate entity and financed entity.
- (iii) Limitation on taxpayers’s use of this section.
- (4) Standard for treatment as a conduit entity.
- (i) In general.
- (ii) Multiple intermediate entities.
- (A) In general.
- (B) Special rule for related persons.
- (b) Determination of whether participation of intermediate entity is pursuant to a tax avoidance plan.
- (1) In general.
- (2) Factors taken into account in determining the presence or absence of a tax avoidance purpose.
- (i) Significant reduction in tax.
- (ii) Ability to make the advance.
- (iii) Time period between financing transactions.
- (iv) Financing transactions in the ordinary course of business.
- (3) Presumption if significant financing activities performed by a related intermediate entity.
- (i) General rule.
- (ii) Significant financing activities.
- (A) Active rents or royalties.
- (B) Active risk management.
- (c) Determination of whether an unrelated intermediate entity would not have participated in financing arrangement on substantially same terms.
- (1) In general.
- (2) Effect of guarantee.
- (i) In general.
- (ii) Definition of guarantee.
- (d) Determination of amount of tax liability.
- (1) Amount of payment subject to recharacterization.
- (i) In general.
- (ii) Determination of principal amount.
- (A) In general.
- (B) Debt instruments and certain stock.
- (C) Partnership and trust interests.
- (D) Leases and licenses.
- (2) Rate of tax.
- (e) Examples.
- (f) Effective date.

§1.881–4 Recordkeeping requirements concerning conduit financing arrangements.

- (a) Scope.
- (b) Recordkeeping requirements.

- (1) In general.
- (2) Application of sections 6038 and 6038A.
- (c) Records to be maintained.
 - (1) In general.
 - (2) Additional documents.
- (3) Effect of record maintenance requirement.
- (d) Effective date.

§1.881-3 Conduit financing arrangements.

(a) *General rules and definitions—*

(1) *Purpose and scope.* Pursuant to the authority of section 7701(l), this section provides rules that permit the district director to disregard, for purposes of section 881, the participation of one or more intermediate entities in a financing arrangement where such entities are acting as conduit entities. For purposes of this section, any reference to tax imposed under section 881 includes, except as otherwise provided and as the context may require, a reference to tax imposed under sections 871 or 884(f)(1)(A) or required to be withheld under section 1441 or 1442. See §1.881-4 for record-keeping requirements concerning financing arrangements. See §§1.1441-3(j) and 1.1441-7(d) for withholding rules applicable to conduit financing arrangements.

(2) *Definitions.* The following definitions apply for purposes of this section and §§1.881-4, 1.1441-3(j) and 1.1441-7(d).

(i) *Financing arrangement—(A) In general.* Financing arrangement means a series of transactions by which one person (the financing entity) advances money or other property, or grants rights to use property, and another person (the financed entity) receives money or other property, or rights to use property, if the advance and receipt are effected through one or more other persons (intermediate entities) and, except in cases to which paragraph (a)(2)-(i)(B) of this section applies, there are financing transactions linking the financing entity, each of the intermediate entities, and the financed entity. A transfer of money or other property in satisfaction of a repayment obligation is not an advance of money or other property. A financing arrangement exists regardless of the order in which the transactions are entered into, but only for the period during which all of the financing transactions coexist. See *Examples 1, 2, and 3* of paragraph (e) of

this section for illustrations of the term financing arrangement.

(B) *Special rule for related parties.* If two (or more) financing transactions involving two (or more) related persons would form part of a financing arrangement but for the absence of a financing transaction between the related persons, the district director may treat the related persons as a single intermediate entity if he determines that one of the principal purposes for the structure of the financing transactions is to prevent the characterization of such arrangement as a financing arrangement. This determination shall be based upon all of the facts and circumstances, including, without limitation, the factors set forth in paragraph (b)(2) of this section. See *Examples 4 and 5* of paragraph (e) of this section for illustrations of this paragraph (a)(2)(i)(B).

(ii) *Financing transaction—(A) In general.* Financing transaction means—

- (1) Debt;
- (2) Stock in a corporation (or a similar interest in a partnership or trust) that meets the requirements of paragraph (a)(2)(ii)(B) of this section;

- (3) Any lease or license; or
- (4) Any other transaction (including an interest in a trust described in sections 671 through 679) pursuant to which a person makes an advance of money or other property or grants rights to use property to a transferee who is obligated to repay or return a substantial portion of the money or other property advanced, or the equivalent in value. This paragraph (a)(2)(ii)(A)(4) shall not apply to the posting of collateral unless the collateral consists of cash or the person holding the collateral is permitted to reduce the collateral to cash (through a transfer, grant of a security interest or similar transaction) prior to default on the financing transaction secured by the collateral.

(B) *Limitation on inclusion of stock or similar interests—(1) In general.* Stock in a corporation (or a similar interest in a partnership or trust) will constitute a financing transaction only if one of the following conditions is satisfied—

- (i) The issuer is required to redeem the stock or similar interest at a specified time or the holder has the right to require the issuer to redeem the stock or similar interest or to make any other payment with respect to the stock or similar interest;

(ii) The issuer has the right to redeem the stock or similar interest, but only if, based on all of the facts and circumstances as of the issue date, redemption pursuant to that right is more likely than not to occur; or

(iii) The owner of the stock or similar interest has the right to require a person related to the issuer (or any other person who is acting pursuant to a plan or arrangement with the issuer) to acquire the stock or similar interest or make a payment with respect to the stock or similar interest.

(2) *Rules of special application—(i) Existence of a right.* For purposes of this paragraph (a)(2)(ii)(B), a person will be considered to have a right to cause a redemption or payment if the person has the right (other than rights arising, in the ordinary course, between the date that a payment is declared and the date that a payment is made) to enforce the payment through a legal proceeding or to cause the issuer to be liquidated if it fails to redeem the interest or to make a payment. A person will not be considered to have a right to force a redemption or a payment if the right is derived solely from ownership of a controlling interest in the issuer in cases where the control does not arise from a default or similar contingency under the instrument. The person is considered to have such a right if the person has the right as of the issue date or, as of the issue date, it is more likely than not that the person will receive such a right, whether through the occurrence of a contingency or otherwise.

(ii) *Restrictions on payment.* The fact that the issuer does not have the legally available funds to redeem the stock or similar interest, or that the payments are to be made in a blocked currency, will not affect the determinations made pursuant to this paragraph (a)(2)(ii)(B).

(iii) *Conduit entity* means an intermediate entity whose participation in the financing arrangement may be disregarded in whole or in part pursuant to this section, whether or not the district director has made a determination that the intermediate entity should be disregarded under paragraph (a)(3)-(i) of this section.

(iv) *Conduit financing arrangement* means a financing arrangement that is effected through one or more conduit entities.

(v) *Related* means related within the meaning of sections 267(b) or 707(b)-

(1), or controlled within the meaning of section 482, and the regulations under those sections. For purposes of determining whether a person is related to another person, the constructive ownership rules of section 318 shall apply, and the attribution rules of section 267(c) also shall apply to the extent they attribute ownership to persons to whom section 318 does not attribute ownership.

(3) *Disregard of participation of conduit entity*—(i) *Authority of district director.* The district director may determine that the participation of a conduit entity in a conduit financing arrangement should be disregarded for purposes of section 881. For this purpose, an intermediate entity will constitute a conduit entity if it meets the standards of paragraph (a)(4) of this section. The district director has discretion to determine the manner in which the standards of paragraph (a)(4) of this section apply, including the financing transactions and parties composing the financing arrangement.

(ii) *Effect of disregarding conduit entity*—(A) *In general.* If the district director determines that the participation of a conduit entity in a financing arrangement should be disregarded, the financing arrangement is recharacterized as a transaction directly between the remaining parties to the financing arrangement (in most cases, the financed entity and the financing entity) for purposes of section 881. To the extent that a disregarded conduit entity actually receives or makes payments pursuant to a conduit financing arrangement, it is treated as an agent of the financing entity. Except as otherwise provided, the recharacterization of the conduit financing arrangement also applies for purposes of sections 871, 884(f)(1)(A), 1441, and 1442 and other procedural provisions relating to those sections. This recharacterization will not otherwise affect a taxpayer's Federal income tax liability under any substantive provisions of the Internal Revenue Code. Thus, for example, the recharacterization generally applies for purposes of section 1461, in order to impose liability on a withholding agent who fails to withhold as required under §1.1441-3(j), but not for purposes of §1.882-5.

(B) *Character of payments made by the financed entity.* If the participation of a conduit financing arrangement is disregarded under this paragraph (a)(3), payments made by the financed entity

generally shall be characterized by reference to the character (e.g., interest or rent) of the payments made to the financing entity. However, if the financing transaction to which the financing entity is a party is a transaction described in paragraph (a)(2)(ii)(A)(2) or (4) of this section that gives rise to payments that would not be deductible if paid by the financed entity, the character of the payments made by the financed entity will not be affected by the disregard of the participation of a conduit entity. The characterization provided by this paragraph (a)(3)(ii)(B) does not, however, extend to qualification of a payment for any exemption from withholding tax under the Internal Revenue Code or a provision of any applicable tax treaty if such qualification depends on the terms of, or other similar facts or circumstances relating to, the financing transaction to which the financing entity is a party that do not apply to the financing transaction to which the financed entity is a party. Thus, for example, payments made by a financed entity that is not a bank cannot qualify for the exemption provided by section 881(i) of the Code even if the loan between the financed entity and the conduit entity is a bank deposit.

(C) *Effect of income tax treaties.* Where the participation of a conduit entity in a conduit financing arrangement is disregarded pursuant to this section, it is disregarded for all purposes of section 881, including for purposes of applying any relevant income tax treaties. Accordingly, the conduit entity may not claim the benefits of a tax treaty between its country of residence and the United States to reduce the amount of tax due under section 881 with respect to payments made pursuant to the conduit financing arrangement. The financing entity may, however, claim the benefits of any income tax treaty under which it is entitled to benefits in order to reduce the rate of tax on payments made pursuant to the conduit financing arrangement that are recharacterized in accordance with paragraph (a)(3)(ii)(B) of this section.

(D) *Effect on withholding tax.* For the effect of recharacterization on withholding obligations, see §§1.1441-3(j) and 1.1441-7(d).

(E) *Special rule for a financing entity that is unrelated to both intermediate entity and financed entity*—(1) *Liability of financing entity.* Notwithstanding the fact that a financing

arrangement is a conduit financing arrangement, a financing entity that is unrelated to the financed entity and the conduit entity (or entities) shall not itself be liable for tax under section 881 unless the financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement. But see §1.1441-3(j) for the withholding agent's withholding obligations.

(2) *Financing entity's knowledge*—(i) *In general.* A financing entity knows or has reason to know that the financing arrangement is a conduit financing arrangement only if the financing entity knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A person that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(ii) *Presumption regarding financing entity's knowledge.* It shall be presumed that the financing entity does not know or have reason to know that the financing arrangement is a conduit financing arrangement if the financing entity is unrelated to all other parties to the financing arrangement and the financing entity establishes that the intermediate entity who is a party to the financing transaction with the financing entity is actively engaged in a substantial trade or business. An intermediate entity will not be considered to be engaged in a trade or business if its business is making or managing investments, unless the intermediate entity is actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. An intermediate entity's trade or business is substantial if it is reasonable for the financing entity to expect that the intermediate entity will be able to make payments under the financing transaction out of the cash flow of that trade or business. This presumption may be rebutted if the district director establishes that the financing entity knew or had reason to know that the financing arrangement is a conduit

financing arrangement. See *Example 6* of paragraph (e) of this section for an illustration of the rules of this paragraph (a)(3)(ii)(E).

(iii) *Limitation on taxpayer's use of this section.* A taxpayer may not apply this section to reduce the amount of its Federal income tax liability by disregarding the form of its financing transactions for Federal income tax purposes or by compelling the district director to do so. See, however, paragraph (b)(2)(i) of this section for rules regarding the taxpayer's ability to show that the participation of one or more intermediate entities results in no significant reduction in tax.

(4) *Standard for treatment as a conduit entity*—(i) *In general.* An intermediate entity is a conduit entity with respect to a financing arrangement if—

(A) The participation of the intermediate entity (or entities) in the financing arrangement reduces the tax imposed by section 881 (determined by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would have been imposed under paragraph (d) of this section);

(B) The participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan; and

(C) Either —

(1) The intermediate entity is related to the financing entity or the financed entity; or

(2) The intermediate entity would not have participated in the financing arrangement on substantially the same terms but for the fact that the financing entity engaged in the financing transaction with the intermediate entity.

(ii) *Multiple intermediate entities*—(A) *In general.* If a financing arrangement involves multiple intermediate entities, the district director will determine whether each of the intermediate entities is a conduit entity. The district director will make the determination by applying the special rules for multiple intermediate entities provided in this section or, if no special rules are provided, applying principles consistent with those of paragraph (a)(4)(i) of this section to each of the intermediate entities in the financing arrangement.

(B) *Special rule for related persons.* The district director may treat related intermediate entities as a single intermediate entity if he determines that one

of the principal purposes for the involvement of multiple intermediate entities in the financing arrangement is to prevent the characterization of an intermediate entity as a conduit entity, to reduce the portion of a payment that is subject to withholding tax or otherwise to circumvent the provisions of this section. This determination shall be based upon all of the facts and circumstances, including, but not limited to, the factors set forth in paragraph (b)(2) of this section. If a district director determines that related persons are to be treated as a single intermediate entity, financing transactions between such related parties that are part of the conduit financing arrangement shall be disregarded for purposes of applying this section. See *Examples 7* and *8* of paragraph (e) of this section for illustrations of the rules of this paragraph (a)(4)(ii).

(b) *Determination of whether participation of intermediate entity is pursuant to a tax avoidance plan*—(1) *In general.* A tax avoidance plan is a plan one of the principal purposes of which is the avoidance of tax imposed by section 881. Avoidance of the tax imposed by section 881 may be one of the principal purposes for such a plan even though it is outweighed by other purposes (taken together or separately). In this regard, the only relevant purposes are those pertaining to the participation of the intermediate entity in the financing arrangement and not those pertaining to the existence of a financing arrangement as a whole. The plan may be formal or informal, written or oral, and may involve any one or more of the parties to the financing arrangement. The plan must be in existence no later than the last date that any of the financing transactions comprising the financing arrangement is entered into. The district director may infer the existence of a tax avoidance plan from the facts and circumstances. In determining whether there is a tax avoidance plan, the district director will weigh all relevant evidence regarding the purposes for the intermediate entity's participation in the financing arrangement. See *Examples 11* and *12* of paragraph (e) of this section for illustrations of the rule of this paragraph (b)(1).

(2) *Factors taken into account in determining the presence or absence of a tax avoidance purpose.* The factors described in paragraphs (b)(2)(i) through (iv) of this section are among

the facts and circumstances taken into account in determining whether the participation of an intermediate entity in a financing arrangement has as one of its principal purposes the avoidance of tax imposed by section 881.

(i) *Significant reduction in tax.* The district director will consider whether the participation of the intermediate entity (or entities) in the financing arrangement significantly reduces the tax that otherwise would have been imposed under section 881. The fact that an intermediate entity is a resident of a country that has an income tax treaty with the United States that significantly reduces the tax that otherwise would have been imposed under section 881 is not sufficient, by itself, to establish the existence of a tax avoidance plan. The determination of whether the participation of an intermediate entity significantly reduces the tax generally is made by comparing the aggregate tax imposed under section 881 on payments made on financing transactions making up the financing arrangement with the tax that would be imposed under paragraph (d) of this section. However, the taxpayer is not barred from presenting evidence that the financing entity, as determined by the district director, was itself an intermediate entity and another entity should be treated as the financing entity for purposes of applying this test. A reduction in the absolute amount of tax may be significant even if the reduction in rate is not. A reduction in the amount of tax may be significant if the reduction is large in absolute terms or in relative terms. See *Examples 13, 14* and *15* of paragraph (e) of this section for illustrations of this factor.

(ii) *Ability to make the advance.* The district director will consider whether the intermediate entity had sufficient available money or other property of its own to have made the advance to the financed entity without the advance of money or other property to it by the financing entity (or in the case of multiple intermediate entities, whether each of the intermediate entities had sufficient available money or other property of its own to have made the advance to either the financed entity or another intermediate entity without the advance of money or other property to it by either the financing entity or another intermediate entity).

(iii) *Time period between financing transactions.* The district director will

consider the length of the period of time that separates the advances of money or other property, or the grants of rights to use property, by the financing entity to the intermediate entity (in the case of multiple intermediate entities, from one intermediate entity to another), and ultimately by the intermediate entity to the financed entity. A short period of time is evidence of the existence of a tax avoidance plan while a long period of time is evidence that there is not a tax avoidance plan. See *Example 16* of paragraph (e) of this section for an illustration of this factor.

(iv) *Financing transactions in the ordinary course of business.* If the parties to the financing transaction are related, the district director will consider whether the financing transaction occurs in the ordinary course of the active conduct of complementary or integrated trades or businesses engaged in by these entities. The fact that a financing transaction is described in this paragraph (b)(2)(iv) is evidence that the participation of the parties to that transaction in the financing arrangement is not pursuant to a tax avoidance plan. A loan will not be considered to occur in the ordinary course of the active conduct of complementary or integrated trades or businesses unless the loan is a trade receivable or the parties to the transaction are actively engaged in a banking, insurance, financing or similar trade or business and such business consists predominantly of transactions with customers who are not related persons. See *Example 17* of paragraph (e) of this section for an illustration of this factor.

(3) *Presumption if significant financing activities performed by a related intermediate entity*—(i) *General rule.* It shall be presumed that the participation of an intermediate entity (or entities) in a financing arrangement is not pursuant to a tax avoidance plan if the intermediate entity is related to either or both the financing entity or the financed entity and the intermediate entity performs significant financing activities with respect to the financing transactions forming part of the financing arrangement to which it is a party. This presumption may be rebutted if the district director establishes that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. See *Examples 21, 22 and 23* of paragraph

(e) of this section for illustrations of this presumption.

(ii) *Significant financing activities.* For purposes of this paragraph (b)(3), an intermediate entity performs significant financing activities with respect to such financing transactions only if the financing transactions satisfy the requirements of either paragraph (b)(3)-(ii)(A) or (B) of this section.

(A) *Active rents or royalties.* An intermediate entity performs significant financing activities with respect to leases or licenses if rents or royalties earned with respect to such leases or licenses are derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A), to be applied by substituting the term *intermediate entity* for the term *controlled foreign corporation*.

(B) *Active risk management*—(1) *In general.* An intermediate entity is considered to perform significant financing activities with respect to financing transactions only if officers and employees of the intermediate entity participate actively and materially in arranging the intermediate entity's participation in such financing transactions (other than financing transactions described in paragraph (b)(3)(ii)(B)(3) of this section) and perform the business activity and risk management activities described in paragraph (b)(3)(ii)(B)(2) of this section with respect to such financing transactions, and the participation of the intermediate entity in the financing transactions produces (or reasonably can be expected to produce) efficiency savings by reducing transaction costs and overhead and other fixed costs.

(2) *Business activity and risk management requirements.* An intermediate entity will be considered to perform significant financing activities only if, within the country in which the intermediate entity is organized (or, if different, within the country with respect to which the intermediate entity is claiming the benefits of a tax treaty), its officers and employees—

(i) Exercise management over, and actively conduct, the day-to-day operations of the intermediate entity. Such operations must consist of a substantial trade or business or the supervision, administration and financing for a substantial group of related persons; and

(ii) Actively manage, on an ongoing basis, material market risks arising

from such financing transactions as an integral part of the management of the intermediate entity's financial and capital requirements (including management of risks of currency and interest rate fluctuations) and management of the intermediate entity's short-term investments of working capital by entering into transactions with unrelated persons.

(3) *Special rule for trade receivables and payables entered into in the ordinary course of business.* If the activities of the intermediate entity consist in whole or in part of cash management for a controlled group of which the intermediate entity is a member, then employees of the intermediate entity need not have participated in arranging any such financing transactions that arise in the ordinary course of a substantial trade or business of either the financed entity or the financing entity. Officers or employees of the financing entity or financed entity, however, must have participated actively and materially in arranging the transaction that gave rise to the trade receivable or trade payable. Cash management includes the operation of a sweep account whereby the intermediate entity nets intercompany trade payables and receivables arising from transactions among the other members of the controlled group and between members of the controlled group and unrelated persons.

(4) *Activities of officers and employees of related persons.* Except as provided in paragraph (b)(3)(ii)(B)(3) of this section, in applying this paragraph (b)(3)(ii)(B), the activities of an officer or employee of an intermediate entity will not constitute significant financing activities if any officer or employee of a related person participated materially in any of the activities described in this paragraph, other than to approve any guarantee of a financing transaction or to exercise general supervision and control over the policies of the intermediate entity.

(c) *Determination of whether an unrelated intermediate entity would not have participated in financing arrangement on substantially the same terms*—

(1) *In general.* The determination of whether an intermediate entity would not have participated in a financing arrangement on substantially the same terms but for the financing transaction between the financing entity and the intermediate entity shall be based upon all of the facts and circumstances.

(2) *Effect of guarantee*—(i) *In general*. The district director may presume that the intermediate entity would not have participated in the financing arrangement on substantially the same terms if there is a guarantee of the financed entity's liability to the intermediate entity (or in the case of multiple intermediate entities, a guarantee of the intermediate entity's liability to the intermediate entity that advanced money or property, or granted rights to use other property). However, a guarantee that was neither in existence nor contemplated on the last date that any of the financing transactions comprising the financing arrangement is entered into does not give rise to this presumption. A taxpayer may rebut this presumption by producing clear and convincing evidence that the intermediate entity would have participated in the financing transaction with the financed entity on substantially the same terms even if the financing entity had not entered into a financing transaction with the intermediate entity.

(ii) *Definition of guarantee*. For the purposes of this paragraph (c)(2), a guarantee is any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another person's obligation with respect to a financing transaction. The term shall be interpreted in accordance with the definition of the term in section 163(j)(6)(D)(iii).

(d) *Determination of amount of tax liability*—(1) *Amount of payment subject to recharacterization*—(i) *In general*. If a financing arrangement is a conduit financing arrangement, a portion of each payment made by the financed entity with respect to the financing transactions that comprise the conduit financing arrangement shall be recharacterized as a transaction directly between the financed entity and the financing entity. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is less than or equal to the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement, the entire amount of the payment shall be so recharacterized. If the aggregate principal amount of the financing transaction(s) to which the financed entity is a party is greater than the aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrange-

ment, then the recharacterized portion shall be determined by multiplying the payment by a fraction the numerator of which is equal to the lowest aggregate principal amount of the financing transaction(s) linking any of the parties to the financing arrangement (other than financing transactions that are disregarded pursuant to paragraphs (a)(2)-(i)(B) and (a)(4)(ii)(B) of this section) and the denominator of which is the aggregate principal amount of the financing transaction(s) to which the financed entity is a party. In the case of financing transactions the principal amount of which is subject to adjustment, the fraction shall be determined using the average outstanding principal amounts for the period to which the payment relates. The average principal amount may be computed using any method applied consistently that reflects with reasonable accuracy the amount outstanding for the period. See *Example 24* of paragraph (e) of this section for an illustration of the calculation of the amount of tax liability.

(ii) *Determination of principal amount*—(A) *In general*. Unless otherwise provided in this paragraph (d)(1)(ii), the principal amount equals the amount of money advanced, or the fair market value of other property advanced or subject to a lease or license, in the financing transaction. In general, fair market value is calculated in U.S. dollars as of the close of business on the day on which the financing transaction is entered into. However, if the property advanced, or the right to use property granted, by the financing entity is the same as the property or rights received by the financed entity, the fair market value of the property or right shall be determined as of the close of business on the last date that any of the financing transactions comprising the financing arrangement is entered into. In the case of fungible property, property of the same type shall be considered to be the same property. See *Example 25* of paragraph (e) for an illustration of the calculation of the principal amount in the case of financing transactions involving fungible property. The principal amount of a financing transaction shall be subject to adjustments, as set forth in this paragraph (d)(1)(ii).

(B) *Debt instruments and certain stock*. In the case of a debt instrument or of stock that is subject to the current inclusion rules of sections 305(c)(3) or (e), the principal amount generally will

be equal to the issue price. However, if the fair market value on the issue date differs materially from the issue price, the fair market value of the debt instrument shall be used in lieu of the instrument's issue price. Appropriate adjustments will be made for accruals of original issue discount and repayments of principal (including accrued original issue discount).

(C) *Partnership and trust interests*. In the case of a partnership interest or an interest in a trust, the principal amount is equal to the fair market value of the money or property contributed to the partnership or trust in return for that partnership or trust interest.

(D) *Leases or licenses*. In the case of a lease or license, the principal amount is equal to the fair market value of the property subject to the lease or license on the date on which the lease or license is entered into. The principal amount shall be adjusted for depreciation or amortization, calculated on a basis that accurately reflects the anticipated decline in the value of the property over its life.

(2) *Rate of tax*. The rate at which tax is imposed under section 881 on the portion of the payment that is recharacterized pursuant to paragraph (d)(1) of this section is determined by reference to the nature of the recharacterized transaction, as determined under paragraphs (a)(3)(ii)(B) and (C) of this section.

(e) *Examples*. The following examples illustrate this section. For purposes of these examples, unless otherwise indicated, it is assumed that FP, a corporation organized in country N, owns all of the stock of FS, a corporation organized in country T, and DS, a corporation organized in the United States. Country T, but not country N, has an income tax treaty with the United States. The treaty exempts interest, rents and royalties paid by a resident of one state (the source state) to a resident of the other state from tax in the source state.

Example 1. Financing arrangement. (i) On January 1, 1996, BK, a bank organized in country T, lends \$1,000,000 to DS in exchange for a note issued by DS. FP guarantees to BK that DS will satisfy its repayment obligation on the loan. There are no other transactions between FP and BK.

(ii) BK's loan to DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(1) of this section. FP's guarantee of DS's repayment obligation is not a financing transaction as described in paragraphs (a)(2)(ii)(A)(1) through (4) of this section. Therefore, these transactions

do not constitute a financing arrangement as defined in paragraph (a)(2)(i) of this section.

Example 2. Financing arrangement. (i) On January 1, 1996, FP lends \$1,000,000 to DS in exchange for a note issued by DS. On January 1, 1997, FP assigns the DS note to FS in exchange for a note issued by FS. After receiving notice of the assignment, DS remits payments due under its note to FS.

(ii) The DS note held by FS and the FS note held by FP are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(I) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 3. Financing arrangement. (i) On December 1, 1994 FP creates a special purposes subsidiary, FS. On that date FP capitalizes FS with \$1,000,000 in cash and \$10,000,000 in debt from BK, a Country N bank. On January 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On August 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for \$10,000,000. DS continues to service the installment notes for FS.

(ii) The C installment note now held by FS (as well as all of the other installment notes now held by FS) and the FS note held by BK are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(I) of this section, and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section.

Example 4. Related persons treated as a single intermediate entity. (i) On January 1, 1996, FP deposits \$1,000,000 with BK, a bank that is organized in country N and is unrelated to FP and its subsidiaries. M, a corporation also organized in country N, is wholly-owned by the sole shareholder of BK but is not a bank within the meaning of section 881(c)(3)(A). On July 1, 1996, M lends \$1,000,000 to DS in exchange for a note maturing on July 1, 2006. The note is in registered form within the meaning of section 881(c)(2)(B)(i) and DS has received from M the statement required by section 881(c)(2)(B)(ii). One of the principal purposes for the absence of a financing transaction between BK and M is the avoidance of the application of this section.

(ii) The transactions described above would form a financing arrangement but for the absence of a financing transaction between BK and M. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of such arrangement as a financing arrangement, the district director may treat the financing transactions between FP and BK, and between M and DS as a financing arrangement under paragraphs (a)(2)-(i)(B) of this section. In such a case, BK and M would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(4)(ii)(B) of this section for the authority to treat BK and M as a single intermediate entity.

Example 5. Related persons treated as a single intermediate entity. (i) On January 1, 1995, FP lends \$10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes \$10,000,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock of FS2. On January 1, 1996, FS2 lends \$10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company whose most significant asset

is the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for the absence of a financing transaction between FS and FS2 is the avoidance of the application of this section.

(ii) The conditions of paragraph (a)(4)(i)(A) of this section would be satisfied with respect to the financing transactions between FP, FS, FS2 and DS but for the absence of a financing transaction between FS and FS2. However, because one of the principal purposes for the structuring of these financing transactions is to prevent characterization of an entity as a conduit, the district director may treat the financing transactions between FP and FS, and between FS2 and DS as a financing arrangement. See paragraph (a)(4)(ii)(B) of this section. In such a case, FS and FS2 would be considered a single intermediate entity for purposes of this section. See also paragraph (a)(2)(i)(B) of this section for the authority to treat FS and FS2 as a single intermediate entity.

Example 6. Presumption with respect to unrelated financing entity. (i) FP is a corporation organized in country T that is actively engaged in a substantial manufacturing business. FP has a revolving credit facility with a syndicate of banks, none of which is related to FP and FP's subsidiaries, which provides that FP may borrow up to a maximum of \$100,000,000 at a time. The revolving credit facility provides that DS and certain other subsidiaries of FP may borrow directly from the syndicate at the same interest rates as FP, but each subsidiary is required to indemnify the syndicate banks for any withholding taxes imposed on interest payments by the country in which the subsidiary is organized. BK, a bank that is organized in country N, is the agent for the syndicate. Some of the syndicate banks are organized in country N, but others are residents of country O, a country that has an income tax treaty with the United States which allows the United States to impose a tax on interest at a maximum rate of 10 percent. It is reasonable for BK and the syndicate banks to be reasonable for BK and the syndicate banks to have determined that FP will be able to meet its payment obligations on a maximum principal amount of \$100,000,000 out of the cash flow of its manufacturing business. At various times throughout 1995, FP borrows under the revolving credit facility until the outstanding principal amount reaches the maximum amount of \$100,000,000. On December 31, 1995, FP receives \$100,000,000 from a public offering of its equity. On January 1, 1996, FP pays BK \$90,000,000 to reduce the outstanding principal amount under the revolving credit facility and lends \$10,000,000 to DS. FP would have repaid the entire principal amount, and DS would have borrowed directly from the syndicate, but for the fact that DS did not want to incur the U.S. withholding tax that would have applied to payments made directly by DS to the syndicate banks.

(ii) Pursuant to paragraph (a)(3)(ii)(E)(I) of this section, even though the financing arrangement is a conduit financing arrangement (because the financing arrangement meets the standards for recharacterization in paragraph (a)(4)(i)), BK and the other syndicate banks have no section 881 liability unless they know or have reason to know that the financing arrangement is a conduit financing arrangement. Moreover, pursuant to

paragraph (a)(3)(ii)(E)(2)(ii) of this section, BK and the syndicate banks are presumed not to know that the financing arrangement is a conduit financing arrangement. The syndicate banks are unrelated to both FP and DS, and FP is actively engaged in a substantial trade or business—that is, the cash flow from FP's manufacturing business is sufficient for the banks to expect that FP will be able to make the payments required under the financing transaction. See §1.1441-3(j) for the withholding obligations of the withholding agents.

Example 7. Multiple intermediate entities—special rule for related persons. (i) On January 1, 1995, FP lends \$10,000,000 to FS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. On January 2, 1995, FS contributes \$9,900,000 to FS2, a wholly-owned subsidiary of FS organized in country T, in exchange for common stock and lends \$100,000 to FS2. On January 1, 1996, FS2 lends \$10,000,000 to DS in exchange for an 8-year note that pays interest annually at a rate of 10 percent per annum. FS is a holding company that has no significant assets other than the stock of FS2. Throughout the period that the FP-FS loan is outstanding, FS causes FS2 to make distributions to FS, most of which are used to make interest and principal payments on the FP-FS loan. Without the distributions from FS2, FS would not have had the funds with which to make payments on the FP-FS loan. One of the principal purposes for structuring the transactions between FS and FS2 as primarily a contribution of capital is to reduce the amount of the payment that would be recharacterized under paragraph (d) of this section.

(ii) Pursuant to paragraph (a)(4)(ii)(B) of this section, the district director may treat FS and FS2 as a single intermediate entity for purposes of this section since one of the principal purposes for the participation of multiple intermediate entities is to reduce the amount of the tax liability on any recharacterized payment by inserting a financing transaction with a low principal amount.

Example 8. Multiple intermediate entities. (i) On January 1, 1995, FP deposits \$1,000,000 with BK, a bank that is organized in country T and is unrelated to FP and its subsidiaries, FS and DS. On January 1, 1996, at a time when the FP-BK deposit is still outstanding, BK lends \$500,000 to BK2, a bank that is wholly-owned by BK and is organized in country T. On the same date, BK2 lends \$500,000 to FS. On July 1, 1996, FS lends \$500,000 to DS. FP pledges its deposit with BK to BK2 in support of FS' obligation to repay the BK2 loan. FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan.

(ii) The conditions of paragraphs (a)(4)(i)(A) and (B) of this section are satisfied because the participation of BK, BK2 and FS in the financing arrangement reduces the tax imposed by section 881, and FS', BK's and BK2's participation in the financing arrangement is pursuant to a tax avoidance plan. However, since BK and BK2 are unrelated to FP and DS, under paragraph (a)(4)-(i)(C)(2) of this section, BK and BK2 will be treated as conduit entities only if BK and BK2 would not have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK.

(iii) It is presumed that BK2 would not have participated in the financing arrangement on substantially the same terms but for the BK-BK2 financing transaction because FP's pledge of an

asset in support of FS' obligation to repay the BK2 loan is a guarantee within the meaning of paragraph (c)(2)(ii) of this section. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK2 will be a conduit entity.

(iv) Because BK and BK2 are related intermediate entities, the district director must determine whether one of the principal purposes for the involvement of multiple intermediate entities was to prevent characterization of an entity as a conduit entity. In making this determination, the district director may consider the fact that the involvement of two related intermediate entities prevents the presumption regarding guarantees from applying to BK. In the absence of evidence showing a business purpose for the involvement of both BK and BK2, the district director may treat BK and BK2 as a single intermediate entity for purposes of determining whether they would have participated in the financing arrangement on substantially the same terms but for the financing transaction between FP and BK. The presumption that applies to BK2 therefore will apply to BK. If the taxpayer does not rebut this presumption by clear and convincing evidence, then BK will be a conduit entity.

Example 9. Reduction of tax. (i) On February 1, 1995, FP issues debt to the public that would satisfy the requirements of section 871(h)(2)(A) (relating to obligations that are not in registered form) if issued by a U.S. person. FP lends the proceeds of the debt offering to DS in exchange for a note.

(ii) The debt issued by FP and the DS note are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(I) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The holders of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Because interest payments on the debt issued by FP would not have been subject to withholding tax if the debt had been issued by DS, there is no reduction in tax under paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 10. Reduction of tax. (i) On January 1, 1995, FP licenses to FS the rights to use a patent in the United States to manufacture product A. FS agrees to pay FP a fixed amount in royalties each year under the license. On January 1, 1996, FS sublicenses to DS the rights to use the patent in the United States. Under the sublicense, DS agrees to pay FS royalties based upon the units of product A manufactured by DS each year. Although the formula for computing the amount of royalties paid by DS to FS differs from the formula for computing the amount of royalties paid by FS to FP, each represents an arm's length rate.

(ii) Although the royalties paid by DS to FS are exempt from U.S. withholding tax, the royalty payments between FS and FP are income from U.S. sources under section 861(a)(4) subject to the 30 percent gross tax imposed by §1.881-2(b) and subject to withholding under §1.1441-2(a). Because the rate of tax imposed on royalties paid by FS to FP is the same as the rate that would have been imposed on royalties paid by DS to FP, the participation of FS in the FP-FS-DS financing arrangement does not reduce the tax imposed by section 881 within the meaning of paragraph (a)(4)(i)(A) of this section. Accordingly, FP is not a conduit entity.

Example 11. A principal purpose. (i) On January 1, 1995, FS lends \$10,000,000 to DS in

exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. As was intended at the time of the loan from FS to DS, on July 1, 1995, FP makes an interest-free demand loan of \$10,000,000 to FS. A principal purpose for FS' participation in the FP-FS-DS financing arrangement is that FS generally coordinates the financing for all of FP's subsidiaries (although FS does not engage in significant financing activities with respect to such financing transactions). However, another principal purpose for FS' participation is to allow the parties to benefit from the lower withholding tax rate provided under the income tax treaty between country T and the United States.

(ii) The financing arrangement satisfies the tax avoidance purpose requirement of paragraph (a)(4)(i)(B) of this section because FS participated in the financing arrangement pursuant to a plan one of the principal purposes of which is to allow the parties to benefit from the country T-U.S. treaty.

Example 12. A principal purpose. (i) DX is a U.S. corporation that intends to purchase property to use in its manufacturing business. FX is a partnership organized in country N that is owned in equal parts by LC1 and LC2, leasing companies that are unrelated to DX. BK, a bank organized in country N and unrelated to DX, LC1 and LC2, lends \$100,000,000 to FX to enable FX to purchase the property. On the same day, FX purchases the property and engages in a transaction with DX which is treated as a lease of the property for country N tax purposes but a loan for U.S. tax purposes. Accordingly, DX is treated as the owner of the property for U.S. tax purposes. The parties comply with the requirements of section 881(c) with respect to the debt obligation of DX to FX. FX and DX structured these transactions in this manner so that LC1 and LC2 would be entitled to accelerated depreciation deductions with respect to the property in country N and DX would be entitled to accelerated depreciation deductions in the United States. None of the parties would have participated in the transaction if the payments made by DX were subject to U.S. withholding tax.

(ii) The loan from BK to FX and from FX to DX are financing transactions and, together constitute a financing arrangement. The participation of FX in the financing arrangement reduces the tax imposed by section 881 because payments made to FX, but not BK, qualify for the portfolio interest exemption of section 881(c) because BK is a bank making an extension of credit in the ordinary course of its trade or business within the meaning of section 881(c)(3)(A). Moreover, because DX borrowed the money from FX instead of borrowing the money directly from BK to avoid the tax imposed by section 881, one of the principal purposes of the participation of FX was to avoid that tax (even though another principal purpose of the participation of FX was to allow LC1 and LC2 to take advantage of accelerated depreciation deductions in country N). Assuming that FX would not have participated in the financing arrangement on substantially the same terms but for the fact that BK loaned it \$100,000,000, FX is a conduit entity and the financing arrangement is a conduit financing arrangement.

Example 13. Significant reduction of tax. (i) FS owns all of the stock of FS1, which also is a resident of country T. FS1 owns all of the stock of DS. On January 1, 1995, FP contributes \$10,000,000 to the capital of FS in return for perpetual preferred stock. On July 1, 1995, FS lends \$10,000,000 to FS1. On January 1, 1996,

FS1 lends \$10,000,000 to DS. Under the terms of the country T-U.S. income tax treaty, a country T resident is not entitled to the reduced withholding rate on interest income provided by the treaty if the resident is entitled to specified tax benefits under country T law. Although FS1 may deduct interest paid on the loan from FS, these deductions are not pursuant to any special tax benefits provided by country T law. However, FS qualifies for one of the enumerated tax benefits pursuant to which it may deduct dividends paid with respect to the stock held by FP. Therefore, if FS had made a loan directly to DS, FS would not have been entitled to the benefits of the country T-U.S. tax treaty with respect to payments it received from DS, and such payments would have been subject to tax under section 881 at a 30 percent rate.

(ii) The FS-FS1 loan and the FS1-DS loan are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(I) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(i) of this section, the significant reduction in tax resulting from the participation of FS1 in the financing arrangement is evidence that the participation of FS1 in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 14. Significant reduction of tax. (i) FP owns 90 percent of the voting stock of FX, an unlimited liability company organized in country T. The other 10 percent of the common stock of FX is owned by FP1, a subsidiary of FP that is organized in country N. Although FX is a partnership for U.S. tax purposes, FX is entitled to the benefits of the U.S.-country T income tax treaty because FX is subject to tax in country T as a resident corporation. On January 1, 1996, FP contributes \$10,000,000 to FX in exchange for an instrument denominated as preferred stock that pays a dividend of 7 percent and that must be redeemed by FX in seven years. For U.S. tax purposes, the preferred stock is a partnership interest. On July 1, 1996, FX makes a loan of \$10,000,000 to DS in exchange for a 7-year note paying interest at 6 percent.

(ii) Because FX is required to redeem the partnership interest at a specified time, the partnership interest constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(2) of this section. Moreover, because the FX-DS note is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(I) of this section, together the transactions constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Payments of interest made directly by DS to FP and FP1 would not be eligible for the portfolio interest exemption and would not be entitled to a reduction in withholding tax pursuant to a tax treaty. Therefore, there is a significant reduction in tax resulting from the participation of FX in the financing arrangement, which is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the existence of such a plan must also be taken into account.

Example 15. Significant reduction of tax. (i) FP owns a 10 percent interest in the profits and capital of FX, a partnership organized in country N. The other 90 percent interest in FX is owned by G, an unrelated corporation that is organized in country T. FX is not engaged in business in the United States. On January 1, 1996, FP contributes \$10,000,000 to FX in exchange for

an instrument documented as perpetual subordinated debt that provides for quarterly interest payments at 9 percent per annum. Under the terms of the instrument, payments on the perpetual subordinated debt do not otherwise affect the allocation of income between the partners. FP has the right to require the liquidation of FX if FX fails to make an interest payment. For U.S. tax purposes, the perpetual subordinated debt is treated as a partnership interest in FX and the payments on the perpetual subordinated debt constitute guaranteed payments within the meaning of section 707(c). On July 1, 1996, FX makes a loan of \$10,000,000 to DS in exchange for a 7-year note paying interest at 8 percent per annum.

(ii) Because FP has the effective right to force payment of the "interest" on the perpetual subordinated debt, the instrument constitutes a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(2) of this section. Moreover, because the note between FX and DS is a financing transaction within the meaning of paragraph (a)(2)(ii)(A)(1) of this section, together the transactions are a financing arrangement within the meaning of (a)(2)(i) of this section. Without regard to this section, 90 percent of each interest payment received by FX would be treated as exempt from U.S. withholding tax because it is beneficially owned by G, while 10 percent would be subject to a 30 percent withholding tax because beneficially owned by FP. If FP held directly the note issued by DS, 100 percent of the interest payments on the note would have been subject to the 30 percent withholding tax. The significant reduction in the tax imposed by section 881 resulting from the participation of FX in the financing arrangement is evidence that the participation of FX in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 16. Time period between transactions. (i) On January 1, 1995, FP lends \$10,000,000 to FS in exchange for a 10-year note that pays no interest annually. When the note matures, FS is obligated to pay \$24,000,000 to FP. On January 1, 1996, FS lends \$10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 10 percent per annum.

(ii) The FS note held by FP and the DS note held by FS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section and together constitute a financing arrangement within the meaning of (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iii) of this section, the short period of time (twelve months) between the loan by FP to FS and the loan by FS to DS is evidence that the participation of FS in the financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 17. Financing transactions in the ordinary course of business. (i) FP is a holding company. FS is actively engaged in country T in the business of manufacturing and selling product A. DS manufactures product B, a principal component in which is product A. FS' business activity is substantial. On January 1, 1995, FP lends \$100,000,000 to FS to finance FS' business operations. On January 1, 1996, FS ships \$30,000,000 of product A to DS. In return, FS creates an interest-bearing account receivable on its books. FS' shipment is in the ordinary course of the active conduct of its trade or business

(which is complementary to DS' trade or business.)

(ii) The loan from FP to FS and the accounts receivable opened by FS for a payment owed by DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to paragraph (b)(2)(iv) of this section, the fact that DS' liability to FS is created in the ordinary course of the active conduct of DS' trade or business that is complementary to a business actively engaged in by DS is evidence that the participation of FS in the financing arrangement is not pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account.

Example 18. Tax avoidance plan—other factors. (i) On February 1, 1995, FP issues debt in Country N that is in registered form within the meaning of section 881(c)(3)(A). The FP debt would satisfy the requirements of section 881(c) if the debt were issued by a U.S. person and the withholding agent received the certification required by section 871(h)(2)(B)(ii). The purchasers of the debt are financial institutions and there is no reason to believe that they would not furnish Forms W-8. On March 1, 1995, FP lends a portion of the proceeds of the offering to DS.

(ii) The FP debt and the loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. The owners of the FP debt are the financing entities, FP is the intermediate entity and DS is the financed entity. Interest payments on the debt issued by FP would be subject to withholding tax if the debt were issued by DS, unless DS received all necessary Forms W-8. Therefore, the participation of FP in the financing arrangement potentially reduces the tax imposed by section 881(a). However, because it is reasonable to assume that the purchasers of the FP debt would have provided certifications in order to avoid the withholding tax imposed by section 881, there is not a tax avoidance plan. Accordingly, FP is not a conduit entity.

Example 19. Tax avoidance plan—other factors. (i) Over a period of years, FP has maintained a deposit with BK, a bank organized in the United States, that is unrelated to FP and its subsidiaries. FP often sells goods and purchases raw materials in the United States. FP opened the bank account with BK in order to facilitate this business and the amounts it maintains in the account are reasonably related to its dollar-denominated working capital needs. On January 1, 1995, BK lends \$5,000,000 to DS. After the loan is made, the balance in FP's bank account remains within a range appropriate to meet FP's working capital needs.

(ii) FP's deposit with BK and BK's loan to DS are financing transactions within the meaning of paragraph (a)(2)(ii)(A)(1) of this section and together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. Pursuant to section 881(i), interest paid by BK to FP with respect to the bank deposit is exempt from withholding tax. Interest paid directly by DS to FP would not be exempt from withholding tax under section 881(i) and therefore would be subject to a 30% withholding tax. Accordingly, there is a significant reduction in the tax imposed by section 881, which is evidence of the existence of a tax avoidance

plan. See paragraph (b)(2)(i) of this section. However, the district director also will consider the fact that FP historically has maintained an account with BK to meet its working capital needs and that, prior to and after BK's loan to DS, the balance within the account remains within a range appropriate to meet those business needs as evidence that the participation of BK in the FP-BK-DS financing arrangement is not pursuant to a tax avoidance plan. In determining the presence or absence of a tax avoidance plan, all relevant facts will be taken into account.

Example 20. Tax avoidance plan—other factors. (i) Assume the same facts as in *Example 19*, except that on January 1, 2000, FP's deposit with BK substantially exceeds FP's expected working capital needs and on January 2, 2000, BK lends additional funds to DS. Assume also that BK's loan to DS provides BK with a right of offset against FP's deposit. Finally, assume that FP would have lent the funds to DS directly but for the imposition of the withholding tax on payments made directly to FP by DS.

(ii) As in *Example 19*, the transactions in paragraph (i) of this *Example 20* are a financing arrangement within the meaning of paragraph (a)(2)(i) and the participation of the BK reduces the section 881 tax. In this case, the presence of funds substantially in excess of FP's working capital needs and the fact that FP would have been willing to lend funds directly to DS if not for the withholding tax are evidence that the participation of BK in the FP-BK-FS financing arrangement is pursuant to a tax avoidance plan. However, other facts relevant to the presence of such a plan must also be taken into account. Even if the district director determines that the participation of BK in the financing arrangement is pursuant to a tax avoidance plan, BK may not be treated as a conduit entity unless BK would not have participated in the financing arrangement on substantially the same terms in the absence of FP's deposit with BK. BK's right of offset against FP's deposit (a form of guarantee of BK's loan to DS) creates a presumption that BK would not have made the loan to DS on substantially the same terms in the absence of FP's deposit with BK. If the taxpayer overcomes the presumption by clear and convincing evidence, BK will not be a conduit entity.

Example 21. Significant financing activities. (i) FS is responsible for coordinating the financing of all of the subsidiaries of FP, which are engaged in substantial trades or businesses and are located in country T, country N, and the United States. FS maintains a centralized cash management accounting system for FP and its subsidiaries in which it records all intercompany payables and receivables; these payables and receivables ultimately are reduced to a single balance either due from or owing to FS and each of FP's subsidiaries. FS is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. FS must borrow any cash necessary to meet those external obligations and invests any excess cash for the benefit of the FP group. FS enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of FS are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. FS has 50 employees, including clerical and other back office personnel, located in country T. At the request of DS, on January 1, 1995, FS pays a supplier \$1,000,000 for materials delivered to DS and charges DS an open

account receivable for this amount. On February 3, 1995, FS reverses the account receivable from DS to FS when DS delivers to FP goods with a value of \$1,000,000.

(ii) The accounts payable from DS to FS and from FS to other subsidiaries of FP constitute financing transactions within the meaning of paragraph (a)(2)(ii)(A)(I) of this section, and the transactions together constitute a financing arrangement within the meaning of paragraph (a)(2)(i) of this section. FS's activities constitute significant financing activities with respect to the financing transactions even though FS did not actively and materially participate in arranging the financing transactions because the financing transactions consisted of trade receivables and trade payables that were ordinary and necessary to carry on the trades or businesses of DS and the other subsidiaries of FP. Accordingly, pursuant to paragraph (b)(3)(i) of this section, FS' participation in the financing arrangement is presumed not to be pursuant to a tax avoidance plan.

Example 22. Significant financing activities—active risk management. (i) The facts are the same as in *Example 21*, except that, in addition to its short-term funding needs, DS needs long-term financing to fund an acquisition of another U.S. company; the acquisition is scheduled to close on January 15, 1995. FS has a revolving credit agreement with a syndicate of banks located in Country N. On January 14, 1995, FS borrows ¥10 billion for 10 years under the revolving credit agreement, paying yen LIBOR plus 50 basis points on a quarterly basis. FS enters into a currency swap with BK, an unrelated bank that is not a member of the syndicate, under which FS will pay BK ¥10 billion and will receive \$100 million on January 15, 1995; these payments will be reversed on January 15, 2004. FS will pay BK U.S. dollar LIBOR plus 50 basis points on a notional principal amount of \$100 million semi-annually and will receive yen LIBOR plus 50 basis points on a notional principal amount of ¥10 billion quarterly. Upon the closing of the acquisition on January 15, 1995, DS borrows \$100 million from FS for 10 years, paying U.S. dollar LIBOR plus 50 basis points semiannually.

(ii) Although FS performs significant financing activities with respect to certain financing transactions to which it is a party, FS does not perform significant financing activities with respect to the financing transactions between FS and the syndicate of banks and between FS and DS because FS has eliminated all material market risks arising from those financing transactions through its currency swap with BK. Accordingly, the financing arrangement does not benefit from the presumption of paragraph (b)(3)(i) of this section and the district director must determine whether the participation of FS in the financing arrangement is pursuant to a tax avoidance plan on the basis of all the facts and circumstances. However, if additional facts indicated that FS reviews its currency swaps daily to determine whether they are the most cost efficient way of managing their currency risk and, as a result, frequently terminates swaps in favor of entering into more cost efficient hedging arrangements with unrelated parties, FS would be considered to perform significant financing activities and FS' participation in the financing arrangements would not be pursuant to a tax avoidance plan.

Example 23. Significant financing activities—presumption rebutted. (i) The facts are the same as in *Example 21*, except that, on January 1,

1995, FP lends to FS DM 15,000,000 (worth \$10,000,000) in exchange for a 10 year note that pays interest annually at a rate of 5 percent per annum. Also, on March 15, 1995, FS lends \$10,000,000 to DS in exchange for a 10-year note that pays interest annually at a rate of 8 percent per annum. FS would not have had sufficient funds to make the loan to DS without the loan from FP. FS does not enter into any long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

(ii) Because FS performs significant financing activities with respect to the financing transactions between FS, DS and FP, the participation of FS in the financing arrangement is presumed not to be pursuant to a tax avoidance plan. The district director may rebut this presumption by establishing that the participation of FS is pursuant to a tax avoidance plan, based on all the facts and circumstances. The mere fact that FS is a resident of country T is not sufficient to establish the existence of a tax avoidance plan. However, the existence of a plan can be inferred from other factors in addition to the fact that FS is a resident of country T. For example, the loans are made within a short time period and FS would not have been able to make the loan to DS without the loan from FP.

Example 24. Determination of amount of tax liability. (i) On January 1, 1996, FP makes two three-year installment loans of \$250,000 each to FS that pay interest at a rate of 9 percent per annum. The loans are self-amortizing with payments on each loan of \$7,950 per month. On the same date, FS lends \$1,000,000 to DS in exchange for a two-year note that pays interest semi-annually at a rate of 10 percent per annum, beginning on June 30, 1996. The FS-DS loan is not self-amortizing. Assume that for the period of January 1, 1996 through June 30, 1996, the average principal amount of the financing transactions between FP and FS that comprise the financing arrangement is \$469,319. Further, assume that for the period of July 1, 1996 through December 31, 1996, the average principal amount of the financing transactions between FP and FS is \$393,632. The average principal amount of the financing transaction between FS and DS for the same periods is \$1,000,000. The district director determines that the financing transactions between FP and FS, and FS and DS, are a conduit financing arrangement.

(ii) Pursuant to paragraph (d)(1)(i) of this section, the portion of the \$50,000 interest payment made by DS to FS on June 30, 1996, that is recharacterized as a payment to FP is \$23,450 computed as follows: $(\$50,000 \times \$469,319/\$1,000,000) = \$23,450$. The portion of the interest payment made on December 31, 1996 that is recharacterized as a payment to FP is \$19,650, computed as follows: $(\$50,000 \times \$393,632/\$1,000,000) = \$19,650$. Furthermore, under §1.1441-3(j), DS is liable for withholding tax at a 30 percent rate on the portion of the \$50,000 payment to FS that is recharacterized as a payment to FP, i.e., \$7,035 with respect to the June 30, 1996 payment and \$5,895 with respect to the December 31, 1996 payment.

Example 25. Determination of principal amount. (i) FP lends DM 5,000,000 to FS in exchange for a ten year note that pays interest semi-annually at a rate of 8 percent per annum. Six months later, pursuant to a tax avoidance plan, FS lends DM 10,000,000 to DS in exchange for a 10 year note that pays interest

semi-annually at a rate of 10 percent per annum. At the time FP makes its loan to FS, the exchange rate is DM 1.5/\$1. At the time FS makes its loan to DS the exchange rate is DM 1.4/\$1.

(ii) FP's loan to FS and FS' loan to DS are financing transactions and together constitute a financing arrangement. Furthermore, because the participation of FS reduces the tax imposed under section 881 and FS' participation is pursuant to a tax avoidance plan, the financing arrangement is a conduit financing arrangement.

(iii) Pursuant to paragraph (d)(1)(i) of this section, the amount subject to recharacterization is a fraction the numerator of which is the lowest aggregate principal amount advanced and the denominator of which is the principal amount advanced from FS to DS. Because the property advanced in these financing transactions is the same type of fungible property, under paragraph (d)(1)(ii)(A) of this section, both are valued on the date of the last financing transaction. Accordingly, the portion of the payments of interest that is recharacterized is $(DM\ 5,000,000 \times DM\ 1.4/\$1)/(DM\ 10,000,000 \times DM\ 1.4/\$1)$ or 0.5.

(f) *Effective date.* This section is effective for payments made by financed entities on or after September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

§1.881-4 Recordkeeping requirements concerning conduit financing arrangements.

(a) *Scope.* This section provides rules for the maintenance of records concerning certain financing arrangements to which the provisions of §1.881-3 apply.

(b) *Recordkeeping requirements—(1) In general.* Any person subject to the general recordkeeping requirements of section 6001 must keep the permanent books of account or records, as required by section 6001, that may be relevant to determining whether that person is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement.

(2) *Application of Sections 6038 and 6038A.* A financed entity that is a reporting corporation within the meaning of section 6038A(a) and the regulations under that section, and any other person that is subject to the recordkeeping requirements of §1.6038A-3, must comply with those recordkeeping requirements with respect to records that may be relevant to determining

whether the financed entity is a party to a financing arrangement and whether that financing arrangement is a conduit financing arrangement. Such records, including records that a person is required to maintain pursuant to paragraph (c) of this section, shall be considered records that are required to be maintained pursuant to section 6038 or 6038A. Accordingly, the provisions of sections 6038 and 6038A (including, without limitation, the penalty provisions thereof), and the regulations under those sections, shall apply to any records required to be maintained pursuant to this section.

(c) *Records to be maintained*—(1) *In general.* An entity described in paragraph (b) of this section shall be required to retain any records containing the following information concerning each financing transaction that the entity knows or has reason to know comprises the financing arrangement—

(i) The nature (e.g., loan, stock, lease, license) of each financing transaction;

(ii) The name, address, taxpayer identification number (if any) and country of residence of—

(A) Each person that advanced money or other property, or granted rights to use property;

(B) Each person that was the recipient of the advance or rights; and

(C) Each person to whom a payment was made pursuant to the financing transaction (to the extent that person is a different person than the person who made the advance or granted the rights);

(iii) The date and amount of—

(A) Each advance of money or other property or grant of rights; and

(B) Each payment made in return for the advance or grant of rights;

(iv) The terms of any guarantee provided in conjunction with a financing transaction, including the name of the guarantor; and

(v) In cases where one or both of the parties to a financing transaction are related to each other or another entity in the financing arrangement, the manner in which these persons are related.

(2) *Additional documents.* An entity described in paragraph (b) of this section must also retain all records relating to the circumstances surrounding its participation in the financing transactions and financing arrange-

ments. Such documents may include, but are not limited to—

(i) Minutes of board of directors meetings;

(ii) Board resolutions or other authorizations for the financing transactions;

(iii) Private letter rulings;

(iv) Financial reports (audited or unaudited);

(v) Notes to financial statements;

(vi) Bank statements;

(vii) Copies of wire transfers;

(viii) Offering documents;

(ix) Materials from investment advisors, bankers and tax advisors; and

(x) Evidences of indebtedness.

(3) *Effect of record maintenance requirement.* Record maintenance in accordance with paragraph (b) of this section generally does not require the original creation of records that are ordinarily not created by affected entities. If, however, a document that is actually created is described in this paragraph (c), it is to be retained even if the document is not of a type ordinarily created by the affected entity.

(d) *Effective date.* This section is effective September 11, 1995. This section shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

Par. 4. In §1.1441-3, the OMB parenthetical at the end of the section is removed and paragraph (j) is added to read as follows:

§1.1441-3 *Exceptions and rules of special application.*

* * * * *

(j) *Conduit financing arrangements*—(1) *Duty to withhold.* A financed entity or other person required to withhold tax under section 1441 with respect to a financing arrangement that is a conduit financing arrangement within the meaning of §1.881-3(a)(2)-(iv) shall be required to withhold under section 1441 as if the district director had determined, pursuant to §1.881-3(a)(3), that all conduit entities that are parties to the conduit financing arrangement should be disregarded. The amount of tax required to be withheld

shall be determined under §1.881-3(d). The withholding agent may withhold tax at a reduced rate if the financing entity establishes that it is entitled to the benefit of a treaty that provides a reduced rate of tax on a payment of the type deemed to have been paid to the financing entity. Section 1.881-3(a)-(3)(ii)(E) shall not apply for purposes of determining whether any person is required to deduct and withhold tax pursuant to this paragraph (j), or whether any party to a financing arrangement is liable for failure to withhold or entitled to a refund of tax under sections 1441 or 1461 to 1464 (except to the extent the amount withheld exceeds the tax liability determined under §1.881-3(d)). See §1.1441-7(d) relating to withholding tax liability of the withholding agent in conduit financing arrangements subject to §1.881-3.

(2) *Effective date.* This paragraph (j) is effective for payments made by financed entities on or after September 11, 1995. This paragraph shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

Par. 5. In §1.1441-7, the OMB parenthetical at the end of the section is removed and paragraph (d) is added to read as follows:

§1.1441-7 *General provisions relating to withholding agents.*

* * * * *

(d) *Conduit financing arrangements*—(1) *Liability of withholding agent.* Subject to paragraph (d)(2) of this section, any person that is required to deduct and withhold tax under §1.1441-3(j) is made liable for that tax by section 1461. A person that is required to deduct and withhold tax but fails to do so is liable for the payment of the tax and any applicable penalties and interest.

(2) *Exception for withholding agents that do not know of conduit financing arrangement*—(i) *In general.* A withholding agent will not be liable under paragraph (d)(1) of this section for failing to deduct and withhold with respect to a conduit financing arrangement unless the person knows or has reason to know that the financing

arrangement is a conduit financing arrangement. This standard shall be satisfied if the withholding agent knows or has reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement, including facts sufficient to establish that the participation of the intermediate entity in the financing arrangement is pursuant to a tax avoidance plan. A withholding agent that knows only of the financing transactions that comprise the financing arrangement will not be considered to know or have reason to know of facts sufficient to establish that the financing arrangement is a conduit financing arrangement.

(ii) *Examples.* The following examples illustrate the operation of paragraph (d)(2) of this section.

Example 1. (i) DS is a U.S. subsidiary of FP, a corporation organized in Country N, a country that does not have an income tax treaty with the United States. FS is a special purpose subsidiary of FP that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. FS is capitalized with \$10,000,000 in debt from BK, a Country N bank, and \$1,000,000 in capital from FS.

(ii) On May 1, 1995, C, a U.S. person, purchases an automobile from DS in return for an installment note. On July 1, 1995, DS sells a number of installment notes, including C's, to FS in exchange for \$10,000,000. DS continues to service the installment notes for FS and C is not notified of the sale of its obligation and continues to make payments to DS. But for the withholding tax on payments of interest by DS to BK, DS would have borrowed directly from BK, pledging the installment notes as collateral.

(iii) The C installment note is a financing transaction, whether held by DS or by FS, and the FS note held by BK also is a financing transaction. After FS purchases the installment note, and during the time the installment note is held by FS, the transactions constitute a financing arrangement, within the meaning of §1.881-3(a)(2)(i). BK is the financing entity, FS is the intermediate entity, and C is the financed entity. Because the participation of FS in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, FS is a conduit entity.

(iv) Because C does not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), C is not required to withhold tax under section 1441. However, DS, who knows that FS's participation in the financing arrangement is pursuant to a tax avoidance plan and is a withholding agent for purposes of section 1441, is not relieved of its withholding responsibilities.

Example 2. Assume the same facts as in Example 1, except that C receives a new payment booklet on which DS is described as "agent". Although C may deduce that its installment note has been sold, without more C

has no reason to know of the existence of a financing arrangement. Accordingly, C is not liable for failure to withhold, although DS still is not relieved of its withholding responsibilities.

Example 3. (i) DC is a U.S. corporation that is in the process of negotiating a loan of \$10,000,000 from BK1, a bank located in Country N, a country that does not have an income tax treaty with the United States. Before the loan agreement is signed, DC's tax lawyers point out that interest on the loan would not be subject to withholding tax if the loan were made by BK2, a subsidiary of BK1 that is incorporated in Country T, a country that has an income tax treaty with the United States that prohibits the imposition of withholding tax on payments of interest. BK1 makes a loan to BK2 to enable BK2 to make the loan to DC. Without the loan from BK1 to BK2, BK2 would not have been able to make the loan to DC.

(ii) The loan from BK1 to BK2 and the loan from BK2 to DC are both financing transactions and together constitute a financing arrangement within the meaning of §1.881-3(a)(2)(i). BK1 is the financing entity, BK2 is the intermediate entity, and DC is the financed entity. Because the participation of BK2 in the financing arrangement reduces the tax imposed by section 881 and because there is a tax avoidance plan, BK2 is a conduit entity.

(iii) Because DC is a party to the tax avoidance plan (and accordingly knows of its existence), DC must withhold tax under section 1441. If DC does not withhold tax on its payment of interest, BK2, a party to the plan and a withholding agent for purposes of section 1441, must withhold tax as required by section 1441.

Example 4. (i) DC is a U.S. corporation that has a long-standing banking relationship with BK2, a U.S. subsidiary of BK1, a bank incorporated in Country N, a country that does not have an income tax treaty with the United States. DC has borrowed amounts of as much as \$75,000,000 from BK2 in the past. On January 1, 1995, DC asks to borrow \$50,000,000 from BK2. BK2 does not have the funds available to make a loan of that size. BK2 considers asking BK1 to enter into a loan with DC but rejects this possibility because of the additional withholding tax that would be incurred. Accordingly, BK2 borrows the necessary amount from BK1 with the intention of on-lending to DC. BK1 does not make the loan directly to DC because of the withholding tax that would apply to payments of interest from DC to BK1. DC does not negotiate with BK1 and has no reason to know that BK1 was the source of the loan.

(ii) The loan from BK2 to DC and the loan from BK1 to BK2 are both financing transactions and together constitute a financing arrangement within the meaning of §1.881-3(a)(2)(i). BK1 is the financing entity, BK2 is the intermediate entity, and DC is the financed entity. The participation of BK2 in the financing arrangement reduces the tax imposed by section 881. Because the participation of BK2 in the financing arrangement reduces the tax imposed by section 881 and because there was a tax avoidance plan, BK2 is a conduit entity.

(iii) Because DC does not know or have reason to know of the tax avoidance plan (and by extension that the financing arrangement is a conduit financing arrangement), DC is not required to withhold tax under section 1441. However, BK2, who is also a withholding agent under section 1441 and who knows that the financing arrangement is a conduit financing

arrangement, is not relieved of its withholding responsibilities.

(3) *Effective date.* This paragraph (d) is effective for payments made by financed entities on or after September 11, 1995. This paragraph shall not apply to interest payments covered by section 127(g)(3) of the Tax Reform Act of 1984, and to interest payments with respect to other debt obligations issued prior to October 15, 1984 (whether or not such debt was issued by a Netherlands Antilles corporation).

Par. 6. In §1.6038A-3, paragraphs (b)(5) and (c)(2)(vii) are added to read as follows:

§1.6038A-3 Record maintenance.

* * * * *

(b) * * *

(5) *Records relating to conduit financing arrangements.* See §1.881-4 relating to conduit financing arrangements.

(c) * * *

(2) * * *

(vii) *Records relating to conduit financing arrangements.* See §1.881-4 relating to conduit financing arrangements.

* * * * *

Par. 7. Section 1.7701(l)-1 is added to read as follows:

§1.7701(l)-1 Conduit financing arrangements.

(a) *Scope.* Section 7701(l) authorizes the issuance of regulations that recharacterize any multiple-party financing transaction as a transaction directly among any two or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed by title 26 of the United States Code.

(b) *Regulations issued under authority of section 7701(l).* The following regulations are issued under the authority of section 7701(l)—

- (1) §1.871-1(b)(7);
- (2) §1.881-3;
- (3) §1.881-4;
- (4) §1.1441-3(j);
- (5) §1.1441-7(d);
- (6) §1.6038A-3(b)(5); and
- (7) §1.6038A-3(c)(2)(vii).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 8. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 9. In §602.101, paragraph (c) is amended by adding an entry in numerical order and revising an entry to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

| CFR part or section where identified and described | Current OMB control number |
|--|----------------------------|
| 1.881-4 | 1545-1440 |
| §1.6038A-3 | 1545-1191
1545-1440 |

Margaret Milner Richardson,
Commissioner of
Internal Revenue.

Approved July 26, 1995.

Leslie Samuels,
Assistant Secretary of
the Treasury.

(Filed by the Office of the Federal Register on August 10, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 11, 1995, 60 F.R. 40997 as corrected by 60 F.R. 55311)

26 CFR 301.7701(i)-0: Outline of taxable mortgage pool provisions.

T.D. 8610

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 301

Taxable Mortgage Pools

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to taxable mortgage pools. This action is necessary because of changes made to the law by the Tax Reform Act of 1986. The final regulations provide guidance to entities for determining whether they are subject to the taxable mortgage pool rules.

EFFECTIVE DATE: These regulations are effective September 6, 1995.

SUPPLEMENTARY INFORMATION:

Background

A notice of proposed rulemaking (FI-55-91 [1993-1 C.B. 764]) under section 7701(i) of the Internal Revenue Code was published in the Federal Register on December 23, 1992 (57 FR 61029). Written comments relating to this notice were received, but no public hearing was requested or held. After consideration of the comments, the proposed regulations under section 7701(i) are adopted as revised by this Treasury decision.

Explanation of Provisions

§301.7701(i)-1(c)(1)—Basis used to determine the composition of an entity's assets.

Among other requirements, to be classified as a taxable mortgage pool, substantially all of an entity's assets must consist of debt obligations, and more than 50 percent of those debt obligations must consist of real estate mortgages (or interests therein). Under the proposed regulations, an entity must apply these tests using the tax bases of its assets. One commentator, however, suggested that the entity should have the choice of using either the tax bases of its assets or the fair market value of its assets. The IRS and Treasury believe that using fair market value for the asset composition tests creates uncertainty and administrative difficulties. The final regulations, therefore, retain the rule in the proposed regulations.

§301.7701(i)-1(c)(5)—Seriously impaired real estate mortgages not treated as debt obligations.

Under the proposed regulations, real estate mortgages that are seriously

impaired are not treated as debt obligations for purposes of the asset composition tests. Whether real estate mortgages are seriously impaired generally depends on all the facts and circumstances. The proposed regulations, however, provide two safe harbors. Under those provisions, whether mortgages are seriously impaired depends only on the number of days the payments on the mortgages are delinquent (more than 89 days for single family residential real estate mortgages and more than 59 days for multi-family residential and commercial real estate mortgages). The safe harbors are not available, however, if an entity is receiving or anticipates receiving certain payments on the mortgages such as payments of principal and interest that are substantial and relatively certain as to amount.

Several commentators have asked for additional safe harbors based on factors other than the number of days a mortgage is delinquent. For example, one suggested a safe harbor for mortgages having excessively high loan to value ratios. Others suggested a safe harbor for mortgages that are purchased at a substantial discount.

The final regulations retain, unchanged, the safe harbors of the proposed regulations. The IRS and Treasury believe that no single factor is as clear an indication that a mortgage is seriously impaired as days delinquent. For example, a mortgage may be purchased at a discount for a variety of reasons, some of which bear no relation to the quality of the mortgage. To provide further guidance, however, the final regulations list some of the facts and circumstances that should be considered in determining whether a mortgage is seriously impaired.

Another commentator has criticized the safe harbors because they are unavailable if an entity anticipates receiving certain payments on a delinquent mortgage. The commentator is concerned that a test based on whether an entity anticipates receiving payments on a mortgage is both subjective and open-ended. To address this concern, the final regulations create a new rule, under which if an entity makes reasonable efforts to resolve a mortgage and fails to do so within a designated time, then the entity is treated as not having anticipated receiving payments on the mortgage.

§301.7701(i)-1(d)(3)(ii)—Obligations secured by other obligations treated as principally secured by real property.

Under the proposed regulations, an obligation is treated as a real estate mortgage if it is principally secured by an interest in real property. Whether an obligation is *principally secured* by an interest in real property ordinarily depends on the value of the real property relative to the amount of the obligation. The proposed regulations also provide that an obligation secured by real estate mortgages is treated as an obligation secured by an interest in real property. That obligation, therefore, may itself qualify as a real estate mortgage.

The final regulations retain these rules and clarify how they are applied if an obligation is secured by both real estate mortgages and other property. Under the final regulations, such an obligation is treated as secured by real property, but only to the extent of the combined value of the real estate mortgages and any real property that secures the obligation.

§301.7701(i)-1(f)(3)—Certain liquidating entities not treated as taxable mortgage pools.

The proposed regulations provide that an entity formed to liquidate real estate mortgages is not treated as a taxable mortgage pool if the entity meets four conditions. One condition is that the entity must liquidate within three years of acquiring its first asset. If the entity fails to liquidate within that time, then the payments the entity receives on its assets must be paid through to the holders of the entity's liabilities in proportion to the adjusted issue prices of the liabilities.

One commentator has asked that this condition be modified. The commentator suggested that either the three-year liquidation period should be extended to four years or an entity should have to liquidate only a certain percentage of its assets within the three-year period. The commentator alternatively suggested that an entity should be treated as meeting the condition if it satisfies fifty percent of the issue price of each of its liabilities using liquidation proceeds.

The final regulations retain the three-year liquidation rule. The IRS and

Treasury believe that performing mortgages that conform to current underwriting standards may easily be disposed of within that time. Further, the market has developed to the point where three years is also ample time to dispose of non-performing mortgages. Mortgages that require more than three years for disposal are more likely to be seriously impaired, and a taxpayer who holds a sufficient quantity can avoid taxable mortgage pool classification by other means. The final regulations, therefore, do not change the basic rules in the proposed regulations.

§301.7701-1(g)—Anti-avoidance rules.

An anti-avoidance rule in the proposed regulations authorizes the Commissioner to disregard or make other adjustments to any transaction if the transaction is entered into with a view to achieving the same economic effect as that of an arrangement subject to section 7701(i) while avoiding the application of that section. This authority is flexible, and among other things, includes the ability to override any safe harbor otherwise available under the regulations. The final regulations retain the anti-avoidance rule and provide two additional examples illustrating its exercise.

§301.7701(i)-4—Certain governmental entities not treated as taxable mortgage pools.

The proposed regulations provide that an entity is not classified as a taxable mortgage pool if: (1) the entity issuing the debt obligations is a State, the District of Columbia, or a political subdivision within the meaning of §1.103-1(b), or is empowered to issue obligations on behalf of one of the foregoing; (2) the entity issues the debt obligations in the performance of a governmental purpose; and (3) the entity holds the remaining interest in any asset that supports the outstanding debt obligations until those obligations are satisfied.

Two commentators have asked that the third requirement be dropped because it prevents a governmental entity from reselling a package of mortgages. The IRS and Treasury believe, however, that dropping the requirement is inappropriate. Typically, when a mortgage pool is used to create multiple class debt, tax gains in excess of

economic gains are generated during the early part of the pool's life and tax losses in excess of economic losses are generated during the latter part of the pool's life. Without the third requirement, a governmental entity can hold an interest in the pool during the early period and then convey that interest to a taxable entity during the latter period. Moreover, requiring a governmental entity to maintain an interest in pool assets is consistent with the second requirement that debt obligations supported by the pool are issued in performance of a governmental purpose.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 301 is amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding the following citations in numerical order to read as follows:

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

Section 301.7701(i)-1(g)(1) also issued under 26 U.S.C. 7701(i)(2)(D).

Section 301.7701(i)-4(b) also issued under 26 U.S.C. 7701(i)(3). * * *

Par. 2. Sections 301.7701(i)-0 through 301.7701(i)-4 are added to read as follows.

§301.7701(i)-0 Outline of taxable mortgage pool provisions.

This section lists the major paragraphs contained in §§301.7701(i)-1 through 301.7701(i)-4.

§301.7701(i)-1 Definition of a taxable mortgage pool.

- (a) Purpose.
- (b) In general.
- (c) Asset composition tests.
 - (1) Determination of amount of assets.
 - (2) Substantially all.
 - (i) In general.
 - (ii) Safe harbor.
 - (3) Equity interests in pass-through arrangements.
- (4) Treatment of certain credit enhancement contracts.
 - (i) In general.
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 - (i) In general.
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 - (d) Real estate mortgages or interests therein defined.
 - (1) In general.
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§301.7701(i)-3 Effective dates and duration of taxable mortgage pool classification.

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- (a) States and municipalities.
 - (1) In general.
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 - (1) In general.
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§301.7701(i)-1 Definition of a taxable mortgage pool.

(a) *Purpose.* This section provides rules for applying section 7701(i), which defines taxable mortgage pools. The purpose of section 7701(i) is to prevent income generated by a pool of real estate mortgages from escaping Federal income taxation when the pool is used to issue multiple class mortgage-backed securities. The regulations in this section and in §§301.7701(i)-2 through 301.7701(i)-4 are to be applied in accordance with

this purpose. The taxable mortgage pool provisions apply to entities or portions of entities that qualify for REMIC status but do not elect to be taxed as REMICs as well as to certain entities or portions of entities that do not qualify for REMIC status.

(b) *In general.* (1) A taxable mortgage pool is any entity or portion of an entity (as defined in §301.7701(i)-2) that satisfies the requirements of section 7701(i)(2)(A) and this section as of any testing day (as defined in §301.7701(i)-3(c)(2)). An entity or portion of an entity satisfies the requirements of section 7701(i)(2)(A) and this section if substantially all of its assets are debt obligations, more than 50 percent of those debt obligations are real estate mortgages, the entity is the obligor under debt obligations with two or more maturities, and payments on the debt obligations under which the entity is obligor bear a relationship to payments on the debt obligations that the entity holds as assets.

(2) Paragraph (c) of this section provides the tests for determining whether substantially all of an entity's assets are debt obligations and for determining whether more than 50 percent of its debt obligations are real estate mortgages. Paragraph (d) of this section defines real estate mortgages for purposes of the 50 percent test. Paragraph (e) of this section defines two or more maturities and paragraph (f) of this section provides rules for determining whether debt obligations bear a relationship to the assets held by an entity. Paragraph (g) of this section provides anti-avoidance rules. Section 301.7701(i)-2 provides rules for applying section 7701(i) to portions of entities and §301.7701(i)-3 provides effective dates. Section 301.7701(i)-4 provides special rules for certain entities. For purposes of the regulations under section 7701(i), the term entity includes a portion of an entity (within the meaning of section 7701(i)(2)(B)), unless the context clearly indicates otherwise.

(c) *Asset composition tests*—(1) *Determination of amount of assets.* An entity must use the Federal income tax basis of an asset for purposes of determining whether substantially all of its assets consist of debt obligations (or interests therein) and whether more than 50 percent of those debt obligations (or interests) consist of real estate mortgages (or interests therein). For purposes of this paragraph, an entity

determines the basis of an asset with the assumption that the entity is not a taxable mortgage pool.

(2) *Substantially all*—(i) *In general*. Whether substantially all of the assets of an entity consist of debt obligations (or interests therein) is based on all the facts and circumstances.

(ii) *Safe harbor*. Notwithstanding paragraph (c)(2)(i) of this section, if less than 80 percent of the assets of an entity consist of debt obligations (or interests therein), then less than substantially all of the assets of the entity consist of debt obligations (or interests therein).

(3) *Equity interests in pass-through arrangements*. The equity interest of an entity in a partnership, S corporation, trust, REIT, or other pass-through arrangement is deemed to have the same composition as the entity's share of the assets of the pass-through arrangement. For example, if an entity's stock interest in a REIT has an adjusted basis of \$20,000, and the assets of the REIT consist of equal portions of real estate mortgages and other real estate assets, then the entity is treated as holding \$10,000 of real estate mortgages and \$10,000 of other real estate assets.

(4) *Treatment of certain credit enhancement contracts*—(i) *In general*. A credit enhancement contract (as defined in paragraph (c)(4)(ii) of this section) is not treated as a separate asset of an entity for purposes of the asset composition tests set forth in section 7701(i)(2)(A)(i), but instead is treated as part of the asset to which it relates. Furthermore, any collateral supporting a credit enhancement contract is not treated as an asset of an entity solely because it supports the guarantee represented by that contract.

(ii) *Credit enhancement contract defined*. For purposes of this section, a credit enhancement contract is any arrangement whereby a person agrees to guarantee full or partial payment of the principal or interest payable on a debt obligation (or interest therein) or on a pool of such obligations (or interests), or full or partial payment on one or more classes of debt obligations under which an entity is the obligor, in the event of defaults or delinquencies on debt obligations, unanticipated losses or expenses incurred by the entity, or lower than expected returns on investments. Types of credit enhancement contracts may include, but are

not limited to, pool insurance contracts, certificate guarantee insurance contracts, letters of credit, guarantees, or agreements whereby an entity, a mortgage servicer, or other third party agrees to make advances (regardless of whether, under the terms of the agreement, the payor is obligated, or merely permitted, to make those advances). An agreement by a debt servicer to advance to an entity out of its own funds an amount to make up for delinquent payments on debt obligations is a credit enhancement contract. An agreement by a debt servicer to pay taxes and hazard insurance premiums on property securing a debt obligation, or other expenses incurred to protect an entity's security interests in the collateral in the event that the debtor fails to pay such taxes, insurance premiums, or other expenses, is a credit enhancement contract.

(5) *Certain assets not treated as debt obligations*—(i) *In general*. For purposes of section 7701(i)(2)(A), real estate mortgages that are seriously impaired are not treated as debt obligations. Whether a mortgage is seriously impaired is based on all the facts and circumstances including, but not limited to: the number of days delinquent, the loan-to-value ratio, the debt service coverage (based upon the operating income from the property), and the debtor's financial position and stake in the property. However, except as provided in paragraph (c)(5)(ii) of this section, no single factor in and of itself is determinative of whether a loan is seriously impaired.

(ii) *Safe harbor*—(A) *In general*. Unless an entity is receiving or anticipates receiving payments with respect to a mortgage, a single family residential real estate mortgage is seriously impaired if payments on the mortgage are more than 89 days delinquent, and a multi-family residential or commercial real estate mortgage is seriously impaired if payments on the mortgage are more than 59 days delinquent. Whether an entity anticipates receiving payments with respect to a mortgage is based on all the facts and circumstances.

(B) *Payments with respect to a mortgage defined*. For purposes of paragraph (c)(5)(ii)(A) of this section, payments with respect to a mortgage mean any payments on the mortgage as defined in paragraph (f)(2)(i) of this section if those payments are substantial and relatively certain as to amount

and any payments on the mortgage as defined in paragraph (f)(2)(ii) or (iii) of this section.

(C) *Entity treated as not anticipating payments*. With respect to any testing day (as defined in §301.7701(i)-3(c)(2)), an entity is treated as not having anticipated receiving payments on the mortgage as defined in paragraph (f)(2)(i) of this section if 180 days after the testing day, and despite making reasonable efforts to resolve the mortgage, the entity is not receiving such payments and has not entered into any agreement to receive such payments.

(d) *Real estate mortgages or interests therein defined*—(1) *In general*. For purposes of section 7701(i)(2)(A)(i), the term real estate mortgages (or interests therein) includes all—

(i) Obligations (including participations or certificates of beneficial ownership therein) that are principally secured by an interest in real property (as defined in paragraph (d)(3) of this section);

(ii) Regular and residual interests in a REMIC; and

(iii) Stripped bonds and stripped coupons (as defined in section 1286(e)(2) and (3)) if the bonds (as defined in section 1286(e)(1)) from which such stripped bonds or stripped coupons arose would have qualified as real estate mortgages or interests therein.

(2) *Interests in real property and real property defined*—(i) *In general*. The definition of interests in real property set forth in §1.856-3(c) of this chapter and the definition of real property set forth in §1.856-3(d) of this chapter apply to define those terms for purposes of paragraph (d) of this section.

(ii) *Manufactured housing*. For purposes of this section, the definition of real property includes manufactured housing, provided the properties qualify as single family residences under section 25(e)(10) and without regard to the treatment of the properties under state law.

(3) *Principally secured by an interest in real property*—(i) *Tests for determining whether an obligation is principally secured*. For purposes of paragraph (d)(1) of this section, an obligation is principally secured by an interest in real property only if it satisfies either the test set out in paragraph (d)(3)(i)(A) of this section or

the test set out in paragraph (d)(3)(i)(B) of this section.

(A) *The 80 percent test.* An obligation is principally secured by an interest in real property if the fair market value of the interest in real property (as defined in paragraph (d)(2) of this section) securing the obligation was at least equal to 80 percent of the adjusted issue price of the obligation at the time the obligation was originated (that is, the issue date). For purposes of this test, the fair market value of the real property interest is first reduced by the amount of any lien on the real property interest that is senior to the obligation being tested, and is reduced further by a proportionate amount of any lien that is in parity with the obligation being tested.

(B) *Alternative test.* An obligation is principally secured by an interest in real property if substantially all of the proceeds of the obligation were used to acquire, improve, or protect an interest in real property that, at the origination date, is the only security for the obligation. For purposes of this test, loan guarantees made by Federal, state, local governments or agencies, or other third party credit enhancement, are not viewed as additional security for a loan. An obligation is not considered to be secured by property other than real property solely because the obligor is personally liable on the obligation.

(ii) *Obligations secured by real estate mortgages (or interests therein), or by combinations of real estate mortgages (or interests therein) and other assets—(A) In general.* An obligation secured only by real estate mortgages (or interests therein), as defined in paragraph (d)(1) of this section, is treated as an obligation secured by an interest in real property to the extent of the value of the real estate mortgages (or interests therein). An obligation secured by both real estate mortgages (or interests therein) and other assets is treated as an obligation secured by an interest in real property to the extent of both the value of the real estate mortgages (or interests therein) and the value of so much of the other assets that constitute real property. Thus, under this paragraph, a collateralized mortgage obligation may be an obligation principally secured by an interest in real property. This section is applicable only to obligations issued after December 31, 1991.

(B) *Example.* The following example illustrates the principles of this paragraph (d)(3)(ii):

Example. At the time it is originated, an obligation has an adjusted issue price of \$300,000 and is secured by a \$70,000 loan principally secured by an interest in a single family home, a fifty percent co-ownership interest in a \$400,000 parcel of land, and \$80,000 of stock. Under paragraph (d)(3)(ii)(A) of this section, the obligation is treated as secured by interests in real property and under paragraph (d)(3)(i)(A) of this section, the obligation is treated as principally secured by interests in real property.

(e) *Two or more maturities—(1) In general.* For purposes of section 7701(i)(2)(A)(ii), debt obligations have two or more maturities if they have different stated maturities or if the holders of the obligations possess different rights concerning the acceleration of or delay in the maturities of the obligations.

(2) *Obligations that are allocated credit risk unequally.* Debt obligations that are allocated credit risk unequally do not have, by that reason alone, two or more maturities. Credit risk is the risk that payments of principal or interest will be reduced or delayed because of a default on an asset that supports the debt obligations.

(3) *Examples.* The following examples illustrate the principles of this paragraph (e):

Example 1. (i) Corporation M transfers a pool of real estate mortgages to a trustee in exchange for Class A bonds and a certificate representing the residual beneficial ownership of the pool. All Class A bonds have a stated maturity of March 1, 2002, but if cash flows from the real estate mortgages and investments are sufficient, the trustee may select one or more bonds at random and redeem them earlier.

(ii) The Class A bonds do not have different maturities. Each outstanding Class A bond has an equal chance of being redeemed because the selection process is random. The holders of the Class A bonds, therefore, have identical rights concerning the maturities of their obligations.

Example 2. (i) Corporation N transfers a pool of real estate mortgages to a trustee in exchange for Class C bonds, Class D bonds, and a certificate representing the residual beneficial ownership of the pool. The Class D bonds are subordinate to the Class C bonds so that cash flow shortfalls due to defaults or delinquencies on the real estate mortgages are borne first by the Class D bond holders. The terms of the bonds are otherwise identical in all relevant aspects except that the Class D bonds carry a higher coupon rate because of the subordination feature.

(ii) The Class C bonds and the Class D bonds share credit risk unequally because of the subordination feature. However, neither this difference, nor the difference in interest rates, causes the bonds to have different maturities. The result is the same if, in addition to the other terms described in paragraph (i) of this *Example 2*, the Class C bonds are accelerated as a result of the issuer becoming unable to make payments on the Class C bonds as they become due.

(f) *Relationship test—(1) In general.* For purposes of section 7701(i)(2)(A)-(iii), payments on debt obligations under which an entity is the obligor (liability obligations) bear a relationship to payments (as defined in paragraph (f)(2) of this section) on debt obligations an entity holds as assets (asset obligations) if under the terms of the liability obligations (or underlying arrangement) the timing and amount of payments on the liability obligations are in large part determined by the timing and amount of payments or projected payments on the asset obligations. For purposes of the relationship test, any payment arrangement, including a swap or other hedge, that achieves a substantially similar result is treated as satisfying the test. For example, any arrangement where the timing and amount of payments on liability obligations are determined by reference to a group of assets (or an index or other type of model) that has an expected payment experience similar to that of the asset obligations is treated as satisfying the relationship test.

(2) *Payments on asset obligations defined.* For purposes of section 7701(i)(2)(A)(iii) and this section, payments on asset obligations include—

(i) A payment of principal or interest on an asset obligation, including a prepayment of principal, a payment under a credit enhancement contract (as defined in paragraph (c)(4)(ii) of this section) and a payment from a settlement at a discount (other than a substantial discount);

(ii) A payment from a settlement at a substantial discount, but only if the settlement is arranged, whether in writing or otherwise, prior to the issuance of the liability obligations; and

(iii) A payment from the foreclosure on or sale of an asset obligation, but only if the foreclosure or sale is arranged, whether in writing or otherwise, prior to the issuance of the liability obligations.

(3) *Safe harbor for entities formed to liquidate assets.* Payments on liability obligations of an entity do not bear a relationship to payments on asset obligations of the entity if—

(i) The entity's organizational documents manifest clearly that the entity is formed for the primary purpose of liquidating its assets and distributing proceeds of liquidation;

(ii) The entity's activities are all reasonably necessary to and consistent

with the accomplishment of liquidating assets;

(iii) The entity plans to satisfy at least 50 percent of the total issue price of each of its liability obligations having a different maturity with proceeds from liquidation and not with scheduled payments on its asset obligations; and

(iv) The terms of the entity's liability obligations (or underlying arrangement) provide that within three years of the time it first acquires assets to be liquidated the entity either—

(A) Liquidates; or

(B) Begins to pass through without delay all payments it receives on its asset obligations (less reasonable allowances for expenses) as principal payments on its liability obligations in proportion to the adjusted issue prices of the liability obligations.

(g) *Anti-avoidance rules*—(1) *In general.* For purposes of determining whether an entity meets the definition of a taxable mortgage pool, the Commissioner can disregard or make other adjustments to a transaction (or series of transactions) if the transaction (or series) is entered into with a view to achieving the same economic effect as that of an arrangement subject to section 7701(i) while avoiding the application of that section. The Commissioner's authority includes treating equity interests issued by a non-REMIC as debt if the entity issues equity interests that correspond to maturity classes of debt.

(2) *Certain investment trusts.* Notwithstanding paragraph (g)(1) of this section, an ownership interest in an entity that is classified as a trust under §301.7701-4(c) will not be treated as a debt obligation of the trust.

(3) *Examples.* The following examples illustrate the principles of this paragraph (g):

Example 1. (i) Partnership P, in addition to its other investments, owns \$10,000,000 of mortgage pass-through certificates guaranteed by FNMA (FNMA Certificates). On May 15, 1997, Partnership P transfers the FNMA Certificates to Trust 1 in exchange for 100 Class A bonds and Certificate 1. The Class A bonds, under which Trust 1 is the obligor, have a stated principal amount of \$5,000,000 and bear a relationship to the FNMA Certificates (within the meaning of §301.7701(i)-1(f)). Certificate 1 represents the residual beneficial ownership of the FNMA Certificates.

(ii) On July 5, 1997, with a view to avoiding the application of section 7701(i), Partnership P transfers Certificate 1 to Trust 2 in exchange for 100 Class B bonds and Certificate 2. The Class

B bonds, under which Trust 2 is the obligor, have a stated principal amount of \$5,000,000, bear a relationship to the FNMA Certificates (within the meaning of §301.7701(i)-1(f)), and have a different maturity than the Class A bonds (within the meaning of §301.7701(i)-1(e)). Certificate 2 represents the residual beneficial ownership of Certificate 1.

(iii) For purposes of determining whether Trust 1 is classified as a taxable mortgage pool, the Commissioner can disregard the separate existence of Trust 2 and treat Trust 1 and Trust 2 as a single trust.

Example 2. (i) Corporation Q files a consolidated return with its two wholly-owned subsidiaries, Corporation R and Corporation S. Corporation R is in the business of building and selling single family homes. Corporation S is in the business of financing sales of those homes.

(ii) On August 10, 1998, Corporation S transfers a pool of its real estate mortgages to Trust 3, taking back Certificate 3 which represents beneficial ownership of the pool. On September 25, 1998, with a view to avoiding the application of section 7701(i), Corporation R issues bonds that have different maturities (within the meaning of §301.7701(i)-1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the real estate mortgages in Trust 3. The holders of the bonds have an interest in a credit enhancement contract that is written by Corporation S and collateralized with Certificate 3.

(iii) For purposes of determining whether Trust 3 is classified as a taxable mortgage pool, the Commissioner can treat Trust 3 as the obligor of the bonds issued by Corporation R.

Example 3. (i) Corporation X, in addition to its other assets, owns \$110,000,000 in Treasury securities. From time to time, Corporation X acquires pools of real estate mortgages, which it immediately uses to issue multiple-class debt obligations.

(ii) On October 1, 1996, Corporation X transfers \$20,000,000 in Treasury securities to Trust 4 in exchange for Class C bonds, Class D bonds, Class E bonds, and Certificate 4. Trust 4 is the obligor of the bonds. The different classes of bonds have the same stated maturity date, but if cash flows from the Trust 4 assets exceed the amounts needed to make interest payments, the trustee uses the excess to retire the classes of bonds in alphabetical order. Certificate 4 represents the residual beneficial ownership of the Treasury securities.

(iii) With a view to avoiding the application of section 7701(i), Corporation X reserves the right to replace any Trust 4 asset with real estate mortgages or guaranteed mortgage pass-through certificates. In the event the right is exercised, cash flows on the real estate mortgages and guaranteed pass-through certificates will be used in the same manner as cash flows on the Treasury securities. Corporation X exercises this right of replacement on February 1, 1997.

(iv) For purposes of determining whether Trust 4 is classified as a taxable mortgage pool, the Commissioner can treat February 1, 1997, as a testing day (within the meaning of §301.7701(i)-3(c)(2)). The result is the same if Corporation X has an obligation, rather than a right, to replace the Trust 4 assets with real estate mortgages and guaranteed pass-through certificates.

Example 4. (i) Corporation Y, in addition to its other assets, owns \$1,900,000 in obligations

secured by personal property. On November 1, 1995, Corporation Y begins negotiating a \$2,000,000 loan to individual A. As security for the loan, A offers a first deed of trust on land worth \$1,700,000.

(ii) With a view to avoiding the application of section 7701(i), Corporation Y induces A to place the land in a partnership in which A will have a 95 percent interest and agrees to accept the partnership interest as security for the \$2,000,000 loan. Thereafter, the loan to A, together with the \$1,900,000 in obligations secured by personal property, are transferred to Trust 5 and used to issue bonds that have different maturities (within the meaning of §301.7701(i)-1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the \$1,900,000 in obligations secured by personal property and the loan to A.

(iii) For purposes of determining whether Trust 5 is a taxable mortgage pool, the Commissioner can treat the loan to A as an obligation secured by an interest in real property rather than as an obligation secured by an interest in a partnership.

Example 5. (i) Corporation Z, in addition to its other assets, owns \$3,000,000 in notes secured by interests in retail shopping centers. Partnership L, in addition to its other assets, owns \$20,000,000 in notes that are principally secured by interests in single family homes and \$3,500,000 in notes that are principally secured by interests in personal property.

(ii) On December 1, 1995, Partnership L asks Corporation Z for two separate loans, one in the amount of \$9,375,000 and another in the amount of \$625,000. Partnership L offers to collateralize the \$9,375,000 loan with \$10,312,500 of notes secured by interests in single family homes and the \$625,000 loan with \$750,000 of notes secured by interests in personal property. Corporation Z has made similar loans to Partnership L in the past.

(iii) With a view to avoiding the application of section 7701(i), Corporation Z induces Partnership L to accept a single \$10,000,000 loan and to post as collateral \$7,500,000 of the notes secured by interests in single family homes and all \$3,500,000 of the notes secured by interests in personal property. Ordinarily, Corporation Z would not make a loan on these terms. Thereafter, the loan to Partnership L, together with the \$3,000,000 in notes secured by interests in retail shopping centers, are transferred to Trust 6 and used to issue bonds that have different maturities (within the meaning of §301.7701(i)-1(e)) and that bear a relationship (within the meaning of §301.7701(i)-1(f)) to the loans secured by interests in retail shopping centers and the loan to Partnership L.

(iv) For purposes of determining whether Trust 6 is a taxable mortgage pool, the Commissioner can treat the \$10,000,000 loan to Partnership L as consisting of a \$9,375,000 obligation secured by interests in real property and a \$625,000 obligation secured by interests in personal property. Under §301.7701(i)-1(d)(3)-(ii)(A), the notes secured by single family homes are treated as \$7,500,000 of interests in real property. Under §301.7701(i)-1(d)(3)(i)(A), \$7,500,000 of interests in real property are sufficient to treat a \$9,375,000 obligation as principally secured by an interest in real property (\$7,500,000 equals 80 percent of \$9,375,000).

§301.7701(i)-2 Special rules for portions of entities.

(a) *Portion defined.* Except as provided in paragraph (b) of this section and §301.7701(i)-1, a portion of an entity includes all assets that support one or more of the same issues of debt obligations. For this purpose, an asset supports a debt obligation if, under the terms of the debt obligation (or underlying arrangement), the timing and amount of payments on the debt obligation are in large part determined, either directly or indirectly, by the timing and amount of payments or projected payments on the asset or a group of assets that includes the asset. Indirect payment arrangements include, for example, a swap or other hedge, or arrangements where the timing and amount of payments on the debt obligations are determined by reference to a group of assets (or an index or other type of model) that has an expected payment experience similar to that of the assets. For purposes of this paragraph, the term payments includes all proceeds and receipts from an asset.

(b) *Certain assets and rights to assets disregarded*—(1) *Credit enhancement assets.* An asset that qualifies as a credit enhancement contract (as defined in §301.7701(i)-1(c)(4)(ii)) is not included in a portion as a separate asset, but is treated as part of the assets in the portion to which it relates under §301.7701(i)-1(c)(4)(i). An asset that does not qualify as a credit enhancement contract (as defined in §301.7701(i)-1(c)(4)(ii)), but that nevertheless serves the same function as a credit enhancement contract, is not included in a portion as a separate asset or otherwise.

(2) *Assets unlikely to service obligations.* A portion does not include assets that are unlikely to produce any significant cash flows for the holders of the debt obligations. This paragraph applies even if the holders of the debt obligations are legally entitled to cash flows from the assets. Thus, for example, even if the sale of a building would cause a series of debt obligations to be redeemed, the building is not included in a portion if it is not likely to be sold.

(3) *Recourse.* An asset is not included in a portion solely because the holders of the debt obligations have recourse to the holder of that asset.

(c) *Portion as obligor*—(1) *In general.* For purposes of section 7701(i)-

(2)(A)(ii), a portion of an entity is treated as the obligor of all debt obligations supported by the assets in that portion.

(2) *Example.* The following example illustrates the principles of this section:

Example. (i) Corporation Z owns \$1,000,000,000 in assets including an office complex and \$90,000,000 of real estate mortgages.

(ii) On November 30, 1998, Corporation Z issues eight classes of bonds, Class A through Class H. Each class is secured by a separate letter of credit and by a lien on the office complex. One group of the real estate mortgages supports Class A through Class D, another group supports Class E through Class G, and a third group supports Class H. It is anticipated that the cash flows from each group of mortgages will service its related bonds.

(iii) Each of the following constitutes a separate portion of Corporation Z: the group of mortgages supporting Class A through Class D; the group of mortgages supporting Class E through Class G; and the group of mortgages supporting Class H. No other asset is included in any of the three portions notwithstanding the lien of the bonds on the office complex and the fact that Corporation Z is the issuer of the bonds. The letters of credit are treated as incidents of the mortgages to which they relate.

(iv) For purposes of section 7701(i)(2)(A)(ii), each portion described above is treated as the obligor of the bonds of that portion, notwithstanding the fact that Corporation Z is the legal obligor with respect to the bonds.

§301.7701(i)-3 Effective dates and duration of taxable mortgage pool classification.

(a) *Effective dates.* Except as otherwise provided, the regulations under section 7701(i) are effective and applicable September 6, 1995.

(b) *Entities in existence on December 31, 1991*—(1) *In general.* For transitional rules concerning the application of section 7701(i) to entities in existence on December 31, 1991, see section 675(c) of the Tax Reform Act of 1986.

(2) *Special rule for certain transfers.* A transfer made to an entity on or after September 6, 1995, is a substantial transfer for purposes of section 675(c)(2) of the Tax Reform Act of 1986 only if—

(i) The transfer is significant in amount; and

(ii) The transfer is connected to the entity's issuance of related debt obligations (as defined in paragraph (b)(3) of this section) that have different maturities (within the meaning of §301.7701-1(e)).

(3) *Related debt obligation.* A related debt obligation is a debt obliga-

tion whose payments bear a relationship (within the meaning of §301.7701-1(f)) to payments on debt obligations that the entity holds as assets.

(4) *Example.* The following example illustrates the principles of this paragraph (b):

Example. On December 31, 1991, Partnership Q holds a pool of real estate mortgages that it acquired through retail sales of single family homes. Partnership Q raises \$10,000,000 on October 25, 1996, by using this pool to issue related debt obligations with multiple maturities. The transfer of the \$10,000,000 to Partnership Q is a substantial transfer (within the meaning of §301.7701(i)-3(b)(2)).

(c) *Duration of taxable mortgage pool classification*—(1) *Commencement and duration.* An entity is classified as a taxable mortgage pool on the first testing day that it meets the definition of a taxable mortgage pool. Once an entity is classified as a taxable mortgage pool, that classification continues through the day the entity retires its last related debt obligation.

(2) *Testing day defined.* A testing day is any day on or after September 6, 1995, on which an entity issues a related debt obligation (as defined in paragraph (b)(3) of this section) that is significant in amount.

§301.7701(i)-4 Special rules for certain entities.

(a) *States and municipalities*—(1) *In general.* Regardless of whether an entity satisfies any of the requirements of section 7701(i)(2)(A), an entity is not classified as a taxable mortgage pool if—

(i) The entity is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof (within the meaning of §1.103-1(b) of this chapter), or is empowered to issue obligations on behalf of one of the foregoing;

(ii) The entity issues the debt obligations in the performance of a governmental purpose; and

(iii) The entity holds the remaining interests in all assets that support those debt obligations until the debt obligations issued by the entity are retired.

(2) *Governmental purpose.* The term governmental purpose means an essential governmental function within the meaning of section 115. A governmental purpose does not include the mere

packaging of debt obligations for resale on the secondary market even if any profits from the sale are used in the performance of an essential governmental function.

(3) *Determinations by the Commissioner.* If an entity is not described in paragraph (a)(1) of this section, but has a similar purpose, then the Commissioner may determine that the entity is not classified as a taxable mortgage pool.

(b) *REITs.* [Reserved]

(c) *Subchapter S corporations—(1) In general.* An entity that is classified as a taxable mortgage pool may not elect to be an S corporation under section 1362(a) or maintain S corporation status.

(2) *Portion of an S corporation treated as a separate corporation.* An S corporation is not treated as a member of an affiliated group under section 1361(b)(2)(A) solely because a portion of the S corporation is treated as a separate corporation under section 7701(i).

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved July 17, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on August 4, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 7, 1995, 60 F.R. 40086 as corrected by 60 F.R. 49754)

26 CFR 301.7701-2: *Associations.*
(Also Section 708.)

Classification of New York limited liability partnership. A general partnership registered as a New York registered limited liability partnership will be classified as a partnership for federal tax purposes.

Rev. Rul. 95-55

ISSUES

(1) Is *PRS*, a New York general partnership that registers as a New York registered limited liability partnership (RLLP), classified for federal

tax purposes as an association or as a partnership under § 7701 of the Internal Revenue Code?

(2) Does *PRS* terminate under § 708(b) as a result of its registration as an RLLP?

FACTS

PRS is organized as a general partnership pursuant to the provisions of the New York Partnership Law (Law), N.Y. Partnership Law §§ 1 to 121-1503 (McKinney 1988 & Supp. 1994). *PRS* provides professional services within the State of New York. *PRS* registered as an RLLP, effective August 1, 1995. Each partner's total percentage interest in the partnership's profits, losses, and capital remained the same after the registration as an RLLP. The business of *PRS* continued to be carried on after its registration as an RLLP.

Section 121-1500(a) of the Law provides that a partnership without limited partners that meets the requirements of § 121-1500 may register as an RLLP by filing with the New York Department of State a registration that sets forth specified information.

Section 121-1500(d) provides that a partnership without limited partners is registered as an RLLP at the time of the payment of the required fee and the filing of the completed registration with the New York Department of State or at the later date, if any, specified in the registration, not to exceed 60 days from the date of the filing. Section 121-1500(d) of the Law also provides that a partnership without limited partners that has registered as an RLLP is for all purposes the same entity that existed before the registration and continues to be a partnership without limited partners under the laws of the State of New York.

Section 26(b) of the Law provides that, except as provided by § 26(c) and § 26(d), no partner of a partnership that is an RLLP is liable or accountable, directly or indirectly (including by way of indemnification, contribution or otherwise), for any debts, obligations, or liabilities of, or chargeable to, the RLLP or each other, whether arising in tort, contract or otherwise, that are incurred, created or assumed by the partnership while the partnership is an RLLP, solely by reason of being a partner or acting (or omitting to act) in a partner capacity or rendering profes-

sional services or otherwise participating (as an employee, consultant, contractor, or otherwise) in the conduct of the other business or activities of the RLLP.

Section 26(c) of the Law provides that, notwithstanding the provisions of § 26(b), each partner, employee, or agent of a partnership that is an RLLP is personally and fully liable and accountable for any negligent or wrongful act or misconduct committed by the partner, employee, or agent or by any person under the partner's, employee's, or agent's direct supervision and control while rendering professional services on behalf of the RLLP.

Section 26(d) of the Law provides that, notwithstanding the provisions of § 26(b), all or specified partners of a partnership that is an RLLP may be liable in their capacity as partners for all or specified debts, obligations, or liabilities of an RLLP to the extent at least a majority of the partners have agreed unless otherwise provided in any agreement between the partners. The partners of *PRS* have no agreement that any of its partners will be liable for all or specified debts, obligations, or liabilities of *PRS*.

Section 62 of the Law provides in part that an RLLP is dissolved (1) without violation of the agreement between the partners by the express will of any partner when no definite term or particular undertaking is specified or (2) in contravention of the agreement between the partners, when the circumstances do not permit a dissolution under any other provision of § 62, by the express will of any partner at any time.

Section 20 of the Law provides that every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for apparently carrying on in the usual way the business of the partnership of which the partner is a member binds the partnership.

Section 40 of the Law provides that no person can become a member of a partnership without the consent of all the partners.

LAW AND ANALYSIS

Issue (1): Section 7701(a)(2) provides that the term "partnership"

includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and that is not a trust or estate or a corporation.

Section 301.7701-1(b) of the Procedure and Administration Regulations states that the Code prescribes certain categories, or classes, into which various organizations fall for purposes of taxation. These categories, or classes, include associations (which are taxable as corporations), partnerships, and trusts. The tests, or standards, that are to be applied in determining the classification in which an organization belongs are set forth in §§ 301.7701-2 through 301.7701-4.

Section 301.7701-2(a)(1) sets forth the following major characteristics of a corporation: (1) associates, (2) an objective to carry on business and divide the gains therefrom, (3) continuity of life, (4) centralization of management, (5) liability for corporate debts limited to corporate property, and (6) free transferability of interests. Whether a particular organization is to be classified as an association must be determined by taking into account the presence or absence of each of these corporate characteristics.

Section 301.7701-2(a)(2) provides that an organization that has associates and an objective to carry on business and divide the gains therefrom is not classified as a trust, but rather as a partnership or association taxable as a corporation. It further provides that characteristics common to partnerships and corporations are not material in attempting to distinguish between a partnership and an association. Since associates and an objective to carry on business and divide the gains therefrom are generally common to corporations and partnerships, the determination of whether an organization that has these characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exist centralization of management, continuity of life, free transferability of interests, and limited liability.

Section 301.7701-2(a)(3) provides that if an unincorporated organization has more corporate characteristics than noncorporate characteristics, it is an association taxable as a corporation.

In interpreting § 301.7701-2, the Tax Court, in *Larson v. Commissioner*, 66 T.C. 159 (1976), *acq.*, 1979-1 C.B. 1,

concluded that equal weight must be given to each of the four corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

In the present situation, *PRS* has associates and an objective to carry on business and divide the gains therefrom. Therefore, *PRS* must be classified as either a partnership or an association. *PRS* is classified as a partnership for federal tax purposes unless the organization has a preponderance of the remaining corporate characteristics of continuity of life, centralization of management, limited liability, and free transferability of interests.

Certain provisions of § 301.7701-2 contain special rules that apply to partnerships subject to a statute corresponding to the Uniform Partnership Act (UPA). A partnership that registers as an RLLP under § 121-1500 of the Law is not subject to a statute that corresponds to the UPA for purposes of § 301.7701-2 because, unlike members of a UPA partnership, the members of an RLLP are not liable for any debts, obligations, or liabilities of the RLLP. Accordingly, whether *PRS* is classified as a partnership or an association taxable as a corporation must be determined under the general rules of § 301.7701-2.

Section 301.7701-2(b)(3) provides that an agreement establishing an organization may provide that the organization is to continue for a stated period or until the completion of a stated undertaking or such agreement may provide for the termination of the organization at will or otherwise. In determining whether any member has the power of dissolution, it will be necessary to examine the agreement and to ascertain the effect of the agreement under the local law. For example, if an agreement provides that an organization can be terminated by the will of any member, it is clear that the organization lacks continuity of life. However, if the agreement provides that the organization is to continue for a stated period or until the completion of a stated transaction, the organization has continuity of life if the effect of the agreement is that no member has the power to dissolve the organization in contravention of the agreement. Nevertheless, if, notwithstanding the agreement, any member has the power under local law to dis-

solve the organization, the organization lacks continuity of life.

Under the Law, an RLLP is dissolved (1) without violation of the agreement between the partners by the express will of any partner when no definite term or particular undertaking is specified in the agreement, or (2) in contravention of the agreement between the partners, where the circumstances do not permit a dissolution under any other provision of the Law, by the express will of any partner at any time. Therefore, *PRS* lacks the corporate characteristic of continuity of life.

Section 301.7701-2(c)(1) provides that an organization has the corporate characteristic of centralized management if any person (or any group of persons that does not include all the members) has continuing exclusive authority to make the management decisions necessary to the conduct of the business for which the organization was formed.

Section 301.7701-2(c)(2) provides that the persons who have this authority may, or may not, be members of the organization and may hold office as a result of a selection by the members from time to time, or may be self-perpetuating in office. Centralized management can be accomplished by election to office, by proxy appointment, or by any other means that has the effect of concentrating in a management group continuing exclusive authority to make management decisions.

Section 301.7701-2(c)(4) provides that there is no centralization of continuing exclusive authority to make management decisions unless the managers have sole authority to make the decisions. For example, in the case of a corporation or a trust, the concentration of management power in a board of directors or trustees effectively prevents stockholder or a trust beneficiary, simply because that person is a stockholder or beneficiary, from binding the corporation or the trust. However, because of the mutual agency relationship between members of a general partnership, the general partnership cannot achieve effective concentration of management powers and, therefore, centralized management.

Under the Law, every partner is an agent of the partnership for the purpose of its business, and the act of every partner, including the execution in the partnership name of any instrument, for

apparently carrying on in the usual way the business of the partnership of which the partner is a member, binds the partnership. Therefore, *PRS* lacks the corporate characteristic of centralization of management.

Section 301.7701-2(d)(1) provides that an organization has the corporate characteristic of limited liability if under local law there is no member who is personally liable for the debts of, or claims against, the organization. Personal liability means that a creditor of an organization may seek personal satisfaction from a member of the organization to the extent that the assets of the organization are insufficient to satisfy the creditor's claim.

Under the Law, the partners of an RLLP are not liable for the RLLP's debts, obligations, or liabilities except for the following: (1) each partner is liable for any negligent or wrongful act or misconduct committed by that partner or by any person under that partner's direct supervision and control while rendering services on behalf of the RLLP, and (2) all or specified partners may be liable for all or specified debts, obligations or liabilities of the RLLP to the extent at least a majority of the partners have agreed unless otherwise provided in any agreement between the partners. The partners of *PRS* have not agreed to be liable for any of *PRS*'s debts, obligations, or liabilities. Therefore, *PRS* possesses the corporate characteristic of limited liability.

Section 301.7701-2(e)(1) provides that an organization has the corporate characteristic of free transferability of interests if each of the members or those members owning substantially all of the interests in the organization have the power, without the consent of other members, to substitute for themselves in the same organization a person who is not a member of the organization. For this power of substitution to exist in the corporate sense, the member must be able, without the consent of other members, to confer upon the member's substitute all of the attributes of the member's interest in the organization. The characteristic of free transferability does not exist if each partner can, without the consent of other members, assign only the right to share in the profits but cannot assign the right to participate in the management of the organization.

Under the Law, no person can become a partner in an RLLP without the

consent of all the partners. Therefore, *PRS* lacks the corporate characteristic of free transferability of interests.

PRS has associates and an objective to carry on business and divide the gains therefrom. In addition, *PRS* possesses the corporate characteristic of limited liability. *PRS* does not, however, possess the corporate characteristics of continuity of life, centralized management, and free transferability of interests. Accordingly, *PRS* is classified as a partnership for federal tax purposes.

Issue (2): Section 708(a) provides that a partnership is considered as continuing if it is not terminated.

Section 708(b) provides that a partnership is considered terminated only if either (1) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership, or (2) within a 12 month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.

Section 721 provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Rev. Rul. 84-52, 1984-1 C.B. 157, considers the federal income tax consequences of the conversion of a general partnership into a limited partnership. Each partner's total percentage interest in the partnership's profits, losses, and capital remained the same after the conversion. Furthermore, the business of the general partnership continued to be carried on after the conversion. The revenue ruling treats the conversion as an exchange under § 721 of the Code. Because the business of the general partnership will continue after the conversion and because, under § 1.708-1(b)(1)(ii) of the Income Tax Regulations, a transaction governed by § 721 is not treated as a sale or exchange for purposes of § 708, the revenue ruling concludes that the general partnership is not terminated under § 708(b). See Rev. Rul. 95-37, 1995-1 C.B. 130 (the conversion of an interest in a domestic partnership into an interest in a domestic limited liability company that is classified as a partnership).

Section 446(e) provides that, except as otherwise expressly provided in chapter 1, a taxpayer who changes the

method of accounting on the basis of which it regularly computes its income in keeping its books shall, before computing its taxable income under the new method, secure the consent of the Secretary.

The registration of *PRS* as an RLLP is treated as a partnership-to-partnership conversion that is subject to the principles of Rev. Rul. 84-52. Therefore, *PRS* will not terminate under § 708(b) as a result of its registration as an RLLP, and *PRS* must continue to use the same methods of accounting used before its registration as an RLLP.

HOLDINGS

(1) *PRS* has associates and an objective to carry on business and divide the gains therefrom, but lacks a preponderance of the four remaining corporate characteristics. Accordingly, *PRS* a New York general partnership registered as a New York RLLP is classified as a partnership for federal tax purposes.

(2) *PRS* will not terminate under § 708(b) as a result of its registration as an RLLP.

Section 7704.—Certain Publicly Traded Partnerships Treated as Corporations.

26 CFR 1.7704-1: Publicly traded partnerships.

T.D. 8629

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Certain Publicly Traded Partnerships Treated as Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the classification of certain publicly traded partnerships as corporations. These regulations provide guidance needed by taxpayers to comply with changes to the law made by the Omnibus Budget Reconciliation Act of 1987. The regulations affect the classification of certain partnerships for federal tax purposes.

DATES: These regulations are effective December 4, 1995.

For dates of applicability of these regulations, see §1.7704-1(I).

SUPPLEMENTARY INFORMATION:

Introduction

This document adds §1.7704-1 to the Income Tax Regulations (26 CFR part 1) relating to the definition of a publicly traded partnership under section 7704(b) of the Internal Revenue Code (Code).

Background

Section 7704 was added to the Code by section 10211(a) of the Omnibus Budget Reconciliation Act of 1987 (Public Law 100-203), as amended by sections 2004(f)(1)-(5) of the Technical and Miscellaneous Revenue Act of 1988 (Public Law 100-647). Section 7704(a) provides that a publicly traded partnership is treated as a corporation for federal tax purposes unless the partnership meets the 90 percent qualifying income test of section 7704(c) or qualifies as an existing partnership. The term *existing partnership* is defined in §1.7704-2. Under section 7704(b), a partnership is a publicly traded partnership if interests in the partnership are traded on an established securities market or are readily tradable on a secondary market or the substantial equivalent thereof. Section 7704 applies to all domestic and foreign entities treated as partnerships under section 7701, including limited liability companies and other entities treated as partnerships for federal tax purposes.

Notice 88-75 (1988-2 C.B. 386) was issued to provide interim guidance on the definition of a publicly traded partnership under section 7704(b). Notice 88-75 provides that interests in a partnership are not treated as readily tradable on a secondary market or the substantial equivalent thereof for purposes of section 7704(b)(2) if the interests are: (1) issued in certain private placements; (2) transferred pursuant to transfers not involving trading; (3) traded in amounts that meet the requirements of a 5-percent or 2-percent safe harbor; (4) transferred through a matching service that meets certain requirements; or (5) transferred

pursuant to a qualifying redemption or repurchase agreement. Notice 88-75 does not address when partnership interests are treated as traded on an established securities market for purposes of section 7704(b)(1).

On May 2, 1995, the IRS published in the Federal Register a notice of proposed rulemaking (60 FR 21475 [PS-13-88, 1995-1 C.B. 994]) to provide guidance regarding section 7704(b). A number of public comments were received concerning the proposed regulations, and a public hearing was held on July 31, 1995. After consideration of the comments received, the proposed regulations are adopted as revised by this Treasury decision.

Summary of significant comments and revisions

The significant comments on the proposed regulations and the revisions made in the final regulations are discussed below.

Public trading

Several commentators requested clarification of the definition of an established securities market, a secondary market, and the substantial equivalent of a secondary market. The definitions in the proposed regulations, however, are drawn directly from the legislative history to section 7704(b) and incorporate the most important elements of public trading within the meaning of section 7704(b). As a result, the final regulations generally adopt the definitions in the proposed regulations.

The final regulations contain two changes to the definition of a secondary market and the substantial equivalent thereof. The final regulations clarify that the determination of whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof is based on all the facts and circumstances. In addition, the final regulations eliminate the separate definitions of a secondary market and the substantial equivalent thereof. This distinction is relevant in the proposed regulations because several of the safe harbors apply only to the substantial equivalent of a secondary market. As discussed below, this distinction is eliminated in the safe harbors. As a result, the separate definitions of a secondary

market and the substantial equivalent thereof are no longer necessary, and they are combined into one definition in the final regulations.

The proposed regulations provide that the transfer of an interest in a partnership is taken into account for purposes of section 7704(b) only if the partnership recognizes the transfer of the interest or the interest is redeemed by the partnership. The preamble to the proposed regulations explains that this provision is intended to prevent a partnership from becoming publicly traded without the knowledge or participation of the partnership. Several commentators requested a clarification of this provision because the definition of a secondary market requires only that the interests be readily tradable, thereby creating some concern that the partnership could be publicly traded even if there were no actual transfer of an interest in the partnership.

The final regulations address this concern by providing more explicitly that interests in a partnership will not be treated as readily tradable on a secondary market or the substantial equivalent thereof unless (i) the partnership participates in the establishment of the market or the inclusion of its interests thereon, or (ii) the partnership recognizes transfers made on that market. This rule also applies to an established securities market that consists of an interdealer quotation system that regularly disseminates firm buy or sell quotations. These modifications will prevent a partnership from being publicly traded without the participation or consent of the partnership. This rule is not extended to established securities markets that consist of the exchanges described in the regulation because these exchanges list interests in the partnership only with the knowledge and participation of the partnership. In addition, the final regulations provide that transfers not recognized by the partnership are treated as private transfers and therefore do not count for purposes of the two-percent and 10-percent limitations in the safe harbors described below.

Safe harbors

Several commentators requested clarification that, as in Notice 88-75, the failure of a partnership to satisfy the safe harbors does not establish or give rise to a presumption that the partnership was publicly traded. In re-

sponse, the final regulations clarify that the fact that a partnership does not qualify for a safe harbor or that a transfer of an interest in the partnership is not within a safe harbor is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof. Thus, these transfers are examined under the general facts and circumstances test in the regulations.

Private transfers

Several commentators requested that the definition of a block transfer be expanded to include transfers by a partner or any person related to the partner within the meaning of section 267(b) or section 707(b)(1). The commentators noted that interests in a partnership are often held by related persons and that, while the related group as a whole may hold more than a two-percent interest in the partnership, no individual partner in the group might hold more than a two-percent interest. This comment is adopted in the final regulations.

One commentator also suggested that the exception for transfers at death be clarified to include transfers from an estate or a testamentary trust. This comment is adopted in the final regulations.

Another commentator suggested that the exception for transfers by one or more partners of interests representing more than 50 percent of the total interests be expanded to include transfers of less than 50 percent. This comment is not adopted in the final regulations. The exception is provided to allow acquisition of control of a partnership without raising a concern that the transfers pursuant to the acquisition would result in the partnership being publicly traded. The exception is, however, amended by reducing the required amount to 50 percent or more of the interests in partnership capital and profits to coordinate the exception with section 708(b)(1)(B) terminations.

Redemption and repurchase agreements

Several commentators suggested that redemptions by an investment partnership for the net asset value of the redeemed interest should not be treated

as a transfer for purposes of section 7704(b) because these transfers do not involve a third party broker or a commission or mark-up. This comment is not adopted in the final regulations. The redemption of a partnership interest combined with the issuance of an interest to a new partner can result in the creation of a secondary market or the substantial equivalent thereof within the meaning of section 7704(b), even if no third party or commission is present.

Qualified matching service

The proposed regulations provide that, to qualify as a matching service, the selling partner cannot enter into a binding agreement to sell an interest until the 15th calendar day after the date information regarding the offering is made available to potential buyers and the closing cannot occur until the 30th calendar day after the date the selling partner can enter into a binding agreement. One commentator suggested a reduction in these fixed time periods. This comment is not adopted in the final regulations. The time periods are necessary to ensure that the matching service does not rise to the level of a secondary market or the substantial equivalent thereof.

Several commentators raised various concerns about the provisions in the proposed regulations requiring subscribers to make certain representations and the provisions preventing the operator of the matching service from quoting certain prices and buying or selling interests for itself or on behalf of others. These provisions are deleted in the final regulations because the requirements for a matching service already provide that the service cannot list quotes that commit any person to buy or sell an interest. This modification, however, does not affect the general rule that a secondary market may exist if anyone, including the operator of a matching service, quotes prices at which it stands ready to buy or sell partnership interests.

Private placements

The proposed regulations generally provide that interests in a partnership are not readily tradable on the substantial equivalent of a secondary market if (i) all interests in the partnership were issued in a transaction not required to be registered under the Securities Act

of 1933; (ii) the partnership does not have more than 500 partners or the initial offering price of each unit was at least \$20,000; and (iii) if the partnership has more than 50 partners, no more than 10 percent of the total interests in capital or profits are transferred during the year. Several commentators suggested expanding this safe harbor to apply to the determination of a secondary market. Other commentators suggested eliminating the 10-percent limitation. Several commentators suggested increasing the 50-partner limit, such as to 100, and modifying the rule for counting the number of partners that looked through partners that were partnerships, grantor trusts, or S corporations. In response to these comments, the final regulations modify the private placement exception in the following respects.

First, the safe harbor is expanded to apply to a secondary market as well as the substantial equivalent of a secondary market. As a result, interests in a partnership that qualifies for the private placement safe harbor will not be readily tradable on a secondary market or the substantial equivalent thereof.

Second, the final regulations provide that the safe harbor does not apply to partnerships subject to Regulation S (17 CFR 230.901 et seq), unless the offering and sale of interests in the partnership would not have been required to be registered if offered and sold within the United States. Regulation S, adopted after the issuance of Notice 88-75, provides an exception from registration for any offerings and sales outside of the United States, even if registration would have been required if the interests were offered and sold within the United States. This modification ensures that the private placement exception applies in a similar manner to offerings within and outside of the United States.

Third, the 10-percent limitation is not adopted in the final regulations. Instead, the final regulations provide that the safe harbor applies only if the partnership has no more than 100 partners at any time during the taxable year of the partnership.

Finally, the final regulations provide a new rule for determining the number of partners in a partnership. Under the proposed regulations, each person owning an interest in a partnership (lower-tier partnership) through another partnership, an S corporation, or a grantor trust (flow-through entity) is treated as

a partner in the lower-tier partnership. The final regulations provide that an owner of a flow-through entity is treated as a partner in the lower-tier partnership only if (i) substantially all of the value of the flow-through entity is attributable to the lower-tier partnership interest, and (ii) a principal purpose for the tiered arrangement is to permit the partnership to satisfy the 100 partner requirement.

The requirement that substantially all of the value of the flow-through entity be attributable to the lower-tier partnership is intended to limit the look-through rule to flow-through entities that are economically equivalent to an interest in the lower-tier partnership. For example, if the only asset held by a flow-through entity is an interest in a lower-tier partnership, an interest in the flow-through entity is economically equivalent to an interest in the lower-tier partnership and the members of the flow-through entity should be counted as partners in the partnership. The requirement that there be a principal purpose to avoid the 100 partner rule recognizes that looking through a flow-through entity is not appropriate in all cases, even if the flow-through entity owns no interest other than an interest in the lower-tier partnership, but should be limited to situations in which a principal purpose of the flow-through entity is to avoid the 100 partner limitation.

Lack of actual trading

The proposed regulations provide that interests in a partnership are not readily tradable on the substantial equivalent of a secondary market if the sum of the percentage interests transferred during the taxable year does not exceed two percent. Several commentators suggested expanding this safe harbor to secondary markets so that partnerships could be assured that some level of trading would not result in public trading. This comment is adopted in the final regulations.

Qualifying income

Several commentators requested guidance on the definition of *qualifying income* and *financial business* for purposes of the qualifying income exception of section 7704. These regulations are intended to address only the definition of public trading and therefore do

not provide guidance on the definition of qualifying income. The IRS and Treasury, however, are actively considering guidance on the definition of qualifying income and financial businesses for investment partnerships and other partnerships engaged in various types of securities transactions. The IRS and Treasury invite comments on the scope and form of such guidance.

Transitional relief

The proposed regulations provide that they will be effective for taxable years of a partnership beginning on or after the date final regulations are published. The preamble to the proposed regulations requests comments on whether transitional relief is necessary for partnerships that qualified for an exclusion under Notice 88-75. Many commentators suggested some form of transitional relief, ranging from 180 days to a permanent grandfather provision.

The final regulations provide that, for partnerships that were actively engaged in an activity before December 4, 1995, the regulations apply for taxable years beginning after December 31, 2005. This ten-year grandfather provision is similar to the grandfather rule provided on the enactment of section 7704. The final regulations provide that this transitional relief expires if the partnership adds a substantial new line of business within the meaning of §1.7704-2. The transitional relief is not affected by a termination of the partnership under section 708(b)(1)(B). Finally, partnerships subject to transitional relief may continue to rely on Notice 88-75 for guidance.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submit-

ted to the Small Business Administration for comment on its impact on small business.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.7704-1 is added to read as follows:

§1.7704-1 Publicly traded partnerships.

(a) *In general*—(1) *Publicly traded partnership.* A domestic or foreign partnership is a publicly traded partnership for purposes of section 7704(b) and this section if—

(i) Interests in the partnership are traded on an established securities market; or

(ii) Interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(2) *Partnership interest*—(i) *In general.* For purposes of section 7704(b) and this section, an interest in a partnership includes—

(A) Any interest in the capital or profits of the partnership (including the right to partnership distributions); and

(B) Any financial instrument or contract the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations).

(ii) *Exception for non-convertible debt.* For purposes of section 7704(b) and this section, an interest in a partnership does not include any financial instrument or contract that—

(A) Is treated as debt for federal tax purposes; and

(B) Is not convertible into or exchangeable for an interest in the capital or profits of the partnership and does not provide for a payment of equivalent value.

(iii) *Exception for tiered entities.* For purposes of section 7704(b) and this

section, an interest in a partnership or a corporation (including a regulated investment company as defined in section 851 or a real estate investment trust as defined in section 856) that holds an interest in a partnership (lower-tier partnership) is not considered an interest in the lower-tier partnership.

(3) *Definition of transfer.* For purposes of section 7704(b) and this section, a transfer of an interest in a partnership means a transfer in any form, including a redemption by the partnership or the entering into of a financial instrument or contract described in paragraph (a)(2)(i)(B) of this section.

(b) *Established securities market.* For purposes of section 7704(b) and this section, an established securities market includes—

(1) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(2) A national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) because of the limited volume of transactions;

(3) A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in paragraph (b)(1) or (2) of this section (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange);

(4) A regional or local exchange; and

(5) An interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

(c) *Readily tradable on a secondary market or the substantial equivalent thereof*—(1) *In general.* For purposes of section 7704(b) and this section, interests in a partnership that are not traded on an established securities market (within the meaning of section 7704(b) and paragraph (b) of this section) are readily tradable on a secondary market or the substantial equivalent thereof if, taking into ac-

count all of the facts and circumstances, the partners are readily able to buy, sell, or exchange their partnership interests in a manner that is comparable, economically, to trading on an established securities market.

(2) *Secondary market or the substantial equivalent thereof.* For purposes of paragraph (c)(1) of this section, interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof if—

(i) Interests in the partnership are regularly quoted by any person, such as a broker or dealer, making a market in the interests;

(ii) Any person regularly makes available to the public (including customers or subscribers) bid or offer quotes with respect to interests in the partnership and stands ready to effect buy or sell transactions at the quoted prices for itself or on behalf of others;

(iii) The holder of an interest in the partnership has a readily available, regular, and ongoing opportunity to sell or exchange the interest through a public means of obtaining or providing information of offers to buy, sell, or exchange interests in the partnership; or

(iv) Prospective buyers and sellers otherwise have the opportunity to buy, sell, or exchange interests in the partnership in a time frame and with the regularity and continuity that is comparable to that described in the other provisions of this paragraph (c)(2).

(3) *Secondary market safe harbors.* The fact that a transfer of a partnership interest is not within one or more of the safe harbors described in paragraph (e), (f), (g), (h), or (j) of this section is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(d) *Involvement of the partnership required.* For purposes of section 7704(b) and this section, interests in a partnership are not traded on an established securities market within the meaning of paragraph (b)(5) of this section and are not readily tradable on a secondary market or the substantial equivalent thereof within the meaning of paragraph (c) of this section (even if interests in the partnership are traded or readily tradable in a manner described in paragraph (b)(5) or (c) of this section) unless—

(1) The partnership participates in the establishment of the market or the inclusion of its interests thereon; or

(2) The partnership recognizes any transfers made on the market by—

(i) Redeeming the transferor partner (in the case of a redemption or repurchase by the partnership); or

(ii) Admitting the transferee as a partner or otherwise recognizing any rights of the transferee, such as a right of the transferee to receive partnership distributions (directly or indirectly) or to acquire an interest in the capital or profits of the partnership.

(e) *Transfers not involving trading*—(1) *In general.* For purposes of section 7704(b) and this section, the following transfers (private transfers) are disregarded in determining whether interests in a partnership are readily tradable on a secondary market or the substantial equivalent thereof—

(i) Transfers in which the basis of the partnership interest in the hands of the transferee is determined, in whole or in part, by reference to its basis in the hands of the transferor or is determined under section 732;

(ii) Transfers at death, including transfers from an estate or testamentary trust;

(iii) Transfers between members of a family (as defined in section 267-(c)(4));

(iv) Transfers involving the issuance of interests by (or on behalf of) the partnership in exchange for cash, property, or services;

(v) Transfers involving distributions from a retirement plan qualified under section 401(a) or an individual retirement account;

(vi) Block transfers (as defined in paragraph (e)(2) of this section);

(vii) Transfers pursuant to a right under a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) that is exercisable only—

(A) Upon the death, disability, or mental incompetence of the partner; or

(B) Upon the retirement or termination of the performance of services of an individual who actively participated in the management of, or performed services on a full-time basis for, the partnership;

(viii) Transfers pursuant to a closed end redemption plan (as defined in paragraph (e)(4) of this section);

(ix) Transfers by one or more partners of interests representing in the aggregate 50 percent or more of the total interests in partnership capital and

profits in one transaction or a series of related transactions; and

(x) Transfers not recognized by the partnership (within the meaning of paragraph (d)(2) of this section).

(2) *Block transfers.* For purposes of paragraph (e)(1)(vi) of this section, a block transfer means the transfer by a partner and any related persons (within the meaning of section 267(b) or 707(b)(1)) in one or more transactions during any 30 calendar day period of partnership interests representing in the aggregate more than 2 percent of the total interests in partnership capital or profits.

(3) *Redemption or repurchase agreement.* For purposes of section 7704(b) and this section, a redemption or repurchase agreement means a plan of redemption or repurchase maintained by a partnership whereby the partners may tender their partnership interests for purchase by the partnership, another partner, or a person related to another partner (within the meaning of section 267(b) or 707(b)(1)).

(4) *Closed end redemption plan.* For purposes of paragraph (e)(1)(viii) of this section, a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) is a closed end redemption plan only if—

(i) The partnership does not issue any interest after the initial offering (other than the issuance of additional interests prior to August 5, 1988); and

(ii) No partner or person related to any partner (within the meaning of section 267(b) or 707(b)(1)) provides contemporaneous opportunities to acquire interests in similar or related partnerships which represent substantially identical investments.

(f) *Redemption and repurchase agreements.* For purposes of section 7704(b) and this section, the transfer of an interest in a partnership pursuant to a redemption or repurchase agreement (as defined in paragraph (e)(3) of this section) that is not described in paragraph (e)(1)(vii) or (viii) of this section is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof only if—

(1) The redemption or repurchase agreement provides that the redemption or repurchase cannot occur until at least 60 calendar days after the partner notifies the partnership in writing of the partner's intention to exercise the redemption or repurchase right;

(2) Either—

(i) The redemption or repurchase agreement requires that the redemption or repurchase price not be established until at least 60 calendar days after receipt of such notification by the partnership or the partner; or

(ii) The redemption or repurchase price is established not more than four times during the partnership's taxable year; and

(3) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (e) of this section) does not exceed 10 percent of the total interests in partnership capital or profits.

(g) *Qualified matching services—(1) In general.* For purposes of section 7704(b) and this section, the transfer of an interest in a partnership through a qualified matching service is disregarded in determining whether interests in the partnership are readily tradable on a secondary market or the substantial equivalent thereof.

(2) *Requirements.* A matching service is a qualified matching service only if—

(i) The matching service consists of a computerized or printed listing system that lists customers' bid and/or ask quotes in order to match partners who want to sell their interests in a partnership (the selling partner) with persons who want to buy those interests;

(ii) Matching occurs either by matching the list of interested buyers with the list of interested sellers or through a bid and ask process that allows interested buyers to bid on the listed interest;

(iii) The selling partner cannot enter into a binding agreement to sell the interest until the 15th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location;

(iv) The closing of the sale effected by virtue of the matching service does not occur prior to the 45th calendar day after the date information regarding the offering of the interest for sale is made available to potential buyers and such time period is evidenced by contemporaneous records ordinarily maintained by the operator at a central location;

(v) The matching service displays only quotes that do not commit any person to buy or sell a partnership interest at the quoted price (nonfirm price quotes) or quotes that express interest in a partnership interest without an accompanying price (nonbinding indications of interest) and does not display quotes at which any person is committed to buy or sell a partnership interest at the quoted price (firm quotes);

(vi) The selling partner's information is removed from the matching service within 120 calendar days after the date information regarding the offering of the interest for sale is made available to potential buyers and, following any removal (other than removal by reason of a sale of any part of such interest) of the selling partner's information from the matching service, no offer to sell an interest in the partnership is entered into the matching service by the selling partner for at least 60 calendar days; and

(vii) The sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in private transfers described in paragraph (e) of this section) does not exceed 10 percent of the total interests in partnership capital or profits.

(3) *Closing.* For purposes of paragraph (g)(2)(iv) of this section, the closing of a sale occurs no later than the earlier of—

(i) The passage of title to the partnership interest;

(ii) The payment of the purchase price (which does not include the delivery of funds to the operator of the matching service or other closing agent to hold on behalf of the seller pending closing); or

(iii) The date, if any, that the operator of the matching service (or any person related to the operator within the meaning of section 267(b) or 707(b)(1)) loans, advances, or otherwise arranges for funds to be available to the seller in anticipation of the payment of the purchase price.

(4) *Optional features.* A qualified matching service may be sponsored or operated by a partner of the partnership (either formally or informally), the underwriter that handled the issuance of the partnership interests, or an unrelated third party. In addition, a qualified matching service may offer the following features—

(i) The matching service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; a description of the business of the partnership; financial and reporting information from the partnership's financial statements and reports; and information regarding material events involving the partnership, including special distributions, capital distributions, and refinancings or sales of significant portions of partnership assets;

(ii) The operator may assist with the transfer documentation necessary to transfer the partnership interest;

(iii) The operator may receive and deliver funds for completed transactions; and

(iv) The operator's fee may consist of a flat fee for use of the service, a fee or commission based on completed transactions, or any combination thereof.

(h) *Private placements*—(1) *In general.* For purposes of section 7704(b) and this section, except as otherwise provided in paragraph (h)(2) of this section, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if—

(i) All interests in the partnership were issued in a transaction (or transactions) that was not required to be registered under the Securities Act of 1933 (15 U.S.C. 77a et seq.); and

(ii) The partnership does not have more than 100 partners at any time during the taxable year of the partnership.

(2) *Exception for certain offerings outside of the United States.* Paragraph (h)(1) of this section does not apply to the offering and sale of interests in a partnership that was not required to be registered under the Securities Act of 1933 by reason of Regulation S (17 CFR 230.901 through 230.904) unless the offering and sale of the interests would not have been required to be registered under the Securities Act of 1933 if the interests had been offered and sold within the United States.

(3) *Anti-avoidance rule.* For purposes of determining the number of partners in the partnership under paragraph (h)(1)(ii) of this section, a person (beneficial owner) owning an interest in a partnership, grantor trust, or S corporation (flow-through entity), that owns, directly or through other flow-

through entities, an interest in the partnership, is treated as a partner in the partnership only if—

(i) Substantially all of the value of the beneficial owner's interest in the flow-through entity is attributable to the flow-through entity's interest (direct or indirect) in the partnership; and

(ii) A principal purpose of the use of the tiered arrangement is to permit the partnership to satisfy the 100-partner limitation in paragraph (h)(1)(ii) of this section.

(i) [Reserved].

(j) *Lack of actual trading*—(1) *General rule.* For purposes of section 7704(b) and this section, interests in a partnership are not readily tradable on a secondary market or the substantial equivalent thereof if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in paragraph (e), (f), or (g) of this section) does not exceed 2 percent of the total interests in partnership capital or profits.

(2) *Examples.* The following examples illustrate the rules of this paragraph (j):

Example 1. Calculation of percentage interest transferred. (i) ABC, a calendar year limited partnership formed in 1996, has 9,000 units of limited partnership interests outstanding at all times during 1997, representing in the aggregate 95 percent of the total interests in capital and profits of ABC. The remaining 5 percent is held by the general partner.

(ii) During 1997, the following transactions occur with respect to the units of ABC's limited partnership interests—

(A) 800 units are sold through the use of a qualified matching service that meets the requirements of paragraph (g) of this section;

(B) 50 units are sold through the use of a matching service that does not meet the requirements of paragraph (g) of this section; and

(C) 500 units are transferred as a result of private transfers described in paragraph (e) of this section.

(iii) The private transfers of 500 units and the sale of 800 units through a qualified matching service are disregarded under paragraph (j)(1) of this section for purposes of applying the 2 percent rule. As a result, the total percentage interests in partnership capital and profits transferred for purposes of the 2 percent rule is .528 percent, determined by—

(A) Dividing the number of units sold through a matching service that did not meet the requirements of paragraph (g) of this section (50) by the total number of outstanding limited partnership units (9,000); and

(B) Multiplying the result by the percentage of total interests represented by limited partnership units (95 percent) $([50/9,000] \times .95 = .528 \text{ percent})$.

Example 2. Application of the 2 percent rule. (i) ABC operates a service consisting of comput-

erized video display screens on which subscribers view and publish nonfirm price quotes that do not commit any person to buy or sell a partnership interest and unpriced indications of interest in a partnership interest without an accompanying price. The ABC service does not provide firm quotes at which any person (including the operator of the service) is committed to buy or sell a partnership interest. The service may provide prior pricing information, including information regarding resales of interests and actual prices paid for interests; transactional volume information; and information on special or capital distributions by a partnership. The operator's fee may consist of a flat fee for use of the service; a fee based on completed transactions, including, for example, the number of nonfirm quotes or unpriced indications of interest entered by users of the service; or any combination thereof.

(ii) The ABC service is not an established securities market for purposes of section 7704(b) and this section. The service is not an interdealer quotation system as defined in paragraph (b)(5) of this section because it does not disseminate firm buy or sell quotations. Therefore, partnerships whose interests are listed and transferred on the ABC service are not publicly traded for purposes of section 7704(b) and this section as a result of such listing or transfers if the sum of the percentage interests in partnership capital or profits transferred during the taxable year of the partnership (other than in transfers described in paragraph (e), (f), or (g) of this section) does not exceed 2 percent of the total interests in partnership capital or profits. In addition, assuming the ABC service complies with the necessary requirements, the service may qualify as a matching service described in paragraph (g) of this section.

(k) *Percentage interests in partnership capital or profits*—(1) *Interests considered*—(i) *General rule.* Except as otherwise provided in this paragraph (k), for purposes of this section, the total interests in partnership capital or profits are determined by reference to all outstanding interests in the partnership.

(ii) *Exceptions*—(A) *General partner with greater than 10 percent interest.* If the general partners and any person related to the general partners (within the meaning of section 267(b) or 707(b)(1)) own, in the aggregate, more than 10 percent of the outstanding interests in partnership capital or profits at any one time during the taxable year of the partnership, the total interests in partnership capital or profits are determined without reference to the interests owned by such persons.

(B) *Derivative interests.* Any partnership interests described in paragraph (a)(2)(i)(B) of this section are taken into account for purposes of determining the total interests in partnership capital or profits only if and to the extent that the partnership satisfies paragraph (d)(1) or (2) of this section.

(2) *Monthly determination.* For purposes of this section, except in the case of block transfers (as defined in paragraph (e)(2) of this section), the percentage interests in partnership capital or profits represented by partnership interests that are transferred during a taxable year of the partnership is equal to the sum of the percentage interests transferred for each calendar month during the taxable year of the partnership in which a transfer of a partnership interest occurs (other than a private transfer as described in paragraph (e) of this section). The percentage interests in capital or profits of interests transferred during a calendar month is determined by reference to the partnership interests outstanding during that month.

(3) *Monthly conventions.* For purposes of paragraph (k)(2) of this section, a partnership may use any reasonable convention in determining the interests outstanding for a month, provided the convention is consistently used by the partnership from month to month during a taxable year and from year to year. Reasonable conventions include, but are not limited to, a determination by reference to the interests outstanding at the beginning of the month, on the 15th day of the month, or at the end of the month.

(4) *Block transfers.* For purposes of paragraph (e)(2) of this section (defining block transfers), the partnership must determine the percentage interests in capital or profits for each transfer of an interest during the 30 calendar day period by reference to the partnership interests outstanding immediately prior to such transfer.

(5) *Example.* The following example illustrates the rules of this paragraph (k):

Example. Conventions. (i) ABC limited partnership, a calendar year partnership formed in 1996, has 1,000 units of limited partnership interests outstanding on January 1, 1997, representing in the aggregate 95 percent of the total interests in capital and profits of ABC. The remaining 5 percent is held by the general partner.

(ii) The following transfers take place during 1997—

(A) On January 15, 10 units of limited partnership interests are sold in a transaction that is not a private transfer;

(B) On July 10, 1,000 additional units of limited partnership interests are issued by the partnership (the general partner's percentage interest is unchanged); and

(C) On July 20, 15 units of limited partnership interests are sold in a transaction that is not a private transfer.

(iii) For purposes of determining the sum of the percentage interests in partnership capital or profits transferred, ABC chooses to use the end of the month convention. The percentage interests in partnership capital and profits transferred during January is .95 percent, determined by dividing the number of transferred units (10) by the total number of limited partnership units (1,000) and multiplying the result by the percentage of total interests represented by limited partnership units ($[10/1,000] \times .95$). The percentage interests in partnership capital and profits transferred during July is .7125 percent ($[15/2,000] \times .95$). ABC is not required to make determinations for the other months during the year because no transfers of partnership interests occurred during such months. ABC may qualify for the 2 percent rule for its 1997 taxable year because less than 2 percent (.95 percent + .7125 percent = 1.6625 percent) of its total interests in partnership capital and profits was transferred during that year.

(iv) If ABC had chosen to use the beginning of the month convention, the interests in capital or profits sold during July would have been 1.425 percent ($[15/1,000] \times .95$) and ABC would not have satisfied the 2 percent rule for its 1997 taxable year because 2.375 percent (.95 + 1.425) of ABC's interests in partnership capital and profits was transferred during that year.

(1) *Effective date*—(1) *In general.* Except as provided in paragraph (l)(2) of this section, this section applies to taxable years of a partnership beginning after December 31, 1995.

(2) *Transition period.* For partnerships that were actively engaged in an activity before December 4, 1995, this section applies to taxable years beginning after December 31, 2005, unless the partnership adds a substantial new line of business after December 4, 1995, in which case this section applies to taxable years beginning on or after the addition of the new line of business. Partnerships that qualify for this transition period may continue to rely on the provisions of Notice 88-75 (1988-2 C.B. 386)(see §601.601(d)(2) of this chapter) for guidance regarding the definition of readily tradable on a secondary market or the substantial equivalent thereof for purposes of section 7704(b).

(3) *Substantial new line of business.* For purposes of paragraph (l)(2) of this section—

(i) Substantial is defined in §1.7704-2(c); and

(ii) A new line of business is defined in §1.7704-2(d), except that the applicable date is “December 4, 1995” instead of “December 17, 1987”.

(4) *Termination under section 708(b)(1)(B).* The termination of a partnership under section 708(b)(1)(B) due to the sale or exchange of 50 percent or more of the total interests in

partnership capital and profits is disregarded in determining whether a partnership qualifies for the transition period provided in paragraph (1)(2) of this section.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

Approved November 21, 1995.

Leslie Samuels,
*Assistant Secretary of
the Treasury.*

(Filed by the Office of the Federal Register on November 29, 1995, 3:02 p.m., and published in the issue of the Federal Register for December 4, 1995, 60 F.R. 62026)

Chapter 80.—General Rules
Subchapter A.—Application of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805-1: Rules and regulations.
(Also §§ 871, 881, 1441, 1442, and 7701(l).)

Obsoleting conduit revenue rulings.
Certain rulings that relate to conduit financing arrangements are obsoleted.

Rev. Rul. 95-56

The Internal Revenue Service is continuing its program of reviewing revenue rulings published in the Internal Revenue Bulletin to identify and publish lists of those revenue rulings that, although not specifically revoked or suspended, are no longer considered determinative because (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations or subsequently published position; or (3) the facts set forth no longer exist or are not sufficiently described to permit clear application of the current statute and regulations.

This revenue ruling publishes a list of revenue rulings that recharacterize back-to-back loans as loans directly between two entities where the arrangements were entered into to obtain the benefits of an income tax treaty that exempted interest payments from U.S. withholding tax or to qualify for the portfolio interest exemption from with-

holding tax under sections 871(h) and 881(c). The revenue rulings listed below are rendered obsolete for payments made after September 10, 1995, that are subject to the final regulations under section 7701(l). See, TD 8611, 60 F.R. 40997.

| <i>Rev. Rul. No.</i> | <i>C.B. Citation</i> |
|---|----------------------|
| Rev. Rul. 84-152 | 1984-2 C.B. 381 |
| Rev. Rul. 84-153 | 1984-2 C.B. 383 |
| Rev. Rul. 85-163 | 1985-2 C.B. 349 |
| Rev. Rul. 87-89,
Situations (1)
and (2) | 1987-2 C.B. 195 |

The Service will continue to review other revenue rulings relating to conduit financing arrangements to ascertain whether any are rendered obsolete. Therefore, failure to include any particular revenue ruling in the above list should not be construed as an indication that the revenue ruling necessarily is determinative with respect to payments governed by the final regulations issued under section 7701(l).

26 CFR 301.7805-1: Rules and regulations.

Obsolete revenue rulings. This ruling publishes a list of revenue rulings identified under the Regulatory Reinvention Initiative as being obsolete.

Rev. Rul. 95-71

As part of the President's Regulatory Reinvention Initiative, the Treasury Department and the Internal Revenue Service have identified revenue rulings published in the Internal Revenue Bulletin that, although not specifically revoked or superseded, are obsolete because (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the ruling position is specifically covered by statute, regulations, or subsequent published position; or (3) the facts set forth no longer exist or are not sufficiently described to permit clear application of the current statute and regulations.

This revenue ruling publishes a list of revenue rulings identified under the Regulatory Reinvention Initiative as being obsolete.

Accordingly, the revenue rulings listed below are hereby declared obsolete.

| <i>Rev. Rul. No.</i> | <i>C.B. Citation</i> |
|----------------------|----------------------|
| Rev. Rul. 87-4 | 1987-1 C.B. 132 |

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|------------------|-----------------|
| Rev. Rul. 85-161 | 1985-2 C.B. 191 |
| Rev. Rul. 85-125 | 1985-2 C.B. 180 |
| Rev. Rul. 83-38 | 1983-1 C.B. 76 |
| Rev. Rul. 82-113 | 1982-1 C.B. 78 |
| Rev. Rul. 82-72 | 1982-1 C.B. 57 |
| Rev. Rul. 82-58 | 1982-1 C.B. 27 |
| Rev. Rul. 81-218 | 1981-2 C.B. 43 |
| Rev. Rul. 81-204 | 1981-2 C.B. 157 |
| Rev. Rul. 80-221 | 1980-2 C.B. 107 |
| Rev. Rul. 79-376 | 1979-2 C.B. 133 |
| Rev. Rul. 79-149 | 1979-1 C.B. 132 |
| Rev. Rul. 79-121 | 1979-1 C.B. 61 |
| Rev. Rul. 79-3 | 1979-1 C.B. 143 |
| Rev. Rul. 78-422 | 1978-2 C.B. 129 |
| Rev. Rul. 78-350 | 1978-2 C.B. 135 |
| Rev. Rul. 78-285 | 1978-2 C.B. 137 |
| Rev. Rul. 77-190 | 1977-1 C.B. 88 |
| Rev. Rul. 76-36 | 1976-1 C.B. 105 |
| Rev. Rul. 75-508 | 1975-2 C.B. 379 |
| Rev. Rul. 75-460 | 1975-2 C.B. 348 |
| Rev. Rul. 75-324 | 1975-2 C.B. 348 |
| Rev. Rul. 75-240 | 1975-1 C.B. 315 |
| Rev. Rul. 75-40 | 1975-1 C.B. 276 |
| Rev. Rul. 74-522 | 1974-2 C.B. 271 |
| Rev. Rul. 74-441 | 1974-2 C.B. 105 |
| Rev. Rul. 74-430 | 1974-2 C.B. 100 |
| Rev. Rul. 74-295 | 1974-1 C.B. 78 |
| Rev. Rul. 74-119 | 1974-1 C.B. 276 |
| Rev. Rul. 74-61 | 1974-1 C.B. 239 |
| Rev. Rul. 73-611 | 1973-2 C.B. 312 |
| Rev. Rul. 73-552 | 1973-2 C.B. 116 |
| Rev. Rul. 73-551 | 1973-2 C.B. 112 |
| Rev. Rul. 73-515 | 1973-2 C.B. 7 |
| Rev. Rul. 73-264 | 1973-1 C.B. 178 |
| Rev. Rul. 73-2 | 1973-1 C.B. 171 |
| Rev. Rul. 71-522 | 1971-2 C.B. 316 |
| Rev. Rul. 70-514 | 1970-2 C.B. 198 |
| Rev. Rul. 70-467 | 1970-2 C.B. 169 |
| Rev. Rul. 69-284 | 1969-1 C.B. 203 |
| Rev. Rul. 69-172 | 1969-1 C.B. 99 |
| Rev. Rul. 69-95 | 1969-1 C.B. 204 |
| Rev. Rul. 68-457 | 1968-2 C.B. 341 |
| Rev. Rul. 68-358 | 1968-2 C.B. 156 |
| Rev. Rul. 68-294 | 1968-1 C.B. 46 |
| Rev. Rul. 68-21 | 1968-1 C.B. 104 |
| Rev. Rul. 67-269 | 1967-2 C.B. 298 |
| Rev. Rul. 66-327 | 1966-2 C.B. 357 |
| Rev. Rul. 66-306 | 1966-2 C.B. 356 |
| Rev. Rul. 66-81 | 1966-1 C.B. 64 |
| Rev. Rul. 65-30 | 1965-1 C.B. 155 |
| Rev. Rul. 64-257 | 1964-2 C.B. 91 |
| Rev. Rul. 64-239 | 1964-2 C.B. 93 |
| Rev. Rul. 64-100 | 1964-1 C.B. 130 |
| Rev. Rul. 63-125 | 1963-2 C.B. 146 |
| Rev. Rul. 58-391 | 1958-2 C.B. 139 |
| Rev. Rul. 58-241 | 1958-1 C.B. 179 |
| Rev. Rul. 58-9 | 1958-1 C.B. 190 |
| Rev. Rul. 57-490 | 1957-2 C.B. 231 |
| Rev. Rul. 57-243 | 1957-1 C.B. 116 |
| Rev. Rul. 56-286 | 1956-1 C.B. 172 |
| Rev. Rul. 56-171 | 1956-1 C.B. 179 |
| Rev. Rul. 54-257 | 1954-2 C.B. 429 |
| Rev. Rul. 54-171 | 1954-1 C.B. 282 |

Treasury and the Service will continue to review other revenue rulings to ascertain those that, for the reasons stated above, are obsolete. Therefore, failure to include any particular revenue ruling in the above list should not be construed as necessarily indicating that the revenue ruling is not obsolete.

26 CFR 301.7805-1: Rules and regulations.

A taxpayer may not use an inventory method under section 471 of the Code to account for REMIC residual interests. See Rev. Rul. 95-81, page 70.

Subchapter C.—Provisions Affecting More Than One Subtitle

Section 7872.—Treatment Of Loans With Below-Market Interest Rates

A procedure is provided whereby an employer and a trustee may request a closing agreement on the application of § 7872 of the Code to certain payments to a defined contribution plan that has assets invested in certain products of a life insurance company in state insurer delinquency proceedings. See Rev. Proc. 95-52, page 439.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1995. See Rev. Rul. 95-48, page 125.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1995. See Rev. Rul. 95-51, page 127.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1995. See Rev. Rul. 95-62, page 129.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1995. See Rev. Rul. 95-67, page 130.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1995. See Rev. Rul. 95-73, page 132.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1995. See Rev. Rul. 95-79, page 134.

Part II. Treaties and Tax Legislation

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Subpart B.—Legislation and Related
Committee Reports

Public Law 104-7

Part II. Treaties and Tax Legislation

Subpart B.—Legislation and Related Committee Reports

Public Law 104-7 104th Congress

An Act to amend the Internal Revenue Code of 1986 to permanently extend the deduction for the health insurance costs of self-employed individuals, to repeal the provision permitting nonrecognition of gain on sales and exchanges effectuating policies of the Federal Communications Commission, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. PERMANENT EXTENSION AND INCREASE OF DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS.

(a) *Permanent Extension.*—Subsection (1) of section 162 of the Internal Revenue Code of 1986 (relating to special rules for health insurance costs of self-employed individuals) is amended by striking paragraph (6).

(b) *Increase in Deduction.*—Paragraph (1) of section 162(1) of the Internal Revenue Code of 1986 is amended by striking “25 percent” and inserting “30 percent”.

(c) *Effective Dates.*—

(1) *Extension.*—The amendment made by subsection (a) shall apply to taxable years beginning after December 31, 1993.

(2) *Increase.*—The amendment made by subsection (b) shall apply to taxable years beginning after December 31, 1994.

SEC. 2. REPEAL OF NONRECOGNITION ON FCC CERTIFIED SALES AND EXCHANGES.

(a) *In General.*—Subchapter O of chapter 1 of the Internal Revenue Code of 1986 is amended by striking part V (relating to changes to effectuate FCC policy).

(b) *Conforming Amendments.*—Sections 1245(b)(5) and 1250(d)(5) of the Internal Revenue Code of 1986 are each amended—

(1) by striking “section 1071 (relating to gain from sale or exchange to effectuate policies of FCC) or”, and

(2) by striking “1071 AND” in the heading thereof.

(c) *Clerical Amendment.*—The table of parts for such subchapter O is amended by striking the item relating to part V.

(d) *Effective Date.*—

(1) *In general.*—The amendments made by this section shall apply to—

(A) sales and exchanges on or after January 17, 1995, and

(B) sales and exchanges before such date if the FCC tax certificate with respect to such sale or exchange is issued on or after such date.

(2) *Binding contracts.*—

(A) *In general.*—The amendments made by this section shall not apply to any sale or exchange pursuant to a written contract which was binding on January 16, 1995, and at all times thereafter before the sale or exchange, if the FCC tax certificate with respect to such sale or exchange was applied for, or issued, on or before such date.

(B) *Sales contingent on issuance of certificate.*—

(i) *In general.*—A contract shall be treated as not binding for purposes of subparagraph (A) if the sale or exchange pursuant to such contract, or the material terms of such contract, were contingent, at any time on January 16, 1995, on the issuance of an FCC tax certificate. The preceding sentence shall not apply if the FCC tax certificate for such sale or exchange is issued on or before January 16, 1995.

(ii) *Material terms.*—For purposes of clause (i), the material terms of a contract shall not be treated as contingent on the issuance of an FCC tax certificate solely because such terms provide that the sales price would, if such certificate were not issued, be increased by an amount not greater than 10 percent of the sales price otherwise provided in the contract.

(3) *FCC tax certificate.*—For purposes of this subsection, the term “FCC tax certificate” means any certificate of the Federal Communications Commission for the effectuation of section 1071 of the Internal Revenue Code of 1986 (as in effect on the day before the date of the enactment of this Act).

SEC. 3. SPECIAL RULES RELATING TO INVOLUNTARY CONVERSIONS.

(a) *Replacement Property Acquired by Corporations From Related Persons.*—

(1) *In general.*—Section 1033 of the Internal Revenue Code of 1986 (relating to involuntary conversions) is amended by redesignating subsection (i) as subsection (j) and by inserting after subsection (h) the following new subsection:

“(i) *Nonrecognition Not To Apply if Corporation Acquires Replacement Property From Related Person.*—

“(1) *In general.*—In the case of—

“(A) a C corporation, or

“(B) a partnership in which 1 or more C corporations own, directly or indirectly (determined in accordance with section 707(b)(3)), more than 50 percent of the capital interest, or profits interest, in such partnership at the time of the involuntary conversion,

subsection (a) shall not apply if the replacement property or stock is acquired from a related person. The preceding sentence shall not apply to the extent that the related person acquired the replacement property or stock from an unrelated person during the period described in subsection (a)(2)(B).

“(2) *Related person.*—For purposes of this subsection, a person is related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1).”

(2) *Effective date.*—The amendment made by paragraph (1) shall apply to involuntary conversions occurring on or after February 6, 1995.

(b) *Application of Section 1033 to Certain Sales Required for Microwave Relocation.*—

(1) *In general.*—Section 1033 of the Internal Revenue Code of 1986 (relating to involuntary conversions), as amended by subsection (a), is amended by redesignating subsection (j) as subsection (k) and by inserting after subsection (i) the following new subsection:

“(j) *Sales or Exchanges To Implement Microwave Relocation Policy.*—

“(1) *In general.*—For purposes of this subtitle, if a taxpayer elects the

application of this subsection to a qualified sale or exchange, such sale or exchange shall be treated as an involuntary conversion to which this section applies.

“(2) *Qualified sale or exchange.*—For purpose of paragraph (1), the term ‘qualified sale or exchange’ means a sale or exchange before January 1, 2000, which is certified by the Federal Communications Commission as having been made by a taxpayer in connection with the relocation of the taxpayer from the 1850–1990MHz spectrum by reason of the Federal Communications Commission’s reallocation of that spectrum for use for personal communications services. The Commission shall transmit copies of certifications under this paragraph to the Secretary.”

(2) *Effective date.*—The amendment made by paragraph (1) shall apply to sales or exchanges after March 14, 1995.

SEC. 4. DENIAL OF EARNED INCOME CREDIT FOR INDIVIDUALS HAVING EXCESSIVE INVESTMENT INCOME.

(a) *In General.*—Section 32 of the Internal Revenue Code of 1986 is amended by redesignating subsections (i) and (j) as subsections (j) and (k), respectively, and by inserting after subsection (h) the following new subsection:

“(i) *Denial of Credit for Individuals Having Excessive Investment Income.*—

“(1) *In general.*—No credit shall be allowed under subsection (a) for the taxable year if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$2,350.

“(2) *Disqualified income.*—For purposes of paragraph (1), the term ‘disqualified income’ means—

“(A) interest or dividends to the extent includible in gross income for the taxable year,

“(B) interest received or accrued during the taxable year which is exempt from tax imposed by this chapter, and

“(C) the excess (if any) of—

“(i) gross income from rents or royalties not derived in the ordinary course of a trade or business, over

“(ii) the sum of—

“(I) the deductions (other than interest) which are clearly and directly allocable to such gross income, plus

“(II) interest deductions properly allocable to such gross income.”

(b) *Effective Date.*—The amendments made by this section shall apply to taxable years beginning after December 31, 1995.

SEC. 5. EXTENSION OF SPECIAL RULE FOR CERTAIN GROUP HEALTH PLANS.

Section 13442(b) of the Omnibus Budget Reconciliation Act of 1993 (Public Law 103–66) is amended by striking “May 12, 1995” and inserting “December 31, 1995”.

SEC. 6. STUDY OF EXPATRIATION TAX.

(a) *In General.*—The staff of the Joint Committee on Taxation shall conduct a study of the issues presented by any proposals to affect the taxation of expatriation, including an evaluation of—

(1) the effectiveness and enforceability of current law with respect to the tax treatment of expatriation,

(2) the current level of expatriation for tax avoidance purposes,

(3) any restrictions imposed by any constitutional requirement that the Federal income tax apply only to realized gains,

(4) the application of international human rights principles to taxation of expatriation,

(5) the possible effects of any such proposals on the free flow of capital into the United States,

(6) the impact of any such proposals on existing tax treaties and future treaty negotiations,

(7) the operation of any such proposals in the case of interests in trusts,

(8) the problems of potential double taxation in any such proposals,

(9) the impact of any such proposals on the trade policy objectives of the United States,

(10) the administrability of such proposals, and

(11) possible problems associated with existing law, including estate and gift tax provisions.

(b) *Report.*—The Chief of Staff of the Joint Committee on Taxation shall, not later than June 1, 1995, report the results of the study conducted under subsection (a) to the Chairmen of the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate.

Approved April 11, 1995.

Part III. Administrative, Procedural, and Miscellaneous

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Part III. Administrative, Procedural, and Miscellaneous

List of Countries Requiring Cooperation with an International Boycott

Notice 95-41

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1986, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986).

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986):

Bahrain
Iraq
Jordan
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Republic of

Dated: June 14, 1995.

Joseph Guttentag,
International Tax Counsel
(*Tax Policy*).

(Filed by the Office of the Federal Register on June 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for June 21, 1995, 60 F.R. 32402)

Weighted Average Interest Rate Update

Notice 95-42

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for June 1995 is 6.57 percent.

The following rates were determined for the plan years beginning in the month shown below.

| Month | Year | Weighted Average | 90% to 109% Permissible Range | 90% to 110% Permissible Range |
|-------|------|------------------|-------------------------------|-------------------------------|
| July | 1995 | 7.23 | 6.51 to 7.88 | 6.51 to 7.96 |

Tax on Certain Imported Substances; Notice of Determination

Notice 95-43

This notice announces determinations, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in § 4672(a)(3) will be modified to include monoethanolamine, diethanolamine, triethanolamine, monoisopropanolamine, diisopropanolamine, triisopropanolamine, toluene diisocyanate, and chlorinated polyethylene. This modification is effective April 1, 1992.

Background

Under § 4672(a), an importer or exporter of any substance may request that the Secretary determine whether the substance should be listed as a taxable substance. The Secretary shall add the substance to the list of taxable substances in § 4672(a)(3) if the Secretary determines that taxable chem-

icals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce the substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61 sets forth the rules relating to the determination process.

Determination

On July 10, 1995, the Secretary determined that monoethanolamine, diethanolamine, triethanolamine, monoisopropanolamine, diisopropanolamine, triisopropanolamine, toluene diisocyanate, and chlorinated polyethylene should be added to the list of taxable substances in § 4672(a)(3), effective April 1, 1992.

The rate of tax prescribed for monoethanolamine, under § 4671(b)(3), is \$3.63 per ton. This is based upon a conversion factor for ethylene of 0.59 and a conversion factor for ammonia of 0.29.

The rate of tax prescribed for di-

ethanolamine, under § 4671(b)(3), is \$3.85 per ton. This is based upon a conversion factor for ethylene of 0.70 and a conversion factor for ammonia of 0.17.

The rate of tax prescribed for triethanolamine, under § 4671(b)(3), is \$3.96 per ton. This is based upon a conversion factor for ethylene of 0.75 and a conversion factor for ammonia of 0.12.

The rate of tax prescribed for monoisopropanolamine, under § 4671(b)(3), is \$6.66 per ton. This is based upon a conversion factor for propylene of 0.62, a conversion factor for chlorine of 1.00, a conversion factor for sodium hydroxide of 1.20, and a conversion factor for ammonia of 0.23.

The rate of tax prescribed for diisopropanolamine, under § 4671(b)(3), is \$7.08 per ton. This is based upon a conversion factor for propylene of 0.70, a conversion factor for chlorine of 1.10, a conversion factor for sodium hydroxide of 1.30, and a conversion factor for ammonia of 0.13.

The rate of tax prescribed for triisopropanolamine, under § 4671(b)(3), is \$7.49 per ton. This is based upon a conversion factor for propylene of 0.74, a conversion factor for chlorine of 1.20, a conversion factor for sodium hydroxide of 1.40, and a conversion factor for ammonia of 0.10.

The rate of tax prescribed for toluene diisocyanate, under § 4671(b)(3), is \$4.90 per ton. This is based upon a conversion factor for toluene of 0.53, a conversion factor for nitric acid of 0.7, and a conversion factor for chlorine of 0.8.

The rate of tax prescribed for chlorinated polyethylene, under § 4671(b)(3), is \$5.05 per ton. This is based upon a conversion factor for ethylene of 0.65 and a conversion factor for chlorine of 0.70.

The petitioner is Dow Chemical Company, a manufacturer and exporter of these substances. No material comments were received on these petitions. The following information is the basis for the determinations.

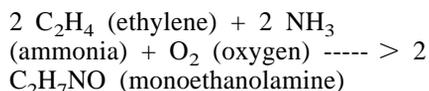
Monoethanolamine

HTS number: 2922.11.00.00

CAS number: 141-43-5

Monoethanolamine is derived from the taxable chemicals ethylene and ammonia and is a liquid produced predominantly by reacting ethylene oxide and aqueous ammonia.

The stoichiometric material consumption formula for this substance is:



Monoethanolamine has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 73.7 percent by weight of the materials used in its production.

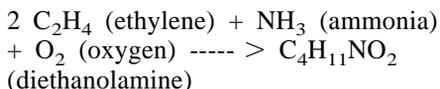
Diethanolamine

HTS number: 2922.12.00.00

CAS number: 111-42-2

Diethanolamine is derived from the taxable chemicals ethylene and ammonia and is a solid produced predominantly by reacting ethylene oxide and aqueous ammonia.

The stoichiometric material consumption formula for this substance is:



Diethanolamine has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 69.5 percent by weight of the materials used in its production.

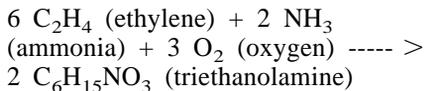
Triethanolamine

HTS number: 2922.13.00.00

CAS number: 102-71-6

Triethanolamine is derived from the taxable chemicals ethylene and ammonia and is a liquid produced predominantly by reacting ethylene oxide and aqueous ammonia.

The stoichiometric material consumption formula for this substance is:



Triethanolamine has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 67.7 percent by weight of the materials used in its production.

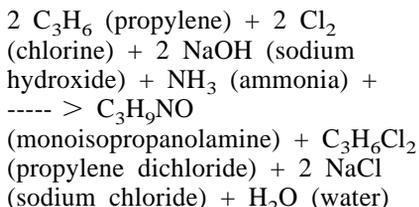
Monoisopropanolamine

HTS number: 2922.19.60.00

CAS number: 78-96-6

Monoisopropanolamine is derived from the taxable chemicals propylene, chlorine, sodium hydroxide, and ammonia and is a liquid produced predominantly by the reaction of propylene oxide and ammonia.

The stoichiometric material consumption formula for this substance is:



Monoisopropanolamine has been determined to be a taxable substance

because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 100 percent by weight of the materials used in its production.

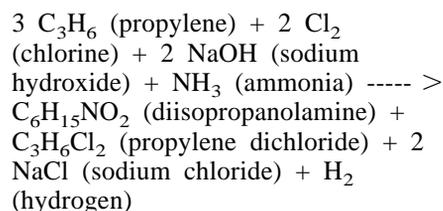
Diisopropanolamine

HTS number: 2922.19.60.00

CAS number: 110-97-4

Diisopropanolamine is derived from the taxable chemicals propylene, chlorine, sodium hydroxide, and ammonia and is a solid produced predominantly by the reaction of propylene oxide and ammonia.

The stoichiometric material consumption formula for this substance is:



Diisopropanolamine has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 100 percent by weight of the materials used in its production.

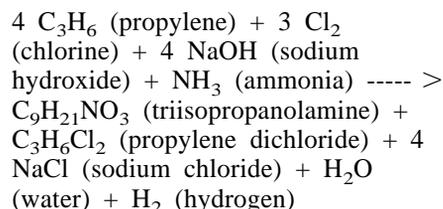
Triisopropanolamine

HTS number: 2922.19.60.00

CAS number: 122-20-3

Triisopropanolamine is derived from the taxable chemicals propylene, chlorine, sodium hydroxide, and ammonia and is a solid produced predominantly by the reaction of propylene oxide and ammonia.

The stoichiometric material consumption formula for this substance is:



Triisopropanolamine has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows

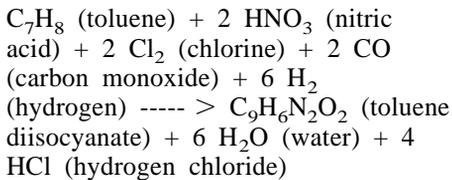
that, based on the predominant method of production, taxable chemicals constitute 100 percent by weight of the materials used in its production.

Toluene diisocyanate

HTS number: 2929.10.15.00
CAS number: 584-84-9

Toluene diisocyanate is derived from the taxable chemicals toluene, nitric acid, and chlorine and is a liquid produced predominantly by the phosphorylation of primary amines.

The stoichiometric material consumption formula for this substance is:



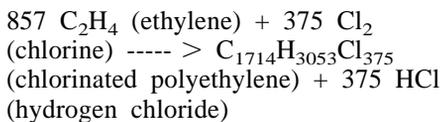
Toluene diisocyanate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 84 percent by weight of the materials used in its production.

Chlorinated polyethylene

HTS number: 3901.90.50.00
CAS number: 064754-90-1

Chlorinated polyethylene is derived from the taxable chemicals ethylene and chlorine and is a solid produced predominantly by chlorination of polyethylene resins.

The stoichiometric material consumption formula for this substance is:



Chlorinated polyethylene has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 100 percent by weight of the materials used in its production.

Tax on Certain Imported Substances; Notice of Determination

Notice 95-44

This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in § 4672(a)(3) will be modified to include toluenediamine. This modification is effective October 1, 1995.

Background

Under § 4672(a), an importer or exporter of any substance may request that the Secretary determine whether that substance should be listed as a taxable substance. The Secretary shall add the substance to the list of taxable substances in § 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce the substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61 sets forth the rules relating to the determination process.

Determination

On July 10, 1995, the Secretary determined that toluenediamine should be added to the list of taxable substances in § 4672(a)(3), effective October 1, 1995.

The rate of tax prescribed for toluenediamine, under § 4671(b)(3), is \$5.59 per ton. This is based upon a conversion factor for toluene of 0.78, a conversion factor for methane of 0.26, and a conversion factor for ammonia of 0.34.

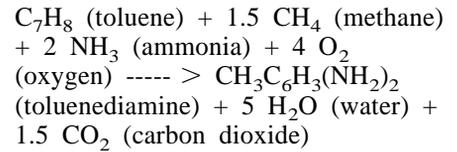
The petitioner is Air Products and Chemicals, Inc., a manufacturer and exporter of this substance. No material comments were received on this petition. The following information is the basis for the determination.

HTS number: 2921.51.10
CAS number: 95-80-7, 823-40-5, 2687-25-4, and 496-72-0

Toluenediamine is derived from the taxable chemicals toluene, methane, and ammonia and is a solid produced predominantly by a two-step process. The first step is mixed-acid nitration of toluene to produce dinitrotoluene. The

second step is the catalytic reaction of hydrogen and dinitrotoluene to produce toluenediamine.

The stoichiometric material consumption formula for this substance is:



Toluenediamine has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 53.95 percent by weight of the materials used in its production.

Suspension of Rev. Rul. 93-88

Notice 95-45

This notice invites public comment concerning areas requiring guidance under § 104(a)(2) of the Internal Revenue Code in light of the opinion of the Supreme Court of the United States in *Commissioner v. Schleier*, 115 S. Ct. 2159 (1995). This notice also (1) suspends Rev. Rul. 93-88, 1993-2 C.B. 61, and (2) amplifies Rev. Proc. 95-3, 1995-1 C.B. 385.

BACKGROUND

Section 104(a)(2) provides, generally, that gross income does not include the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness.

Section 1.104-1(c) of the Income Tax Regulations provides that the term "damages received (whether by suit or agreement)" means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based on tort or tort-type rights, or through a settlement agreement entered into in lieu of such prosecution.

In *United States v. Burke*, 504 U.S. 229 (1992), the Supreme Court held that back pay received for disparate impact gender discrimination under § 2000e-5(g) of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e to 2000e-17, was not excludable as damages received on account of personal injury under § 104(a)(2). The Court concluded

that § 1.104-1(c) has “linked the identification of a personal injury for purposes of § 104(a)(2) to traditional tort principles.” Examining the nature of a traditional tort, the Court concluded that the most important characteristic is the availability of a broad range of damages, such as damages for emotional distress, pain and suffering, harm to reputation, and other compensatory damages. This broad range of damages was not available under Title VII prior to its amendment by 42 U.S.C. § 1981a in 1991.

Relying on *Burke*, Rev. Rul. 93-88 holds that compensatory damages and back pay recoveries are excludable from gross income as damages for personal injury under § 104(a)(2) when received for: (1) gender discrimination claims under the disparate treatment provisions of Title VII of the Civil Rights Act of 1964, as amended in 1991; (2) racial discrimination claims under § 16 of the Civil Rights Act of 1870, 42 U.S.C. § 1981, and Title VII; and (3) discrimination claims under the Americans With Disabilities Act, 42 U.S.C. §§ 12101-12213.

In *Schleier*, the Supreme Court held that back pay and liquidated damages received in settlement of a claim under the Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (ADEA), are not excludable from gross income under § 104(a)(2). The Court concluded that § 104(a)(2) and its regulations set forth two requirements for a recovery to be excludable from gross income: (1) it must be based on tort or tort-type rights, and (2) it must be received “on account of personal injuries or sickness.” The Court held that back pay and liquidated damages received under the ADEA meet neither requirement because (1) the ADEA provides no compensation for any of the other traditional harms associated with personal injury, (2) the back pay is completely independent of the existence or extent of any personal injury, and (3) the ADEA liquidated damages are punitive in nature.

REQUEST FOR PUBLIC COMMENT

The Service requests public comment concerning areas requiring guidance under § 104(a)(2) in light of *Schleier*. In particular, comments are specifically requested regarding *Schleier*'s impact on: (1) the treatment of recoveries, including those arising under the stat-

utes described in Rev. Rul. 93-88; (2) the allocation of the excludable and nonexcludable portions of lump-sum awards and settlements; and (3) the extent to which § 7805(b) relief should be granted in the event that guidance previously issued by the Service is modified.

Written comments should be submitted by September 30, 1995. Written comments should be sent to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (IA-Branch 2), Room 5228, Washington, D.C. 20044. All materials submitted will be available for public inspection and copying.

SUSPENSION OF REV. RUL. 93-88

In light of the Supreme Court's opinion in *Schleier*, Rev. Rul. 93-88 is suspended.

AMPLIFICATION OF REV. PROC. 95-3

This notice amplifies § 5 of Rev. Proc. 95-3, 1995-1 C.B. 385, relating to areas under extensive study in which rulings or determination letters will not be issued until the Service publishes guidance, by adding the following new paragraph:

Section 104.—Compensation for Injuries or Sickness.—Whether amounts received are excludable from gross income under § 104(a)(2) in situations affected by *Commissioner v. Schleier*, 115 S. Ct. 2159 (1995).

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 93-88 is suspended. Rev. Proc. 95-3 is amplified.

Applicable Rate of Interest on Nonqualified Withdrawals From a Capital Construction Fund

Notice 95-46

Under the authority in Section 607(h)(4)(B) of the Merchant Marine Act, 1936, as amended (the Act, 46 U.S.C. 1177(h)(4)(B)), we hereby determine and announce that the applicable rate of interest on the amount of additional tax attributable to any nonqualified withdrawals from a Capital

Construction Fund established under Section 607 of the Act shall be 7.18 percent, with respect to nonqualified withdrawals made in the taxable year beginning in 1995. The determination of the applicable rate of interest with respect to nonqualified withdrawals was computed, according to the joint regulations issued under the Act (46 CFR 391.7(e)(2)(ii)), by multiplying eight percent by the ratio which (a) the average yield on 5-year Treasury securities for the calendar year immediately preceding the beginning of such taxable year bears to (b) the average yield on 5-year Treasury securities for the calendar year 1970. The applicable rate so determined was computed to the nearest one-hundredth of one percent.

So Ordered By: Maritime Administrator, Maritime Administration; Administrator, National Oceanic and Atmospheric Administration; Assistant Secretary for Tax Policy, Department of the Treasury.

Dated: July 27, 1995.

A.J. Herberger,
Maritime Administrator.

D. James Baker,
Administrator, National Oceanic and Atmospheric Administration.

Leslie Samuels,
Assistant Secretary for Tax Policy.

(Filed by the Office of the Federal Register on August 1, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 2, 1995, 60 F.R. 39480)

Organizations Providing Relief to Victims of the Floods in Virginia

Notice 95-47

As a result of the devastation, personal injury and loss of life caused by the floods in the Commonwealth of Virginia during June and July, 1995, the President has declared the affected area to be eligible for Federal disaster assistance. The Internal Revenue Service has received questions regarding the tax consequences of private efforts to provide relief to disaster victims in this area.

Contributions earmarked for Virginia flood relief that are made to organizations currently recognized by the Service as tax exempt under section 501(c)-

(3) of the Internal Revenue Code are fully deductible as charitable contributions. However, the tax law does not allow taxpayers to deduct contributions earmarked for relief of any particular individual or family.

Donors should exercise care before contributing to any organization. With increased public interest in making donations to charitable organizations to assist disaster victims, there is the increased possibility that some organizations (or their fundraisers) may make false or inaccurate claims regarding how contributions will be used or whether these contributions are tax deductible. Donors have advance assurance of deductibility only for contributions to organizations recognized as exempt by the Service under section 501(c)(3) of the Code.

Charitable organizations formed to aid victims of the Virginia floods but not yet recognized as exempt can receive expedited consideration of their application for recognition of exemption by writing "VIRGINIA FLOOD RELIEF" at the top of Form 1023, which is the form they use to apply for exempt status. In addition, organizations should carefully follow the checklist in the Form 1023 package to insure the application is complete. Detailed information on the requirements for tax exempt status is contained in Publication 557, "Tax Exempt Status for Your

Organization." The latest version of the Form 1023 package, Publication 557, Form SS-4, Application for Employer Identification Number, and Form 8718, User Fee for Exempt Organization Determination Request, may be obtained by calling the Service's toll-free number 1-800-TAX-FORM (1-800-829-3676), or by writing the nearest IRS Forms Distribution Center.

The expedited application processing does not modify or relax the requirement that tax exempt organizations operate exclusively for charitable purposes. However, to the extent that an organization is providing appropriate relief, in good faith, in the designated disaster area, the Service will not raise certain issues that might otherwise affect the organization's qualification for exempt status or, in the case of a private foundation, liability for certain taxes under Chapter 42. Examples of these issues include an organization providing emergency assistance to its own employees or employees of related organizations who have been victimized by the floods (which raise the issue of prohibited inurement), and a private foundation providing emergency assistance to disqualified persons (as defined in section 4946 of the Code) victimized by the floods.

This relief is also granted to organizations exempt under other paragraphs

of section 501(c). For example, the Service will not raise the issue of particular services with respect to a business league exempt under section 501(c)(6) if the organization's good faith relief efforts include aid provided to members victimized by the floods.

This relief is available to both new organizations and existing tax exempt organizations until December 31, 1995, or later if an extension by the Service is determined to be necessary or appropriate.

Weighted Average Interest Rate Update

Notice 95-48

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for July 1995 is 6.72 percent.

The following rates were determined for the plan years beginning in the month shown below.

| Month | Year | Weighted Average | 90% to 109% Permissible Range | 90% to 110% Permissible Range |
|--------|------|------------------|-------------------------------|-------------------------------|
| August | 1995 | 7.20 | 6.48 to 7.85 | 6.48 to 7.92 |

Notice 95-42, page 328, this Bulletin, provided the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) for the month of July 1995. The 90% portion of the range for the 90% to 110% range was incorrect. The correct value is 6.51.

Weighted Average Interest Rate Update

Notice 95-49

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of

the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for August 1995 is 6.86 percent.

The following rates were determined for the plan years beginning in the month shown below.

| Month | Year | Weighted Average | 90% to 109% Permissible Range | 90% to 110% Permissible Range |
|-----------|------|------------------|-------------------------------|-------------------------------|
| September | 1995 | 7.19 | 6.47 to 7.84 | 6.47 to 7.91 |

Substantiation Requirements for Travel and Entertainment Expenses

Notice 95-50

This notice provides information on a change that the Service will make to the substantiation rules in the regulations under § 274(d) of the Internal Revenue Code, and also invites public comment on possible additional changes to certain other substantiation rules under that section.

Receipt threshold to increase from \$25 to \$75. Section 274(d) disallows an otherwise allowable deduction under §§ 162 or 212 for any expense for traveling, entertainment, gifts, or listed property, unless the expense is substantiated by adequate records. Section 1.274-5T(c)(2)(iii) of the temporary Income Tax Regulations requires a taxpayer to maintain documentary evidence (such as receipts) for (A) any lodging expenditure, and (B) any other expenditure of \$25 or more. The \$25 receipt threshold was established in

1962. The Service will amend § 1.274-5T(c)(2)(iii)(B) to increase the \$25 receipt threshold to \$75, effective for expenditures incurred on or after October 1, 1995.

Public comment invited. An employee who is reimbursed by his or her employer may substantiate expenses under the "adequate accounting" rules of § 1.274-5T(f). Under these rules, (1) the employee must furnish the employer with adequate records as provided in § 1.274-5T(c)(2), including documentary evidence (such as receipts), that establish each element (e.g., amount, time, place, and business purpose) of the expenditure, and (2) the employer must maintain the documentary evidence and produce it if requested by the Service.

The Service is also reviewing § 1.274-5T(f) to determine whether changes should be made to the adequate accounting rules to provide alternative means of satisfying the substantiation requirements of § 274(d). The Service invites public comment on this matter. Written comments should be

submitted by December 15, 1995, to: Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Attn: CC:CORP:T:R (IA-Branch 2), Room 5228, Washington, D.C. 20044. All materials submitted will be available for public inspection and copying.

Regulatory Reinvention Initiative—Request for Comments

Notice 95-51

As part of the President's Regulatory Reinvention Initiative, the Treasury Department and the Internal Revenue Service have identified obsolete regulations that relate to prior law, provide elections for prior years, or are otherwise outdated due to changes in the underlying statutory provisions. The Treasury Department and the Internal Revenue Service believe that the regulations listed below should be withdrawn or removed.

Public comments are requested prior to December 1, 1995 regarding whether any of these regulations should be retained.

| <i>Section</i> | <i>Subject</i> |
|---------------------------------|--|
| 1.103-12 | Transitional provisions—application of regulations under section 103(c) |
| 1.110-1 and 1.114-1 | Income taxes paid by lessee corporation; Proceeds from certain sports programs conducted for the benefit of the American National Red Cross |
| 1.115-1 | Bridges to be acquired by state or political subdivisions |
| 1.116-1 and 1.116-2 | Partial exclusion of dividends and effective date; taxable years ending after July 31, 1954, subject to the Internal Revenue Code of 1939 |
| 1.367(a)-7T | Temporary regulations providing a transitional rule for certain transfers of intangibles (temporary) |
| 1.383-1A | Special limitations on carryovers of unused investment credits, work incentive program credits, foreign taxes, and capital losses (pre-Tax Reform Act of 1986) |
| 1.383-2A | Purchase of a corporation and change in its trade or business (pre-Tax Reform Act of 1986) |
| 1.383-3A | Change in ownership as the result of a reorganization (pre-Tax Reform Act of 1986) |
| 1.673(a)-1 | Reversionary interests; Income payable to beneficiaries other than charitable organizations; General rule |
| 1.804-1 and -2 | Taxable years affected; Taxable investment income |
| 1.805-1 through -8 | Tax on life insurance companies in the case of a taxable year beginning in 1954; Reserve interest credits; Taxable Years Affected; Policy and other contract liability requirements; Adjusted reserves rate and earnings rates; Adjusted life insurance reserves; Pension plan reserves; Interest paid |
| 1.820-1 through -3 | Taxable years affected; Optional treatment of policies reinsured under modified coinsurance contracts; Special rules |
| 1.824-1 through -3 | Adjustments to provide protection against losses; Termination of taxability under section 821; Election to subtract amount from protection against loss account |
| 1.907(a)-0A through 1.907(f)-1A | Limitation on creditable taxes |
| 1.907(e)-1 | Transitional rules for amounts carried between a taxable year beginning before January 1, 1983, and a taxable year beginning after December 31, 1982 (carryover of FOGEI and FORI taxes) |
| 1.995-7 | Taxable income attributable to base period export gross receipts |
| 1.1301-0 and -1 | Taxable years affected; Limitation on tax |
| 1.1302-1 through -3 | Definition of averageable income; Average Base Period Income; Other related definitions |

| <i>Section</i> | <i>Subject</i> |
|---------------------------------|--|
| 1.1303-1 | Eligible individuals |
| 1.1304-1 through -6 | Choice of income averaging by taxpayer; Provisions inapplicable if income averaging is chosen; Special rules for computing base period income; Dollar limitations in case of joint returns; Determination of total tax for the computation year; Short taxable years |
| 20.2035-1 | Transactions in contemplation of death |
| 23.1 | Election and eligibility to treat interest in property held jointly on December 31, 1976, as qualified joint interests |
| 24.1T | Special rules applicable in the case of certain wills and trusts in existence on September 21, 1974 |
| 25.2517-1 | Employees' annuities |
| 27.642-1T | Reports of transfer of public housing bonds |
| 33.1 | Constructive filing of waivers of exemption from Social Security taxes by certain tax-exempt organizations |
| 1.32-1 | Earned income credit for taxable years beginning before January 1, 1979 |
| 38.3507-1 and -2, and 38.6302-1 | Advance payments of earned income credit; Earned income credit advance payment certificates; Use of government depositions in connection with taxes under Federal Insurance Contributions Act and income tax withheld |
| 301.6676-1 | Penalty for failure to supply identifying number |
| 301.7424-1 | Civil action to clear title to property |

Federal Register Cite and Project Number

49 FR 2794 (1/23/84) (EE-148-81)

Section

1.409-1(b)(2)(i)

Subject

Retirement bonds

Weighted Average Interest Rate Update

Notice 95-52

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible

range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for September 1995 is 6.55 percent.

The following rates were determined for the plan years beginning in the month shown below.

| Month | Year | Weighted Average | 90% to 109% Permissible Range | 90% to 110% Permissible Range |
|---------|------|------------------|-------------------------------|-------------------------------|
| October | 1995 | 7.16 | 6.45 to 7.81 | 6.45 to 7.88 |

Accounting for Lease Strips and Other Stripping Transactions

Notice 95-53

The Internal Revenue Service understands that certain persons have entered into, or may be considering, multiple-party transactions intended to allow one party to realize rental or other income from property or service contracts and to allow another party to report deductions related to that income (for example, depreciation or rental expenses). Transactions of this type are sometimes referred to as "lease strips" or "stripping transactions." This notice discusses certain tax consequences of

stripping transactions, both under current law and under regulations to be issued.

The stripping transactions covered by this notice include a variety of forms. For example:

(a) Some typical stripping transactions are effected through a transferred basis transaction. In exchange for cash, notes, or other consideration, one party sells, assigns, or otherwise transfers ("assigns") the right to receive future payments under a lease of tangible property, and treats the amount realized from the assignment as its current income. The party later transfers the property (subject to the lease) in a

transaction intended to qualify as a transferred basis transaction, for example, a transaction described in § 351 of the Internal Revenue Code. The transferee often is not identified until after the transferor has assigned the future payments. Typically, the transferor (or a partner in a partnership that is a transferor) is generally not subject to federal income tax or has available net operating losses, and the equity of the transferee is owned predominantly by persons other than the transferor.

(b) Other stripping transactions may be effected through a transfer of an interest in a partnership (or other pass-through entity). In exchange for cash, notes, or other consideration, the part-

nership assigns its right to receive future payments under a lease of tangible property and allocates the amount realized from the assignment to its current partners (many of whom are generally not subject to federal income tax or have available net operating losses). The partnership retains the underlying property, and thereafter, there is a transfer or redemption of a partnership interest by one or more partners to whom the partnership allocated the income that it reported from the assignment. The transfer or redemption is structured to avoid a reduction in the basis of partnership property.

(c) Other variations of stripping transactions might involve, among other things, licenses of intangible property; service contracts; leaseholds or other non-fee interests in property; or prepayment, front-loading, or retention (rather than assignment) of rights to receive future payments.

The Service understands that the parties to stripping transactions generally claim that one party realizes the income from property or services and that another party is entitled to take related depreciation, rental expense, or other deductions. The Service believes, however, that the claimed tax treatment improperly separates income from related deductions and that stripping transactions generally do not produce the tax consequences desired by the parties.

For example, in the case of stripping transactions structured in a manner similar to that described in paragraph (a) above (including transactions with variations like those described in paragraph (c) above), the Service intends to exercise its authority under § 482 to reallocate gross income, deductions, credits, or allowances between the parties as appropriate. Section 482 permits reallocation between two or more organizations owned or controlled directly or indirectly by the same interests if necessary to clearly reflect income or to prevent the evasion of taxes. For purposes of § 482, the parties in these stripping transactions generally are “controlled ... by the same interests” because, among other factors, they act in concert with the common goal of arbitrarily shifting income or deductions between the transferor and the transferee. *See, e.g.*, § 1.482-1(i)(4) of the Income Tax Regulations. The Service will not apply § 482 to other transactions where not necessary to clearly reflect income or

to prevent the evasion of taxes. *See* Rev. Rul. 80-198, 1980-2 C.B. 113 (subject to the limitations described therein).

Depending on the facts of a particular case, the Service also may determine that one or more of the following authorities (among others) apply to a stripping transaction: (i) sections 269, 382, 446(b), 701, or 704, and the regulations thereunder; (ii) authorities that recharacterize certain assignments or accelerations of future payments as financings; (iii) assignment-of-income principles; (iv) the business-purpose doctrine; or (v) the substance-over-form doctrines (including the step transaction and sham doctrines).

In addition, regulations will be issued pursuant to § 7701(l) (and, as appropriate, other sections of the Code) recharacterizing stripping transactions. Under § 7701(l), the Secretary has the authority to prescribe regulations recharacterizing any multiple-party financing arrangement as a transaction directly among two or more of the parties in order to prevent the avoidance of tax. The regulations will be effective with respect to stripping transactions any significant element of which is entered into or undertaken on or after October 13, 1995. For example, the regulations will apply to the stripping transaction described in paragraph (a) above if the property is transferred to the transferee on or after October 13, 1995, even if the rights to receive future rental payments were assigned by the transferor prior to that date.

The Service requests comments with respect to the regulations that will be issued. Written comments should be sent in duplicate to: CC:DOM:FI&P, Room 4300, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. 20224. The Service will make these comments available for public inspection.

Household Employers—How To Correct 1994 and Prior Year Forms 942, Employer's Quarterly Tax Return for Household Employees

Notice 95-54

If a household employer finds an error on a previously filed 1994 or prior year Form 942 and that error resulted in reporting more than or less than the correct amount of social security or Medicare tax or wages, the

employer must file a corrected Form 942 by following these steps:

1. Use a 1994 Form 942 (Rev. November 1994).

2. Print or type “CORRECTED” across the top of the return, complete it with the correct information, and sign and date the return.

3. Prepare and attach an explanation of the correction to the return. In addition to the explanation, the attachment must contain the following information: the date(s) of the return period (quarter) for which the corrected information is being provided and the date(s) the error was discovered. Also, if filing for a refund include one of the following statements: (1) I have not withheld social security and Medicare taxes from the employee's pay, (2) I have returned to the employee any over-payment of social security and Medicare taxes withheld from the employee's pay, or (3) I have obtained the employee's written consent to claim a refund on the employee's behalf of the social security and Medicare taxes withheld from the employee's pay. The employer should obtain a written statement indicating that the employee has not claimed a refund or credit of the overpayment.

4. Send the corrected return, attachment, and any payment to the Internal Revenue Service at the address given in the instructions for Form 942 (Rev. November 1994).

Generally, a corrected return must be filed within 3 years after the original return was filed or within 2 years after the date the tax was paid, whichever is later. Each quarterly Form 942 is considered filed on April 15 following the tax year.

Instead of filing a corrected Form 942 for a refund, the employer can file Form 843, Claim for Refund and Request for Abatement. If Form 843 is filed, include the information in item 3.

If household employers correct previously reported wage, social security tax, or Medicare tax amounts, they will need to file Form W-2c, Statement of Corrected Income and Tax Amounts, and Form W-3c, Transmittal of Corrected Income and Tax Statements, to correct the employee's Form W-2.

The forms listed in this notice, and their instructions, can be obtained by calling 1-800-TAX-FORM (1-800-829-3676).

1996 Pension Plan Limitations¹

Notice 95-55

Section 415 of the Internal Revenue Code provides for dollar limitations on benefits and contributions under qualified plans. Section 415 also requires that the Commissioner annually adjust these limits for cost-of-living increases. Other limitations applicable to such plans are also affected by these adjustments.

Effective January 1, 1996, the maximum limitation for the annual benefit under § 415(b)(1)(A) for defined benefit plans remains unchanged at \$120,000. For participants who separated from service before January 1, 1996, the limitation for defined benefit plans under § 415(b)(1)(B) is computed by multiplying the participant's compensation limitation, as adjusted through 1995 by 1.0264. The limitation for defined contribution plans under § 415(c)(1)(A) remains unchanged at \$30,000.

The Code provides that various other dollar amounts are to be adjusted at the same time and in the same manner as the dollar limitation of § 415(b)(1)(A) is adjusted. These dollar amounts and the adjusted amounts are as follows:

The special limitation for qualified police or firefighters under § 415(b)(2)(G) remains unchanged at \$66,000.

The limitation on the exclusion for elective deferrals under § 402(g)(1) is increased from \$9,240 to \$9,500.

The dollar amount under § 409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan subject to a 5-year distribution period is increased from \$670,000 to \$690,000, while the dollar amount used to determine the lengthening of the 5-year distribution period is increased from \$132,000 to \$135,000.

The threshold amount under § 4980A(c)(1)(B) regarding excess distributions is increased from \$150,000 to \$155,000.

The limitation used in the definition of highly compensated employee under § 414(q)(1)(B) remains unchanged at \$100,000, while the limitation used in § 414(q)(1)(C) remains unchanged at \$66,000.

The annual compensation limit under §§ 401(a)(17) and 404(l) for plans for which the amendments made by § 13212 of the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) are effective for the plan years beginning in 1994, 1995 or 1996 remains unchanged at \$150,000. For collectively bargained plans for which the amendments made by § 13212 of OBRA '93 are not effective for the plan years beginning in 1994, 1995, and 1996, the annual compensation limit under §§ 401(a)(17) and 404(l) of the Code is increased from \$245,000 to \$250,000.

The compensation amount under § 408(k)(2)(C) regarding simplified employee pension plans (SEPs) remains unchanged at \$400. The compensation amount under § 408(k)(3)(C) for SEPs for which the amendments made by § 13212 of OBRA '93 are effective for the plan year beginning in 1994, 1995, or 1996 remains unchanged at \$150,000. For collectively bargained SEPs for which the amendments made by § 13212 of OBRA '93 are not effective for the plan years beginning in 1994, 1995, and 1996, the compensation amount under § 408(k)(3)(C) of the Code is increased from \$245,000 to \$250,000.

Administrators of defined benefit or defined contribution plans that have received favorable determination letters should not request new determination letters solely because of yearly amendments to adjust maximum limitations in the plans.

Organizations Providing Relief to Victims of Hurricane Marilyn

Notice 95-56

As a result of the devastation, personal injury and loss of life caused by Hurricane Marilyn in the Virgin Islands and portions of Puerto Rico in September, 1995, the President has declared the affected area to be eligible for Federal disaster assistance. The Internal Revenue Service has received questions regarding the tax consequences of private efforts to provide relief to disaster victims in the affected areas.

Contributions earmarked for Hurricane Marilyn relief that are made to organizations currently recognized by the Service as tax exempt under section 501(c)(3) of the Internal Revenue Code are fully deductible as charitable contri-

butions. However, the tax law does not allow taxpayers to deduct contributions earmarked for relief of any *particular* individual or family.

Donors should exercise care before contributing to any organization. With increased public interest in making donations to charitable organizations to assist disaster victims, there is the increased possibility that some organizations (or their fundraisers) may make false or inaccurate claims regarding how contributions will be used or whether these contributions are tax deductible. Donors have advance assurance of deductibility only for contributions to organizations recognized as exempt by the Service under section 501(c)(3) of the Code.

Charitable organizations formed to aid victims of Hurricane Marilyn but not yet recognized as exempt can receive expedited consideration of their application for recognition of exemption by writing "HURRICANE MARILYN RELIEF" at the top of Form 1023, which is the form they use to apply for exempt status. In addition, organizations should carefully follow the checklist in the Form 1023 package to insure the application is complete. Detailed information on the requirements for tax exempt status is contained in Publication 557, "Tax Exempt Status for Your Organization." The latest version of the Form 1023 package, Publication 557, Form SS-4, Application for Employer Identification Number, and Form 8718, User Fee for Exempt Organization Determination Request, may be obtained by calling the Service's toll-free number 1-800-TAX-FORM (1-800-829-3676), or by writing the nearest IRS Forms Distribution Center.

The expedited application processing does not modify or relax the requirement that tax exempt organizations operate exclusively for charitable purposes. However, to the extent that an organization is providing appropriate relief, in good faith, in the designated disaster area, the Service will not raise certain issues that might otherwise affect the organization's qualification for exempt status or, in the case of a private foundation, liability for certain taxes under Chapter 42. Examples of these issues include an organization providing emergency assistance to its own employees or employees of related organizations who have been victimized by the hurricane (which raise the issue of prohibited inurement), and a private foundation providing emer-

¹Based on News Release IR-95-57, dated October 17, 1995.

gency assistance to disqualified persons (as defined in section 4946 of the Code) victimized by the hurricane.

This relief is also granted to organizations exempt under other paragraphs of section 501(c). For example, the Service will not raise the issue of particular services with respect to a business league exempt under section 501(c)(6) if the organization's good faith relief efforts include aid provided to members victimized by the hurricane.

This relief is available to both new organizations and existing tax exempt organizations until December 31, 1995, or later if an extension by the Service is determined to be necessary or appropriate.

Method of Accounting for Cash Method Banks for Stated Interest on Short-term Loans Made in the Ordinary Course of Business

Notice 95-57

This notice provides guidance on how the Service will process applications for a change in accounting method and claims for refund filed as a result of the decision in *Security Bank Minnesota v. Commissioner*, 994 F.2d 432 (8th Cir. 1993), *aff'g* 98 T.C. 33 (1992).

Section 446(e) of the Internal Revenue Code and § 1.446-1(e) of the Income Tax Regulations provide that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Rev. Proc. 92-20, 1992-1 C.B. 685, contains procedures for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes.

Section 481(a) generally requires a taxpayer changing its method of accounting to take into account those adjustments that are determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted.

Section 1281, in part, requires certain holders of short-term obligations to include in gross income any interest income on the obligations as it accrues, regardless of the holder's overall method of accounting. In *Security Bank Minnesota*, the Eighth Circuit held that § 1281 does not require a bank using the overall cash receipts and disbursements method of accounting to include

in gross income stated interest on short-term loans made in the ordinary course of business as it accrues. The Service disagrees with the Eighth Circuit's interpretation of § 1281 in *Security Bank Minnesota* and intends to pursue this issue in other circuits.

In light of *Security Bank Minnesota*, however, cash method banks in the Eighth Circuit will be granted permission to change to the cash method of accounting for stated interest on short-term loans made in the ordinary course of business. If the change in method is made after November 6, 1995, cash method banks in the Eighth Circuit that comply with the provisions of this notice will be considered to have obtained the consent of the Commissioner to make that change. If the change in method was made on or before November 6, 1995, the Service will not seek to deny cash method banks in the Eighth Circuit the use of the cash method on the ground that there was an unauthorized change in method of accounting. If the Service is later successful in further litigation on this issue in other circuits, or there is a change in law, then cash method banks in the Eighth Circuit may be required to use an accrual method of accounting for any taxable year not barred by the statute of limitations.

A taxpayer is permitted to make a change in method of accounting under this notice for (1) its current taxable year, or (2) any earlier open taxable year after which there is no closed taxable year. If the tax return for the year of change has not been filed, a taxpayer making a change must attach a current Form 3115 to its timely filed (including extensions) federal income tax return for the year of change. If the tax return for the year of change has already been filed, a taxpayer making a change must attach a current Form 3115 to an amended return for the year of change, and must file, on or before June 30, 1996, that amended return and amended returns for all subsequent affected taxable years, if any. Also, any applicable § 481(a) adjustment must be taken into account in the year of change. In addition, a copy of the Form 3115 must be filed with the national office no later than when the original Form 3115 is filed with the federal income tax return or the amended return. The copy should be sent to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Financial Institutions and

Products) CC:DOM:FI&P, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20024.

This notice provides the exclusive procedures for a cash method bank in the Eighth Circuit to use in making a change to the cash method of accounting for stated interest on short-term loans made in the ordinary course of business. The national office will return any Form 3115 (and user fee) submitted by a cash method bank in the Eighth Circuit that is based on *Security Bank Minnesota* and does not comply with the procedures of this notice.

The Service will deny any request for a change in accounting method and any claim for refund based on *Security Bank Minnesota* that is filed by a taxpayer outside the Eighth Circuit.

Tax on Certain Imported Substances; Notice of Determination

Notice 95-58

This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in § 4672(a)(3) will be modified to include methyl methacrylate. This modification is effective October 1, 1995.

Background

Under § 4672(a), an importer or exporter of any substance may request that the Secretary determine whether that substance should be listed as a taxable substance. The Secretary shall add the substance to the list of taxable substances in § 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce the substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61 sets forth the rules relating to the determination process.

Determination

On October 12, 1995, the Secretary determined that methyl methacrylate should be added to the list of taxable substances in § 4672(a)(3), effective October 1, 1995.

The rate of tax prescribed for methyl methacrylate, under § 4671(b)(3), is \$10.12 per ton. This is based upon a

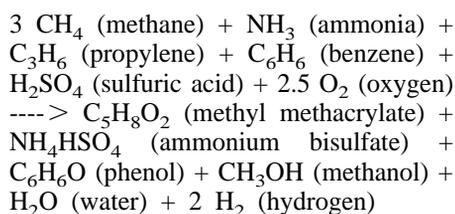
conversion factor for methane of 0.47, a conversion factor for ammonia of 0.22, a conversion factor for propylene of 0.6, a conversion factor for benzene of 0.94, and a conversion factor for sulfuric acid of 1.63.

The petitioner is Rohm and Haas Texas, Inc., a manufacturer and exporter of this substance. No material comments were received on this petition. The following information is the basis for the determination.

HTS number: 2916.14.00.20
CAS number: 80-62-6

Methyl methacrylate is derived from the taxable chemicals methane, ammonia, propylene, benzene, and sulfuric acid and is a liquid produced predominantly by the catalytic reaction of acetone cyanohydrin and methyl alcohol. The methyl methacrylate is then purified by distillation.

The stoichiometric material consumption formula for this substance is:



Methyl methacrylate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 77.9 percent by weight of the materials used in its production.

Tax on Certain Imported Substances; Notice of Determination

Notice 95-59

This notice announces a determination, under Notice 89-61, 1989-1 C.B. 717, that the list of taxable substances in § 4672(a)(3) will be modified to include poly 1,4 butyleneterephthalate. This modification is effective April 1, 1991.

Background

Under § 4672(a), an importer or exporter of any substance may request that the Secretary determine whether that substance should be listed as a

taxable substance. The Secretary shall add the substance to the list of taxable substances in § 4672(a)(3) if the Secretary determines that taxable chemicals constitute more than 50 percent of the weight, or more than 50 percent of the value, of the materials used to produce the substance. This determination is to be made on the basis of the predominant method of production. Notice 89-61 sets forth the rules relating to the determination process.

Determination

On October 12, 1995, the Secretary determined that poly 1,4 butyleneterephthalate should be added to the list of taxable substances in § 4672(a)(3), effective April 1, 1991.

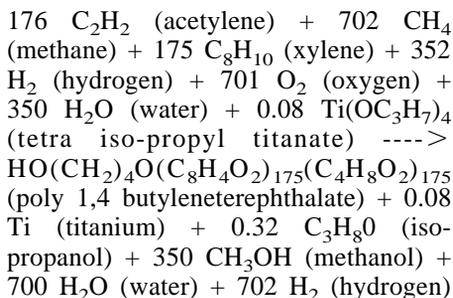
The rate of tax prescribed for poly 1,4 butyleneterephthalate, under § 4671(b)(3), is \$3.92 per ton. This is based upon a conversion factor for acetylene of 0.1186, a conversion factor for methane of 0.2920, and a conversion factor for xylene of 0.4816.

The petitioner is GE Plastics, a manufacturer and exporter of this substance. No material comments were received on this petition. The following information is the basis for the determination.

HTS number: 3907.91.00
CAS number: 26062-94-2

Poly 1,4 butyleneterephthalate is derived from the taxable chemicals acetylene, methane, and xylene and is a solid produced predominantly by the melt polycondensation process.

The stoichiometric material consumption formula for this substance is:



Poly 1,4 butyleneterephthalate has been determined to be a taxable substance because a review of its stoichiometric material consumption formula shows that, based on the predominant method of production, taxable chemicals constitute 53.8 per-

cent by weight of the materials used in its production.

Suspension of FSC Requirements Due to Hurricane Marilyn

Notice 95-60

The Internal Revenue Service in this notice temporarily suspends certain of the regulations governing foreign sales corporations ("FSC") due to major disruptions in the United States Virgin Islands caused by Hurricane Marilyn on September 16 and 17, 1995.

1. FSCs were created by the Tax Reform Act of 1984, 1984-3 (Vol. 1) C.B. 1. These corporations, in order to qualify as a FSC for any taxable year, must satisfy certain requirements set forth in section 922 of the Internal Revenue Code of 1986.

Section 922(a)(1)(D)(i) of the Code requires the FSC to maintain an office located outside the United States in a qualifying foreign country or United States possession. Section 1.922-1(h), Q & A 9, of the Income Tax Regulations sets forth certain requirements (including the required type of structure, required communication and information retention equipment and required activities) that must be met in order for the FSC to have a qualifying office. These requirements will be waived with respect to FSCs having their office in the United States Virgin Islands during the period September 16, 1995, through June 30, 1996.

Section 922(a)(1)(D)(ii) of the Code requires the FSC to maintain in its office located outside the United States a set of permanent books of account (including invoices) of the corporation. With regard to this requirement, section 1.922-1(i), Q & A 13, of the regulations sets forth certain dates by which the required books of account must be maintained at the FSC's office. These dates were modified by Notice 88-93, 1988-2 C.B. 419, to provide, in general, that all records required by the regulations must be maintained at the FSC's foreign office no later than 30 days after the due date, including extensions, of the tax return of the FSC for the applicable taxable year. Records that under the regulations would have been required to be maintained at the FSC office in the United States Virgin Islands by September 16, 1995, or by any date between September 16, 1995 through June 30, 1996, need not be

maintained at that office until July 1, 1996. In addition, records maintained at the FSC's United States Virgin Islands office that were damaged or destroyed by Hurricane Marilyn do not have to be replaced.

Section 922(a)(1)(E) of the Code requires that at least one member of the FSC's board of directors be an individual who is not a resident of the United States. If a FSC incorporated in the United States Virgin Islands no longer has a non-resident director because of Hurricane Marilyn, the FSC will have until July 1, 1996, to appoint a new non-resident director.

2. Section 924(c)(2) of the Code provides that the principal bank account of the FSC must be maintained at all times during the taxable year in a qualifying foreign country or United States possession. Although the bank in the United States Virgin Islands in which the bank account is maintained may have been destroyed or damaged by Hurricane Marilyn, the bank account would still be maintained because it is intangible personal property and is not subject to physical destruction like tangible personal property. In the case of a newly created or organized FSC, the requirement that the principal bank account must be "maintained at all times during the taxable year" is satisfied under section 1.924(c)-1(c)(4) if a principal bank account is opened not later than 30 days after the effective date of the corporation's election to be treated as a FSC. Due to the lack of functioning of some banking institutions in the United States Virgin Islands due to hurricane damage to physical structures and the loss of electrical power, some newly established FSCs may not be able to establish a principal bank account in the appropriate time period. This notice provides that newly established FSCs required to establish a principal bank account between August 17, 1995 and January 1, 1996, will meet this requirement by establishing a principal bank

account in the United States Virgin Islands no later than January 31, 1996.

Section 1.924(c)-1(d)(1) of the regulations provides that disbursements of dividends, legal and accounting fees, and salaries of officers and directors must be disbursed from the FSC's principal bank account. Section 1.924(c)-1(d)(1) further provides that inadvertent payments from a bank account other than the FSC's principal bank account may be counted as qualified payments out of the principal bank account if, on determination that such payment was made from such other account, reimbursement from the principal bank account is made within a reasonable period from the date of the determination. Section 1.924(c)-1(d)(2) permits a related person to the FSC to pay certain expenses on behalf of the FSC if the related person is reimbursed no later than the last date prescribed for filing the FSC's tax return (including extensions) for the taxable year to which the reimbursement relates. Finally, section 1.924(c)-1(d)(3) provides that upon a determination by the Commissioner that all or part of certain expenses were paid by a related person without receiving reimbursement, the FSC may satisfy the requirements if such expenses were paid by the related person in good faith and the reimbursement is made within 90 days after the determination. The time requirement for each of these regulations is extended to July 1, 1996. Thus, if a good faith reimbursement otherwise would have been required to be made on a day during the period September 16, 1995, through June 30, 1996, the date by which the good faith reimbursement must be made is July 1, 1996.

3. Section 924(b)(1)(B) of the Code provides that a FSC will have foreign trading gross receipts from a transaction only if economic processes with respect to that transaction take place outside the United States. Section 1.924(e)-1(d)(2)(iii) of the regulations

provides that the receipt of payment economic process requirement of section 924(e)(4) of the Code with regard to a transaction will be satisfied if payment is made by the purchaser directly to the FSC or the related supplier in the United States, and the FSC or the related supplier transfers the gross receipts amount associated with the transaction to the FSC's bank account outside the United States within 35 calendar days after receipt of good funds. If a FSC uses for this requirement a bank account in a bank located in the United States Virgin Islands, this requirement will be met with regard to funds that would have been required to have been transferred during the period September 16, 1995, through June 30, 1996, if the funds are transferred by July 1, 1996.

4. All Forms 1120 FSC of FSCs that rely on any provision in this Notice should be clearly marked "Marilyn" on the top center of the return. A statement should be included with the FSC's Form 1120 FSC describing the extent to which the Notice applies.

This document serves as an "administrative pronouncement" as that term is described in section 1.6661-3(b)(2) of the regulations and may be relied on to the same extent as a revenue ruling or revenue procedure.

Tables for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income

Notice 95-61

1. Table for Figuring Amount Exempt from Levy on Wages, Salary, and Other Income (Forms 668-W, 668-W(c), & 668-W(c)(DO)) 1996

Publication 1494, shown below, provides tables which show the amount of an individual's income that is exempt from a notice of levy used to collect delinquent tax in 1996.

(Amounts are for each pay period.)

Filing Status: Single

| Pay Period | Number of Exemptions Claimed on Statement | | | | | | |
|-------------|---|--------|--------|---------|---------|---------|---------------------------------------|
| | 1 | 2 | 3 | 4 | 5 | 6 | More Than 6 |
| Daily | 25.19 | 35.00 | 44.81 | 54.62 | 64.42 | 74.23 | 15.38 plus 9.81 for each exemption |
| Weekly | 125.96 | 175.00 | 224.04 | 273.08 | 322.12 | 371.15 | 76.92 plus 49.04 for each exemption |
| Biweekly | 251.92 | 350.00 | 448.08 | 546.15 | 644.23 | 742.31 | 153.85 plus 98.08 for each exemption |
| Semimonthly | 272.92 | 379.17 | 485.42 | 591.67 | 697.92 | 804.17 | 166.67 plus 106.25 for each exemption |
| Monthly | 545.83 | 758.33 | 970.83 | 1183.33 | 1395.83 | 1608.33 | 333.33 plus 212.50 for each exemption |

Filing Status: Unmarried Head of Household

| Pay Period | Number of Exemptions Claimed on Statement | | | | | | |
|-------------|---|--------|---------|---------|---------|---------|---------------------------------------|
| | 1 | 2 | 3 | 4 | 5 | 6 | More Than 6 |
| Daily | 32.50 | 42.31 | 52.12 | 61.92 | 71.73 | 81.54 | 22.69 plus 9.81 for each exemption |
| Weekly | 162.50 | 211.54 | 260.58 | 309.62 | 358.65 | 407.69 | 113.46 plus 49.04 for each exemption |
| Biweekly | 325.00 | 423.08 | 521.15 | 619.23 | 717.31 | 815.38 | 226.92 plus 98.08 for each exemption |
| Semimonthly | 352.08 | 458.33 | 564.58 | 670.83 | 777.08 | 883.33 | 245.83 plus 106.25 for each exemption |
| Monthly | 704.17 | 916.67 | 1129.17 | 1341.67 | 1554.17 | 1766.67 | 491.67 plus 212.50 for each exemption |

Filing Status: Married Filing Joint (and Qualifying Widow(er)s)

| Pay Period | Number of Exemptions Claimed on Statement | | | | | | |
|-------------|---|--------|---------|---------|---------|---------|---------------------------------------|
| | 1 | 2 | 3 | 4 | 5 | 6 | More Than 6 |
| Daily | 35.58 | 45.38 | 55.19 | 65.00 | 74.81 | 84.62 | 25.77 plus 9.81 for each exemption |
| Weekly | 177.88 | 226.92 | 275.96 | 325.00 | 374.04 | 423.08 | 128.85 plus 49.04 for each exemption |
| Biweekly | 355.77 | 453.85 | 551.92 | 650.00 | 748.08 | 846.15 | 257.69 plus 98.08 for each exemption |
| Semimonthly | 385.42 | 491.67 | 597.92 | 704.17 | 810.42 | 916.67 | 279.17 plus 106.25 for each exemption |
| Monthly | 770.83 | 983.33 | 1195.83 | 1408.33 | 1620.83 | 1833.33 | 558.33 plus 212.50 for each exemption |

Filing Status: Married Filing Separate

| Pay Period | Number of Exemptions Claimed on Statement | | | | | | |
|-------------|---|--------|--------|---------|---------|---------|---------------------------------------|
| | 1 | 2 | 3 | 4 | 5 | 6 | More Than 6 |
| Daily | 22.69 | 32.50 | 42.31 | 52.12 | 61.92 | 71.73 | 12.88 plus 9.81 for each exemption |
| Weekly | 113.46 | 162.50 | 211.54 | 260.58 | 309.62 | 358.65 | 64.42 plus 49.04 for each exemption |
| Biweekly | 226.92 | 325.00 | 423.08 | 521.15 | 619.23 | 717.31 | 128.85 plus 98.08 for each exemption |
| Semimonthly | 245.83 | 352.08 | 458.33 | 564.58 | 670.83 | 777.08 | 139.58 plus 106.25 for each exemption |
| Monthly | 491.67 | 704.17 | 916.67 | 1129.17 | 1341.67 | 1554.17 | 279.17 plus 212.50 for each exemption |

2. Table for Figuring Additional Exempt Amount for Taxpayers at Least 65 Years Old and/or Blind

Additional Exempt Amount

| Filing Status | * | Daily | Wkly | Bi-Wkly | Semi-Mo | Monthly |
|-----------------------------|---|-------|-------|---------|---------|---------|
| Single or Head of Household | 1 | 3.85 | 19.23 | 38.46 | 41.67 | 83.33 |
| | 2 | 7.69 | 38.46 | 76.92 | 83.33 | 166.67 |
| Any Other Filing Status | 1 | 3.08 | 15.38 | 30.77 | 33.33 | 66.67 |
| | 2 | 6.15 | 30.77 | 61.54 | 66.67 | 133.33 |
| | 3 | 9.23 | 46.15 | 92.31 | 100.00 | 200.00 |
| | 4 | 12.31 | 61.54 | 123.08 | 133.33 | 266.67 |

* ADDITIONAL STANDARD DEDUCTION claimed on Parts 3, 4, & 5 of levy.

Examples

These tables show the amount exempt from a levy on wages, salary, and other income. For example:

1. A single taxpayer who is paid weekly and claims three exemptions (including one for the taxpayer) has \$224.04 exempt from levy.
2. If the taxpayer in number 1 is over 65 and writes 1 in the ADDITIONAL STANDARD DEDUCTION space on Parts 3, 4, & 5 of the levy, \$243.27 is exempt from this levy (\$224.04 plus \$19.23).
3. A taxpayer who is married, files jointly, is paid bi-weekly, and claims two exemptions (including one for the taxpayer) has \$453.85 exempt from levy.
4. If the taxpayer in number 3 is over 65 and has a spouse who is blind, this taxpayer should write 2 in the ADDITIONAL STANDARD DEDUCTION space on Parts 3, 4, & 5 of the levy. Then, \$515.39 is exempt from this levy (\$453.85 plus \$61.54).

Authority of the Federal Crop Insurance Corporation to Require Employer Identification Numbers from Policyholders and Reinsured Companies for Purposes of the Federal Crop Insurance Act

Notice 95-62

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws the notice of proposed rulemaking published in the Federal Register on August 31, 1992, that relates to the authority of the Federal Crop Insurance Corporation (FCIC) to require policyholders and reinsured companies to furnish employer identification numbers for purposes of administering the Federal Crop Insurance Act.

SUPPLEMENTARY INFORMATION:

Background

On August 31, 1992, the IRS pub-

lished proposed regulations (IA-4-92 [1992-2 C.B. 735]) in the Federal Register (57 FR 39379) under section 6109 of the Internal Revenue Code, relating to the authority of the FCIC to collect employer identification numbers. Although written comments and requests for a public hearing were solicited, no written or oral comments were received and no public hearing was requested or held. Because the proposed regulations merely restate the rules in section 6109, the IRS has decided, in the interest of simplifica-

tion, to withdraw those proposed regulations.

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking that was published in the

Federal Register on August 31, 1992, (57 FR 39379) is withdrawn.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on October 27, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 30, 1995, 60 F.R. 55228)

Weighted Average Interest Rate Update

Notice 95-63

Notice 88-73 provides guidelines for

determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for October 1995 is 6.37 percent.

The following rates were determined for the plan years beginning in the month shown below.

| Month | Year | Weighted Average | 90% to 109% Permissible Range | 90% to 110% Permissible Range |
|----------|------|------------------|-------------------------------|-------------------------------|
| November | 1995 | 7.13 | 6.42 to 7.77 | 6.42 to 7.85 |

Magnetic Media Filing Requirements for Employers Filing Wage and Tax Statements for Employees in Puerto Rico, U.S. Virgin Islands, Guam, and American Samoa

Notice 95-64

This notice provides information on magnetic media filing requirements that the Internal Revenue Service intends to prescribe for employers filing wage and tax statements for employees in Puerto Rico, U.S. Virgin Islands, Guam, and American Samoa, and also invites public comment on this matter.

Returns required on magnetic media. Under § 6011(e) of the Internal Revenue Code, the Secretary is authorized to issue regulations providing standards for determining which returns must be filed on magnetic media.

Currently, employers are encouraged, but are not required, to file the following wage and tax statements on magnetic media:

- (1) Form 499R-2/W-2PR, Withholding Statement (Puerto Rico);
- (2) Form W-2VI, U.S. Virgin Islands Wage and Tax Statement;
- (3) Form W-2GU, Guam Wage and Tax Statement; and
- (4) Form W-2AS, American Samoa Wage and Tax Statement.

The Service intends to issue proposed regulations that will require an employer to file these wage and tax statements on magnetic media if the employer is required to file 250 or more statements during the calendar year, unless a waiver for hardship is obtained. This magnetic media filing requirement will be effective for wage and tax statements required to be *filed after December 31, 1996*, with the Social Security Administration.

Information regarding magnetic media specifications. Specifications for magnetic media filing may be obtained from the Social Security Administration by contacting:

- (1) for Form W-2GU and Form W-2AS, contact:
Social Security Administration
Regional Magnetic Media Coordinator, RSI
75 Hawthorne Street
San Francisco, CA 94105
Telephone: (415) 744-4559
FAX: (415) 744-2849
(not toll-free calls)
- (2) for Form W-2VI and Form 499R-2/W-2PR, contact:
Social Security Administration
Wage Reporting Specialist
Federal Office Bldg., Suite 751
San Juan, Puerto Rico 00918
Telephone: (809) 766-5574
FAX: (809) 766-5913
(not toll-free calls)

Public comment invited. The Service invites public comment on this matter. Written comments should be submitted by January 31, 1996, to:

Internal Revenue Service
P.O. Box 7604
Ben Franklin Station
Attn: CC:CORP:T:R (IA-Branch 1), Room 5228
Washington, D.C. 20044.

All materials submitted will be available for public inspection and copying.

List of Countries Requiring Cooperation With an International Boycott

Notice 95-65

In order to comply with the mandate of section 999(a)(3) of the Internal Revenue Code of 1986, the Department of the Treasury is publishing a current list of countries which may require participation in, or cooperation with, an international boycott (within the meaning of section 999(b)(3) of the Internal Revenue Code of 1986). The current list reflects a decision to remove Jordan as a result of its recent accords with Israel.

On the basis of the best information currently available to the Department of the Treasury, the following countries may require participation in, or cooper-

ation with, an international boycott (within the meaning of section 999(b)-(3) of the Internal Revenue Code of 1986):

Bahrain
Iraq
Kuwait
Lebanon
Libya
Oman
Qatar
Saudi Arabia
Syria
United Arab Emirates
Yemen, Republic of

Dated: November 6, 1995.

Joseph Guttentag,
International Tax Counsel.

(Filed by the Office of the Federal Register on November 14, 1995, 8:45 a.m., and published in the issue of the Federal Register for November 15, 1995, 60 F.R. 57480)

Organizations Providing Relief to Victims of Hurricane Opal

Notice 95-66

As a result of the devastation, personal injury and loss of life caused by Hurricane Opal in parts of Alabama, Florida and Georgia, starting October 4, 1995, the President has declared the affected area to be eligible for Federal disaster assistance. The Internal Revenue Service has received questions regarding the tax consequences of private efforts to provide relief to disaster victims in this area.

Contributions earmarked for Hurricane Opal relief that are made to organizations currently recognized by the Service as tax exempt under section 501(c)(3) of the Internal Revenue Code are fully deductible as charitable contributions. However, the tax law does not allow taxpayers to deduct contributions earmarked for relief of any *particular* individual or family.

Donors should exercise care before contributing to any organization. With increased public interest in making donations to charitable organizations to assist disaster victims, there is the increased possibility that some organizations (or their fundraisers) may make false or inaccurate claims regarding how contributions will be used or whether these contributions are tax

deductible. Donors have advance assurance of deductibility only for contributions to organizations recognized as exempt by the Service under section 501(c)(3) of the Code.

Charitable organizations formed to aid victims of Hurricane Opal but not yet recognized as exempt can receive expedited consideration of their application for recognition of exemption by writing "HURRICANE OPAL RELIEF" at the top of Form 1023, which is the form they use to apply for exempt status. In addition, organizations should carefully follow the checklist in the Form 1023 package to insure the application is complete. Detailed information on the requirements for tax exempt status is contained in Publication 557, "Tax Exempt Status for Your Organization." The latest version of the Form 1023 package, Publication 557, Form SS-4, Application for Employer Identification Number, and Form 8718, User Fee for Exempt Organization Determination Request, may be obtained by calling the Service's toll-free number 1-800-TAX-FORM (1-800-829-3676), or by writing the nearest IRS Forms Distribution Center.

The expedited application processing does not modify or relax the requirement that tax exempt organizations operate exclusively for charitable purposes. However, to the extent that an organization is providing appropriate relief, in good faith, in the designated disaster area, the Service will not raise certain issues that might otherwise affect the organization's qualification for exempt status or, in the case of a private foundation, liability for certain taxes under Chapter 42. Examples of these issues include an organization providing emergency assistance to its own employees or employees of related organizations who have been victimized by the hurricane (which raise the issue of prohibited inurement), and a private foundation providing emergency assistance to disqualified persons (as defined in section 4946 of the Code) victimized by the hurricane.

This relief is also granted to organizations exempt under other paragraphs of section 501(c). For example, the Service will not raise the issue of particular services with respect to a business league exempt under section 501(c)(6) if the organization's good faith relief efforts include aid provided to members victimized by the hurricane.

This relief is available to both new organizations and existing tax exempt organizations until December 31, 1995, or later if an extension by the Service is determined to be necessary or appropriate.

Travel Expense Substantiation

Notice 95-67

The purpose of this notice is to inform taxpayers that the annual update of the revenue procedure regarding business travel expenses and per diem reimbursements (Rev. Proc. 94-77, 1994-2 C.B. 825) will be published as soon as possible in 1996. This revenue procedure, which is normally updated in the last Internal Revenue Bulletin of the year, provides rules under which the amount of business expenses of an employee or a self-employed individual incurred while traveling away from home will be deemed substantiated. This revenue procedure incorporates by reference rates for lodging, meals, and/or incidental expenses set forth in Appendix A of 41 C.F.R., Chapter 301, as amended. Changes in these rates for 1996 were not available as of the date that this Bulletin 1995-52 went to print. Accordingly, when these rates become available, the Service will update Rev. Proc. 94-77, with the same effective date as the amended rates in Appendix A. Until that effective date, the rates deemed substantiated under Rev. Proc. 94-77 will continue in effect.

26 CFR 601.602: Tax forms and instructions.

Rev. Proc. 95-29A

This revenue procedure modifies and amplifies Rev. Proc. 95-29, 1995-1 C.B. 706, which provides specifications for filing Forms 1098, 1099, 5498, and W-2G. Revenue Procedure 95-29 is reprinted as Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W-2G Magnetically or Electronically.

For TY95, the use of Amount Code 9 for Form 1099-R was changed from "State income tax withheld" to "Total employee contribution." Therefore, state income tax must be reported in the Special Data Entries Field.

Note 5 under the 1099-R amount code field specifies "For the convenience of the payer, state and local income tax withheld may be reported in the Special Data Entries Field in the Payee "B" Record." However, unique field positions in Special Data Entries Field were not designated for this purpose.

To assist in identifying state and local reporting for Form 1099-R, IRS/MCC has designated two specific field

positions in both the Payee "B" Records and in the corresponding State "K" Records. If not reporting Form 1099-R, these fields may be used as continuation of the Special Data Entries Field.

For ease of reading, changes are identified by italics and double underline.

PART B CHANGES

Changes to specifications for tape,

tape cartridge, 5¼- and 3½-inch diskettes found in Part B, Sec. 7.10(1) through Sec. 9 follow.

**SEC. 7. PAYEE "B" RECORD
GENERAL FIELD DESCRIPTIONS
AND RECORD LAYOUTS**

(1) FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498

RECORD NAME: PAYEE "B" RECORD—Continued

| Field Position | Field Title | Length | Description |
|----------------|---|-----------|---|
| 322-349 | Blank | 28 | Enter blanks |
| <u>350-396</u> | Special Data Entries | <u>47</u> | This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks . |
| <u>397-406</u> | <u>State Income Tax Withheld (Form 1099-R only)</u> | <u>10</u> | <u>State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| <u>407-416</u> | <u>Local Income Tax Withheld (Form 1099-R only)</u> | <u>10</u> | <u>Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| 417-418 | Combined Federal/State Code | 2 | If this payee record is to be forwarded to a state agency as a part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states not participating in this program or for forms not valid for state reporting, enter blanks . |
| 419-420 | Blank | 2 | Enter blanks, or carriage return/line feed (cr/lf) characters. |

PAYEE "B" RECORD—RECORD LAYOUT POSITIONS 322-420
FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498

| BLANK | SPECIAL DATA ENTRIES | <u>STATE INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | <u>LOCAL INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | COMBINED FEDERAL/STATE CODE |
|---------|----------------------|---|---|-----------------------------|
| 322-349 | <u>350-396</u> | <u>397-406</u> | <u>407-416</u> | 417-418 |

SEC. 8. END OF PAYER "C" RECORD

There are no changes to the Payer "C" Record.

SEC. 9. STATE TOTALS "K" RECORD—RECORD LAYOUT

.01 The State Totals "K" record is a fixed record length of 420 positions. The control total fields are each 15 positions in length.

.02 The "K" Record is a summary

for a given payer and a given state in the Combined Federal/State Filing Program, used **only** when state reporting approval has been granted.

.03 The "K" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer for a given state. The "K" Record(s) must be written after the "C" Record for the related "A" Record.

.04 In developing the "K" Record, for example, if a payer used Amount Codes 1, 3, and 6 in the "A" Record,

the totals from the "B" Records coded for this state will appear in Control Totals 1, 3, and 6 of the "K" Record.

.05 There **must** be a separate "K" Record for **each state** being reported.

.06 Refer to Part A, Sec. 16 for the requirements and conditions that **must** be met to file via this program.

.07 Control total fields have been added for the accumulated totals of state and local withholding fields from the "B" Records for Form 1099-R only for each state being reported.

RECORD NAME: STATE TOTALS "K" RECORD

| Field Position | Field Title | Length | Description |
|--|---|------------|--|
| 1 | Record Type | 1 | Required. Enter "K" |
| 2-7 | Number of Payees | 6 | Required. Enter the total number of "B" Records being coded for this state. Right justify and fill unused positions with zeros. |
| 8-10 | Blank | 3 | Enter blanks. |
| Required. Accumulate totals of any payment amount fields in the "B" Records for each state being reported into the appropriate control total fields of the appropriate "K" Record. Control totals must be right justified, and unused control total fields zero-filled. All control total fields are 15 positions in length. | | | |
| 11-25 | Control Total 1 | 15 | |
| 26-40 | Control Total 2 | 15 | |
| 41-55 | Control Total 3 | 15 | |
| 56-70 | Control Total 4 | 15 | |
| 71-85 | Control Total 5 | 15 | |
| 86-100 | Control Total 6 | 15 | |
| 101-115 | Control Total 7 | 15 | |
| 116-130 | Control Total 8 | 15 | |
| 131-145 | Control Total 9 | 15 | |
| <u>146-386</u> | Blank | <u>241</u> | Reserved for IRS use. Enter blanks. |
| <u>387-401</u> | <u>Control Total State Income Tax Withheld (Form 1099-R only)</u> | <u>15</u> | <u>Accumulate totals of the state income tax withheld field in the Payee "B" Record. Otherwise, enter blanks.</u> |

RECORD NAME: STATE TOTALS "K" RECORD—Continued

| Field Position | Field Title | Length | Description |
|----------------|---|-----------|---|
| <u>402-416</u> | <u>Control Total</u>
<u>Local Income Tax</u>
<u>Withheld (Form</u>
<u>1099-R only)</u> | <u>15</u> | <u>Accumulate totals of the local income tax withheld field in the Payee "B"</u>
<u>Record. Otherwise, enter blanks.</u> |
| 417-418 | Combined
Federal/State Code | 2 | Required. Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16, Table 1.) |
| 419-420 | Blank | 2 | Enter blanks or carriage return/line feed (cr/lf) characters. |

STATE TOTALS "K" RECORD—RECORD LAYOUT

| RECORD TYPE | NUMBER OF PAYEES | BLANK | CONTROL TOTAL 1 | CONTROL TOTAL 2 | CONTROL TOTAL 3 |
|-------------|------------------|-------|-----------------|-----------------|-----------------|
| 1 | 2-7 | 8-10 | 11-25 | 26-40 | 41-55 |

| CONTROL TOTAL 4 | CONTROL TOTAL 5 | CONTROL TOTAL 6 | CONTROL TOTAL 7 | CONTROL TOTAL 8 | CONTROL TOTAL 9 |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| 56-70 | 71-85 | 86-100 | 101-115 | 116-130 | 131-145 |

| BLANK | <u>CONTROL TOTAL</u>
<u>STATE INCOME TAX</u>
<u>WITHHELD (FORM</u>
<u>1099-R ONLY)</u> | <u>CONTROL TOTAL</u>
<u>LOCAL INCOME</u>
<u>TAX WITHHELD</u>
<u>(FORM 1099-R</u>
<u>ONLY)</u> | COMBINED
FEDERAL/
STATE
CODE | BLANK |
|----------------|---|---|---------------------------------------|---------|
| <u>146-386</u> | <u>387-401</u> | <u>402-416</u> | 417-418 | 419-420 |

PART E CHANGES

Changes to Single Density (8-inch) Diskettes Specifications found in Part E, Sec. 6, Sector 4, Sec. 7, Sec. 14, and Sec. 15 follow.

SEC. 6. PAYEE "B" RECORD—FIELD DESCRIPTIONS

SECTOR 4

The following field descriptions describe the record positions for Sector 4 of the "B" Record for Forms 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, and 5498. If a payer is not a Combined Federal/State Payer, or if they are not utilizing the Special Data Entries Field, Sector 4 can be eliminated for all "B" Records except Forms 1099-A, 1099-B, 1099-C, 1099-0ID, 1099-S, and W-2G. See Part E, Secs. 8, 9, 10, 11, 12 and 13 for the field descriptions for Section 4 of Forms 1099-A, 1099-B, 1099-C, 1099-0ID, 1099-S and W-2G.

RECORD NAME: PAYEE "B" RECORD—Continued

| Diskette Position | Field Title | Length | Description and Remarks |
|-------------------|-------------------------|-----------|---|
| 1 | Record Sequence | 1 | Required. Enter a "4" to sequence the sectors making up a payee record. |
| 2 | Record Type | 1 | Required. Enter "B." |
| <u>3-49</u> | Special Data
Entries | <u>47</u> | This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks. |

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 4 (Continued)

| Diskette Position | Field Title | Length | Description and Remarks |
|-------------------|---|-----------|---|
| <u>50-59</u> | <u>State Income Tax Withheld (Form 1099-R Only)</u> | <u>10</u> | <u>State income tax withheld is for the convenience of the filer. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| <u>60-69</u> | <u>Local Income Tax Withheld (Form 1099-R only)</u> | <u>10</u> | <u>Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| 70-71 | Combined Federal/State Code | 2 | If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states not participating in this program or for forms not valid for state reporting, enter blanks . |
| 72-128 | Blank | 57 | Enter blanks |

SEC. 7. PAYEE "B" RECORD—RECORD LAYOUTS FOR SECTORS 1 THROUGH 4 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTORS 1 THROUGH 3 OF FORMS 1099-A, 1099-B, 1099-C, 1099-OID, 1099-S, AND W-2G.

SECTOR 1

| RECORD SEQUENCE | RECORD TYPE | PAYMENT YEAR | DOCUMENT SPECIFIC/DISTRIBUTION CODE | 2ND TIN NOTICE (OPTIONAL) |
|-----------------|-------------|--------------|-------------------------------------|---------------------------|
| 1 | 2 | 3-4 | 5-6 | 7 |

| CORRECTED RETURN INDICATOR | NAME CONTROL* | DIRECT SALES INDICATOR | BLANK | TYPE OF TIN* | TAXPAYER IDENTIFICATION NUMBER* |
|----------------------------|---------------|------------------------|-------|--------------|---------------------------------|
| 8 | 9-12 | 13 | 14 | 15 | 16-24 |

| PAYER'S ACCOUNT NUMBER FOR PAYEE* | IRA/SEP INDICATOR | PERCENTAGE OF TOTAL DISTRIBUTION | TOTAL DISTRIBUTION INDICATOR |
|-----------------------------------|-------------------|----------------------------------|------------------------------|
| 25-44 | 45 | 46-47 | 48 |

| TAXABLE AMT NOT DETERMINED INDICATOR | BLANK | PAYMENT AMOUNT 1 | PAYMENT AMOUNT 2 | PAYMENT AMOUNT 3 | PAYMENT AMOUNT 4 |
|--------------------------------------|-------|------------------|------------------|------------------|------------------|
| 49 | 50-51 | 52-61 | 62-71 | 72-81 | 82-91 |

| PAYMENT AMOUNT 5 | PAYMENT AMOUNT 6 | PAYMENT AMOUNT 7 | BLANK |
|------------------|------------------|------------------|---------|
| 92-101 | 102-111 | 112-121 | 122-128 |

SECTOR 2

| RECORD SEQUENCE | RECORD TYPE | PAYMENT AMOUNT 8 | PAYMENT AMOUNT 9 | BLANK | FOREIGN COUNTRY INDICATOR |
|-----------------|-------------|------------------|------------------|-------|---------------------------|
| 1 | 2 | 3-12 | 13-22 | 23-42 | 43 |

| FIRST PAYEE NAME LINE* | SECOND PAYEE NAME LINE* | BLANK |
|------------------------|-------------------------|---------|
| 44-83 | 84-123 | 124-128 |

SECTOR 3

| RECORD SEQUENCE | RECORD TYPE | PAYEE MAILING ADDRESS | PAYEE CITY | PAYEE STATE | PAYEE ZIP CODE | BLANK |
|-----------------|-------------|-----------------------|------------|-------------|----------------|--------|
| 1 | 2 | 3-42 | 43-71 | 72-73 | 74-82 | 83-128 |

SECTOR 4 (See Note)

| RECORD SEQUENCE | RECORD TYPE | SPECIAL DATA ENTRIES | <u>STATE INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | <u>LOCAL INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> |
|-----------------|-------------|----------------------|---|---|
| 1 | 2 | <u>3-49</u> | <u>50-59</u> | <u>60-69</u> |

| COMBINED FEDERAL/STATE CODE | BLANKS |
|-----------------------------|--------|
| 70-71 | 72-128 |

Note: See Part E, Secs. 8, 9, 10, 11, 12 and 13 for the Record Layouts for Sector 4 of Forms 1099-A, 1099-B, 1099-C, 1099-OID, 1099-S, and W-2G.

* When filing Form 1098, Mortgage Interest Statement, the "B" Record will reflect the individual paying the interest (the borrower/payer of record) and the amount paid.

SEC. 14. END OF PAYER "C" RECORD

There are no changes to the Payer "C" Record.

SEC. 15. STATE TOTALS "K" RECORD—RECORD LAYOUT

.01 The State Totals "K" Record

consists of 2 sectors of 128 positions each. The Control Total Fields are each 15 positions in length.

.02 The "K" Record is a summary for a given payer and a given state in the Combined Federal/State Filing Program. Use **only** when state reporting approval has been granted.

.03 The "K" Record will contain the total number of payees and the totals of the Payment Amount Fields filed for a given payer for a given state. The "K" Record(s) must be written after the "C" Record for the related "A" Record.

.04 In developing the "K" Record, for example, if a payer used Amount

Codes 1, 3, and 6 in the "A" Record, the totals from the "B" Records coded for this state will appear in Control Totals 1, 3, and 6 of the "K" Record.

.05 There **must** be a separate "K" Record for **each state** being reported.

.06 Refer to Part A, Sec. 16 for the requirements and conditions that **must** be met to file via this program.

.07 Control total fields have been added for the accumulated totals of state and local withholding fields from the "B" Records for Form 1099-R only for each state being reported.

RECORD NAME: STATE TOTALS "K" RECORD

SECTOR 1

| Diskette Position | Field Title | Length | Description and Remarks |
|---|------------------|--------|---|
| 1 | Record Sequence | 1 | Required. Enter a "1" (one) to sequence the sectors making up a payer record. |
| 2 | Record Type | 1 | Required. Enter "K" |
| 3-8 | Number of Payees | 6 | Required. Enter the total number of "B" Records being coded for this state. Right justify and zero fill. |
| 9-11 | Blank | 3 | Enter blanks |
| <p>Required. Accumulate totals of any payment amount fields in the "B" Records for each state being reported, into the appropriate control total fields of the appropriate "K" Record. Control totals must be right-justified and unused control total fields zero-filled. All control total fields are 15 positions in length.</p> | | | |
| 12-26 | Control Total 1 | 15 | |
| 27-41 | Control Total 2 | 15 | |
| 42-56 | Control Total 3 | 15 | |
| 57-71 | Control Total 4 | 15 | |
| 72-86 | Control Total 5 | 15 | |
| 87-101 | Control Total 6 | 15 | |
| 102-116 | Control Total 7 | 15 | |
| 117-128 | Blank | 12 | Enter blanks |

SECTOR 2

| | | | |
|----------------|---|-----------|---|
| 1 | Record Sequence | 1 | Required. Enter a "2" to sequence the sectors making up a payer record. |
| 2 | Record Type | 1 | Required. Enter "K" |
| 3-17 | Control Total 8 | 15 | |
| 18-32 | Control Total 9 | 15 | |
| 33-95 | Blank | 94 | Enter blanks |
| <u>96-110</u> | <u>State Income Tax withheld (Form 1099-R only)</u> | <u>10</u> | <u>State income tax withheld is for the convenience of the filer. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| <u>111-126</u> | <u>Local Income Tax Withheld (Form 1099-R only)</u> | <u>10</u> | <u>Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| 127-128 | Combined Federal/State Code | 2 | Required. Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16, Table 1.) |

END OF PAYER "K" RECORD—RECORD LAYOUT

SECTOR 1

| RECORD SEQUENCE | RECORD TYPE | NUMBER OF PAYEES | BLANK | CONTROL TOTAL 1 | CONTROL TOTAL 2 |
|-----------------|-------------|------------------|-------|-----------------|-----------------|
| 1 | 2 | 3-8 | 9-11 | 12-26 | 27-41 |

| CONTROL TOTAL 3 | CONTROL TOTAL 4 | CONTROL TOTAL 5 | CONTROL TOTAL 6 | CONTROL TOTAL 7 | BLANK |
|-----------------|-----------------|-----------------|-----------------|-----------------|---------|
| 42-56 | 57-71 | 72-86 | 87-101 | 102-116 | 117-128 |

SECTOR 2

| RECORD SEQUENCE | RECORD TYPE | CONTROL TOTAL 8 | CONTROL TOTAL 9 | BLANK |
|-----------------|-------------|-----------------|-----------------|--------------|
| 1 | 2 | 3-17 | 18-32 | <u>33-95</u> |

| <u>CONTROL TOTAL STATE INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | <u>CONTROL TOTAL LOCAL INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | COMBINED FEDERAL/STATE CODE |
|---|---|-----------------------------|
| <u>96-110</u> | <u>111-126</u> | 127-128 |

PART F CHANGES

Changes to Part F, Double Density (8-inch) Diskette Specifications found in Part F, Sec. 6, Sector 2, Sec. 7 and Sec. 15 follow.

SEC. 6. PAYEE "B" RECORD—FIELD DESCRIPTIONS

SECTOR 2—FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R AND 5498.

See Part F, Secs. 8, 9, 10, 11, 12 and 13 for field descriptions for Sector 2 of Forms 1099-A, 1099-B, 1099-C, 1099-OID, 1099-S and W-2G.

RECORD NAME: PAYEE "B" RECORD—Continued

SECTOR 2 (Continued)

| Diskette Position | Field Title | Length | Description and Remarks |
|-------------------|-----------------------|--------|---|
| 1 | Record Sequence | 1 | Required. Enter a "2" to sequence the sectors making up a payee record. |
| 2 | Record Type | 1 | Required. Enter "B" |
| 3-42 | Payee Mailing Address | 40 | Required. Enter mailing address of payee. Street address should include number, street, apartment or suite number (or P. O. Box if mail is not delivered to street address). Left justify information and fill unused positions with blanks. This field must not contain any data other than the payee's mailing address. |

For U.S. addresses, the payee city, state, and ZIP Code must be reported as a 29, 2, and 9 position fields, respectively. Filers must adhere to the correct format for the payee city, state, and ZIP Code. **For foreign addresses**, filers may use the payee city, state and ZIP Code as a continuous 40 position field. Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Country Indicator Field, Sector 1, position 162, must contain a "1" (one).

SECTOR 2 (Continued)

| Diskette Position | Field Title | Length | Description and Remarks |
|-------------------|---|-----------|--|
| 43-71 | Payee City | 29 | Required. Enter the city, town, or post office. Left justify information and fill unused positions with blanks. Enter APO or FPO if applicable. Do not enter state and ZIP Code information in this field. |
| 72-73 | Payee State | 2 | Required. Enter the valid U.S. Postal Service state abbreviation for the state or the appropriate postal identifier (AA, AE, or AP) described in Part A, Sec. 18. |
| 74-82 | Payee ZIP Code | 9 | Required. Enter the valid nine digit ZIP Code assigned by the U.S. Postal Service. If only the first five digits are known, left justify information and fill unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a "1" (one) in the Foreign Country Indicator Field located in position 162 of Sector 1 of the "B" Record. |
| 83-112 | Blank | 30 | Enter blanks. |
| <u>113-159</u> | Special Data Entries | <u>47</u> | This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, enter blanks. |
| <u>160-169</u> | <u>State Income Tax Withheld (Form 1099-R only)</u> | <u>10</u> | <u>State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| <u>170-179</u> | <u>Local Income Tax Withheld (Form 1099-R only)</u> | <u>10</u> | <u>Local income tax withheld is for the reporting convenience of the filers. This information does not need to be reported to IRS. Payment amount must be right justified and unused positions must be zero-filled. If not reporting Form 1099-R, this field may be used as a continuation of the Special Data Entries field.</u> |
| 180-181 | Combined Federal/State Code | 2 | If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states not participating in this program, or for forms not valid for state reporting, enter blanks. |
| 182-256 | Blank | 75 | Enter blanks. |

SEC. 7. PAYEE "B" RECORD — RECORD LAYOUTS FOR SECTORS 1 AND 2 OF FORMS 1098, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-PATR, 1099-R, 5498 AND SECTOR 1 OF FORMS 1099-A, 1099-B, 1099-C, 1099-OID, 1099-S AND W-2G.

See Part F, Secs. 8, 9, 10, 11, 12 and 13 for the field descriptions and record layouts for Sector 2 of Forms 1099-A, 1099-B, 1099-C, 1099-OID, 1099-S and W-2G.

PAYEE "B" RECORD—RECORD LAYOUTS

Sector 1

| RECORD SEQUENCE | RECORD TYPE | PAYMENT YEAR | DOCUMENT SPECIFIC/DISTRIBUTION CODE | 2ND TIN NOTICE (OPTIONAL) |
|-----------------|-------------|--------------|-------------------------------------|---------------------------|
| 1 | 2 | 3-4 | 5-6 | 7 |

PAYEE "B" RECORD—RECORD LAYOUTS—Continued

Sector 1 (Continued)

| | | | | | |
|----------------------------|---------------|------------------------|-------|--------------|---------------------------------|
| CORRECTED RETURN INDICATOR | NAME CONTROL* | DIRECT SALES INDICATOR | BLANK | TYPE OF TIN* | TAXPAYER IDENTIFICATION NUMBER* |
| 8 | 9-12 | 13 | 14 | 15 | 16-24 |

| | | | | |
|-----------------------------------|-------------------|----------------------------------|------------------------------|--------------------------------------|
| PAYER'S ACCOUNT NUMBER FOR PAYEE* | IRA/SEP INDICATOR | PERCENTAGE OF TOTAL DISTRIBUTION | TOTAL DISTRIBUTION INDICATOR | TAXABLE AMT NOT DETERMINED INDICATOR |
| 25-44 | 45 | 46-47 | 48 | 49 |

| | | | | | |
|-------|------------------|------------------|------------------|------------------|------------------|
| BLANK | PAYMENT AMOUNT 1 | PAYMENT AMOUNT 2 | PAYMENT AMOUNT 3 | PAYMENT AMOUNT 4 | PAYMENT AMOUNT 5 |
| 50-51 | 52-61 | 62-71 | 72-81 | 82-91 | 92-101 |

| | | | | | |
|------------------|------------------|------------------|------------------|---------|---------------------------|
| PAYMENT AMOUNT 6 | PAYMENT AMOUNT 7 | PAYMENT AMOUNT 8 | PAYMENT AMOUNT 9 | BLANK | FOREIGN COUNTRY INDICATOR |
| 102-111 | 112-121 | 122-131 | 132-141 | 142-161 | 162 |

| | | |
|------------------------|-------------------------|---------|
| FIRST PAYEE NAME LINE* | SECOND PAYEE NAME LINE* | BLANK |
| 163-202 | 203-242 | 243-256 |

SECTOR 2 (See Note)

| | | | | | |
|-----------------|-------------|-----------------------|------------|-------------|----------------|
| RECORD SEQUENCE | RECORD TYPE | PAYEE MAILING ADDRESS | PAYEE CITY | PAYEE STATE | PAYEE ZIP CODE |
| 1 | 2 | 3-42 | 43-71 | 72-73 | 74-82 |

| | | | | | |
|--------|----------------------|--|--|-----------------------------|---------|
| BLANK | SPECIAL DATA ENTRIES | <u>STATE INCOME TAX WITHHELD</u>
(FORM 1099-R ONLY) | <u>LOCAL INCOME TAX WITHHELD</u>
(FORM 1099-R ONLY) | COMBINED FEDERAL STATE CODE | BLANK |
| 83-112 | <u>113-159</u> | <u>160-169</u> | <u>170-179</u> | 180-181 | 182-256 |

Note: See Part F, Secs. 8, 9, 10, 11, 12 and 13 for field descriptions for Sector 2 of Forms 1099-A, 1099-B, 1099-C, 1099-OID, 1099-S and W-2G.

*When filing Form 1098, Mortgage Interest Statement, the "B" Record will reflect the individual paying the interest (the borrower/payer of record) and the amount paid.

SEC. 15. STATE TOTALS “K” RECORD—RECORD LAYOUT

.01 The State Totals “K” Record consists of 2 sectors of 128 positions each. The Control Total Fields are each 15 positions in length.

.02 The “K” Record is a summary for a given payer and a given state in the Combined Federal/State Filing Program. Use **only** when state reporting approval has been granted.

.03 The “K” Record will contain the total number of payees and the totals of the Payment Amount Fields filed for a given payer for a given state. The “K” Record(s) must be written after the “C” Record for the related “A” Record.

.04 In developing the “K” Record, for example, if a payer used Amount Codes 1, 3, and 6 in the “A” Record, the totals from the “B” Records coded for this state will appear in Control

Totals 1, 3, and 6 of the “K” Record.

.05 There **must** be a separate “K” Record for **each state** being reported.

.06 Refer to Part A, Sec. 16 for the requirements and conditions that **must** be met to file via this program.

.07 Control Total fields have been added for the accumulated totals of state and local withholding fields from the “B” Records for Form 1099-R only for each state being reported.

RECORD NAME: STATE TOTALS “K” RECORD

SECTOR 1

| Diskette Position | Field Title | Length | Description and Remarks |
|-------------------|------------------|--------|--|
| 1 | Record Sequence | 1 | Required. Enter a “1” (one) to sequence the sectors making up a payer record. |
| 2 | Record Type | 1 | Required. Enter “K” |
| 3–8 | Number of Payees | 6 | Required. Enter the total number of “B” Records being coded for this state. Right justify and fill unused positions with zeros. |
| 9–11 | Blank | 3 | Enter blanks |

Required. Accumulate totals of any payment amount fields in the “B” Records for each state being reported, into the appropriate control total fields of the appropriate “K” Record. **Control totals must be right-justified and unused control total fields zero filled.** All control total fields are 15 positions in length.

| | | | |
|----------------|---|-----------|---|
| 12–26 | Control Total 1 | 15 | |
| 27–41 | Control Total 2 | 15 | |
| 42–56 | Control Total 3 | 15 | |
| 57–71 | Control Total 4 | 15 | |
| 72–86 | Control Total 5 | 15 | |
| 87–101 | Control Total 6 | 15 | |
| 102–116 | Control Total 7 | 15 | |
| 117–131 | Control Total 8 | 15 | |
| 132–146 | Control Total 9 | 15 | |
| <u>147–224</u> | Blank | <u>78</u> | Enter blanks. |
| <u>225–239</u> | <u>Control Total State Income Tax Withheld (Form 1099-R only)</u> | <u>15</u> | <u>Accumulate totals of the state income tax withheld field in the Payee “B” Record. Otherwise, enter blanks.</u> |
| <u>240–254</u> | <u>Control Total Local Income Tax Withheld (Form 1099-R only)</u> | <u>15</u> | <u>Accumulate totals of the local income tax withheld field in the Payee “B” Record. Otherwise, enter blanks.</u> |

SECTOR 1 (Continued)

| Diskette Position | Field Title | Length | Description and Remarks |
|-------------------|-----------------------------|--------|---|
| 255-256 | Combined Federal/State Code | 2 | Required. Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16, Table 1.) |

END OF PAYER "K" RECORD—RECORD LAYOUT

SECTOR 1

| RECORD SEQUENCE | RECORD TYPE | NUMBER OF PAYEES | BLANK | CONTROL TOTAL 1 | CONTROL TOTAL 2 |
|-----------------|-------------|------------------|-------|-----------------|-----------------|
| 1 | 2 | 3-8 | 9-11 | 12-26 | 27-41 |

| CONTROL TOTAL 3 | CONTROL TOTAL 4 | CONTROL TOTAL 5 | CONTROL TOTAL 6 | CONTROL TOTAL 7 | CONTROL TOTAL 8 |
|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| 42-56 | 57-71 | 72-86 | 87-101 | 102-116 | 117-131 |

| CONTROL TOTAL 9 | BLANK | <u>CONTROL TOTAL STATE INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | <u>CONTROL TOTAL LOCAL INCOME TAX WITHHELD (FORM 1099-R ONLY)</u> | COMBINED FEDERAL/ STATE CODE |
|-----------------|----------------|---|---|------------------------------|
| 132-146 | <u>147-224</u> | <u>225-239</u> | <u>240-254</u> | 255-256 |

26 CFR 601.602: Forms and instructions. (Also Part I, Sections 408, 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N, 6050P; 1.408-5, 1.408-7, 1.6041-1, 7.6041-1, 1.6042-2, 1.6042-4, 1.6044-2, 1.6044-5, 1.6045-1, 1.6045-2, 1.6045-4, 5f.6045-1, 1.6047-1, 1.6049-4, 1.6049-6, 1.6049-7, 1.6050A-1, 1.6050B-1, 1.6050D-1, 1.6050E-1, 1.6050H-1, 1.6050H-2, 1.6050J-1T, 1.6050P-1T.)

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PART A. GENERAL

SECTION 1. PURPOSE

.01 The purpose of this revenue procedure is to set forth the requirements for:

1. Using official Internal Revenue Service (IRS) forms to file information returns with IRS.

2. Preparing acceptable substitutes of the official IRS forms to file information returns, and

3. Using such official or acceptable substitute forms to furnish information to a recipient.

This revenue procedure contains specifications for the following information returns:

(a) Form 1098 Mortgage Interest Statement;

(b) Form 1099-A Acquisition or Abandonment of Secured Property;

(c) Form 1099-B Proceeds From Broker and Barter Exchange Transactions;

(d) Form 1099-C Cancellation of Debt;

(e) Form 1099-DIV Dividends and Distributions;

(f) Form 1099-G Certain Government Payments;

(g) Form 1099-INT Interest Income;

(h) Form 1099-MISC Miscellaneous Income;

(i) Form 1099-OID Original Issue Discount;

(j) Form 1099-PATR Taxable Distributions Received From Cooperatives;

(k) Form 1099-R Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.;

(l) Form 1099-S Proceeds From Real Estate Transactions;

(m) Form W-2G Certain Gambling Winnings;

(n) Form 5498 Individual Retirement Arrangement Information; and

(o) Form 1096 Annual Summary and Transmittal of U.S. Information Returns.

.02 For the purpose of this revenue procedure, a substitute form or state-

ment is one that is not printed by the IRS. For a substitute form or statement to be acceptable to the IRS, it must conform to the official form or the specifications outlined in this revenue procedure. **DO NOT SUBMIT ANY SUBSTITUTE FORMS OR STATEMENTS TO IRS FOR APPROVAL.** Private printers cannot state "This is an IRS approved form." Further, only those forms that conform to the official form or comply with the specifications set forth herein are acceptable. See Part A, Section 7, for the specifications that apply to form recipient statements (generally Copy B).

.03 Filers who make payments to certain persons (payees) (or in some cases receive payments) during a calendar year are required by the Internal Revenue Code (IRC) to file information returns with the IRS reflecting these payments. Further, as discussed below, these filers must provide this information to their payees.

.04 In general, the manner in which a filer must file an information return is governed by section 6011 of the IRC. A filer must file information returns on magnetic media or on paper. Under section 6011 of the IRC, a filer who is required to file 250 or more information returns (of any one type) during a calendar year must file those returns on magnetic media. Filers required to file less than 250 returns during a calendar year may, but are not required to, file such information returns on magnetic media (small volume filers). The IRS explains these legal requirements for filing information returns (and providing a copy to a payee) in the annual publication of Instructions for Forms 1099, 1098, 5498, and W-2G.

.05 Copies of the official forms for the reporting year and the instruction booklet may be obtained by calling our toll-free number **1-800-TAX-FORM (1-800-829-3676)**.

.06 The IRS prints and provides the forms on which various payments must be reported. Alternatively, filers may prepare substitute copies of these IRS forms and use such forms to report payments to the IRS.

.07 IRS operates a centralized call site, located at the Martinsburg Computing Center (MCC), to answer questions related to information returns. The call site phone number is **304-263-8700**. The number for Telecommunications Device for the Deaf

(TDD) is **304-267-3367**. These are not toll-free numbers.

.08 IRS has established a personal computer based Information Reporting Bulletin Board System (IRP-BBS) at MCC. This system provides information about forms and publications including this revenue procedure, news of the latest changes, answers to questions, access to shareware, and other features. The IRP-BBS is available for public use and can be reached by dialing **304-263-2749**. The IRP-BBS is compatible with most modems. For more information concerning this system, call MCC at **304-263-8700 (not a toll-free number) Monday through Friday 8:30 A.M. to 4:30 P.M. eastern time.**

SEC. 2. NATURE OF CHANGES

.01 The text and exhibits were updated for tax year 1995.

.02 The title of Pub. 1179 was changed to "Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series 5498, and W-2G."

.03 The mailing address used for questions regarding specifications contained in Pub. 1179 has been changed. See Part A, Sec. 3.01.

.04 IRS has adopted a new requirement that all substitute statements must contain the tax year, form number, and form name prominently displayed together in one area of the statement. See Part A, Sec. 7.01 (6). Note: The proposal to eliminate the practice of furnishing one sheet of multiple form instructions was withdrawn. Although the IRS is concerned that a single sheet of instructions may be confusing to recipients, it may still be used.

.05 IRS has adopted new requirement relative to the quality of carbon used to produce statements to recipients. See Part A, Sec. 7.03 (4).

.06 On Form 1099-A, box 3, previously titled "Gross foreclosure proceeds," was eliminated, and the title of box 4 was changed to "Fair market value of property." See Exhibit B.

.07 On Form 1099-C, the title of box 6 (Copy A) was changed to "Check for bankruptcy," and a new box 7 titled "Fair market value of property" was added. See Exhibit D.

.08 On Form 1099-R, a new box 9b, "Total employee contributions," was added. See Exhibit K.

.09 On Form 1098, the title of box 2 was changed to "Points paid on purchase of principal residence."

.10 The next issuance of Publication 1179 (1996 revision) will include new verbiage for the paper and ink specifications for substitute forms to be filed with IRS. See "NOTE" in Part B, Sec. 2.02.

SEC. 3. REQUIREMENTS FOR ACCEPTABLE SUBSTITUTE FORMS 1096, 1098, 1099, 5498, AND W-2G

.01. Paper substitutes for Form 1096 and Copy A of Forms 1098, 1099, 5498, and W-2G that totally conform to the specifications contained in this revenue procedure may be privately printed and filed as returns with the IRS. The reference to the Department of the Treasury - Internal Revenue Services should be included on all such forms. The Catalog Number (Cat. No.) shown on the 1995 Forms 1096, 1098, 1099, 5498, and W-2G is used for IRS distribution purposes and need not be printed on any substitute forms.

If you are uncertain of any specification set forth herein and want that specification clarified, you may submit a letter citing the specification in question, giving your understanding and interpretation of the specification, and enclosing an example of the form (if appropriate) to:

Internal Revenue Service
ATTN:T:S:P:S - SAL (IRP Coordinator)
1111 Constitution Avenue, N.W.
Washington, DC 20224

NOTE: Allow at least 45 days for the IRS to respond.

.02 Copy B (Form 1098 - For Payer, Form 1099-A - For Borrower, Form 1099-C - For Debtor, Form 1099-S - For Transferor, other Forms 1099 - For Recipient, Form 5498 - For Participant, and Forms W-2G and 1099-R - To Be Attached To the Federal Tax Return), and Copy C-(Form 1099-R For Recipient's Records and Form W-2G For Winner's Records) must contain the information specified in PART A Section 7 in order to constitute a "statement" or "official form" under the applicable provisions of the Internal Revenue Code. The format of this information is at the discretion of the filer with the exception of the location of the tax year, form number and form name specified in Part A Section 7.01(6) and composite Form 1099 statements specified in PART A Sections 7.02 and 7.04.

.03 Forms 1096, 1098, 1099, 5498, and W-2G are subject to annual review and possible change. Therefore, filers and cautioned against overstocking supplies of privately printed substitutes. **THE SPECIFICATIONS CONTAINED IN THIS REVENUE PROCEDURE APPLY TO 1995 FORMS ONLY.**

.04 Proposed substitutes for Copy A that do not conform to the specifications in this revenue procedure are not acceptable. Further, if you file such forms with IRS, you may be subject to a penalty for failure to file an information return under section 6721 of the Internal Revenue Code (IRC). Generally, the penalty is \$50 for each failure to file a form (up to \$250,000) that the IRS can not accept as a return because it does not meet the provisions in this revenue procedure. No IRS office is authorized to allow deviations from this revenue procedure.

SEC. 4. DEFINITIONS

.01 The term "form recipient" means the person to whom you are required by law to furnish a copy of the official form or information statement: *i.e.*, for Form 1098, the recipient is the "payer/borrower"; Form 1099-A, the "borrower"; Form 1099-C, the "debtor"; Form 1099-S, the "transferor"; other Forms 1099, the payment recipient; Form 5498, the "participant"; and Form W-2G, the "winner."

.02 The term "filer" means the person or organization required by law to file a form listed in PART A Section 1.01 with the IRS. Thus, a filer may be a payer, a creditor, a recipient of mortgage interest payments, a broker, a barter exchange, a person reporting real estate transactions, a trustee or issuer of an individual retirement arrangement (including an IRA or SEP), or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

.03 A corrected (or amended) return is one that corrects information previously reported to IRS. (A voided return will not correct previously reported information.)

.04 The term "substitute form" means a paper substitute of Copy A of an official form listed in PART A Section 1.01 that totally conforms to the provisions in this revenue procedure.

.05 The term "substitute form recipient statement" means a paper state-

ment of the information reported on a form listed in PART A Section 1.01 that must be furnished to a person (form recipient), as so defined under the applicable provisions of the Internal Revenue Code and the applicable regulations.

.06 A composite substitute statement is one in which two or more required statements (*e.g.*, Forms 1099-INT and 1099-DIV) are furnished to the recipient on one document. However, each statement must be separately designated and must contain all the requisite Form 1099 information except as provided in Part A Section 7. A composite statement CANNOT be filed with the IRS. See PART A Section 7.02 and 7.04 for more information on composite statements.

SEC. 5. INSTRUCTIONS FOR PREPARING PAPER FORMS THAT WILL BE FILED WITH THE IRS (Copy A)

.01 The form recipient's name, street address, city, state, and ZIP code information should be TYPED OR MACHINE PRINTED IN BLACK INK on separate lines. Carbon copies and photocopies are not acceptable. The city, state, and ZIP code must be on the same line.

.02 The name of the appropriate form recipient must be shown on the first or second name line in the area on the form provided for the form recipient's name and address. No descriptive information or other name should precede the form recipient's name. Only ONE form recipient's name should appear on the first name line of the form. If the names of multiple recipients must be set forth on the form, on the first name line insert the recipient name that corresponds to the taxpayer identification number (TIN) used for information reporting purposes. Place the other form recipients' names, on the succeeding name line (up to 2 name lines are allowable). Because certain states require that trust accounts be provided in a different format, *generally* filers should provide information returns reflecting payments to trust accounts with (1) the trust's employer identification number (EIN) in the recipient's TIN area, (2) the trust's name on the recipient's first name line, and (3) the name of the trustee on the recipient's second name line.

.03 You should use the **account number** box for an account number

designation. This number must not appear anywhere else on the form, and this box may not be used for any other item. Showing the account number is optional. However, it may be to your benefit to include the recipient's account number or designation on paper documents if your system of records uses the account number or designation in conjunction with, or rather than, the name, social security number, or employer identification number for identification purposes. If you furnish the account number, the IRS will include it in future notices to you about backup withholding. If you use window envelopes and reduced rate mail to mail statements to recipients, be sure the account number does not appear in the window. Otherwise the Postal Service may not accept them for mailing.

.04 Filers should TYPE OR MACHINE PRINT data entries, insert data in the *middle of blocks* well separated from other printing and guidelines, and take other measures to guarantee a clear, dark black, sharp image.

.05 Machine printed forms should be printed using a 6 lines/inch option.

.06 Machine printed forms should be printed in 10 pitch pica (*i.e.*, 10 print positions per inch) or 12 pitch elite (*i.e.*, 12 print positions per inch). Proportional spaced fonts are unacceptable.

.07 To correct returns, enter an "X" within the checkbox located at the top of the form making the correction, to the left of the word "CORRECTED." DO NOT type the words CORRECTED RETURN on the Form 1096, 1098, 1099, 5498, or W-2G. See "Corrected Returns" located in the 1995 "Instructions for Forms 1099, 1098, 5498, and W-2G."

.08 If you make an error while typing or printing a Form 1098, 1099, or 5498, enter an "X" in the "VOID" box at the top of the form. An entry in the "VOID" box will not correct previously filed information returns. See "Void Returns" in the 1995 "Instructions for Forms 1099, 1098, 5498, and W-2G."

.09 Use only computer print or a typewriter. DO NOT use a felt tip marker. The machine used to "read" paper forms generally cannot "read" think ink type.

.10 Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single sheet before they

are filed with IRS. The size specified *does not include pinfeed holes*. Pinfeed holes MUST NOT be present on forms filed with the IRS.

.11 Use decimal points to indicate dollars and cents. DO NOT use dollar signs (\$), ampersands (&), asterisks (*), commas (,), or other special characters in the numbered money boxes. Example: 2000.00 is acceptable.

.12 DO NOT FOLD Forms 1096, 1098, 1099, or 5498 being mailed to IRS. Mail these forms flat in an appropriately sized envelope or box. Folded documents cannot be readily moved through the scanner transport used in IRS processing.

.13 DO NOT STAPLE Forms 1096 to the returns being transmitted. Staple holes in the vicinity of the return code number reduce the IRS's ability to machine scan the type of documents.

.14 DO NOT type other information on Copy A. NO NOT cut or separate the individual forms on the sheet of forms of Copy A (except Forms W-2G).

.15 MAIL completed paper forms to the IRS service center specified on the back of Form 1096 and in the 1995 "Instructions for Forms 1099, 1098, 5498, and W-2G." CAUTION: SEE NEW "WHERE TO FILE" ADDRESSES, for tax year 1995. Specific information needed to complete the forms in this revenue procedure is given in those instructions. A chart is included in those instructions giving a quick guide to which form must be filed to report a particular payment.

SEC. 6. MAGNETIC MEDIA AND ELECTRONIC FILING

.01 All forms listed in Section 1.01 (except Form 1096) may be filed magnetically or electronically. The IRS encourages all filers including nominees (hereafter collectively referred to as filers) to file information returns on magnetic media or electronically instead of on paper forms.

.02 Any person who is required to file 250 or more (of any one type of form) information returns for one calendar year MUST file on magnetic media unless an undue hardship waiver is requested and received. To request a one year waiver of the magnetic media filing requirements, for the current tax year only, submit Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media. See Publication 1220 Part A, Sec. 5, for more

information. Specifications for filing information returns on magnetic media are contained in Publication 1220, "Specifications for Filing Forms 1098, 1099, 5498, and W-2G Magnetically or Electronically." Copies of this publication may be obtained by calling 1-800-TAX-FORM (1-800-829-3676). Payers who do not comply with the magnetic filing requirements and who are not granted a waiver may be subject to certain penalties. **Note:** Filing electronically will satisfy the magnetic media filing requirements. Refer to Publication 1220, Part C, Biscynchronous (Mainframe) Electronic Filing Specifications and Part D, Asynchronous (IRB-BBS) Electronic Filing Specifications.

SEC. 7. SUBSTITUTE STATEMENTS TO RECIPIENTS AND RECIPIENT COPIES

If you are not using the official IRS form to furnish statements to your recipients, your substitute statement must comply with the rules in this section.

.01 SUBSTITUTE STATEMENTS TO RECIPIENTS - Form 1099-INT, DIV, OID, and PATR ONLY. - The requirement to furnish form recipients with an official Form 1099-INT, DIV, OID, OR PATR may be met by furnishing Copy B of the official form or by furnishing a substitute Form 1099 (form recipient statement) if it contains the same language as that of the official IRS form (such as aggregate amounts paid to the form recipient, any backup withholding, the name, address, and TIN of the person making the return, and any other information required by the official form). Information not required by the official form should not be included on the substitute form except for state tax withholding information. You may enter a total of the individual accounts listed on the form only if they have been paid by the same payer. For example, if you are listing interest paid on several accounts by one financial institution on Form 1099-INT, you may also enter the total interest amount. You may also enter a date next to the corrected box if that box is checked.

The form recipient statement, *e.g.*, Copy B of a substitute form for 1099-INT, 1099-DIV, 1099-OID, and 1099-PATR, must contain the information listed below:

(1) Box captions and numbers that are applicable must be clearly identified, using the same wording and numbering as on the official form. However on **Form 1099-INT**, if box 3 is not on your substitute form, you may drop "not included in box 3" from the box 1 caption.

(2) The form recipient statement must contain all applicable form recipient instructions provided on the front and back of the official IRS form. Those instructions may be provided on a separate sheet of paper.

(3) The form recipient statement must contain the following statement in bold and conspicuous type, "This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported."

(4) The caption "Federal income tax withheld" must be in bold face type on the form recipient statement.

(5) The form recipient statement must contain the Office of Management and Budget (OMB) number as shown on the official IRS form. See Part D, Section 2.

(6) The form recipient statement must contain the tax year (e.g., 1995), form number (e.g., Form 1099-INT), and form name (e.g., Interest Income) of the official IRS Form 1099 for which it substitutes prominently displayed together in one area of the statement. For example, the tax year, form number, and form name could be shown in the upper right part of the statement. Each copy must be appropriately labeled (such as Copy B, For Recipient) (see PART D Section 1.02 for applicable labels of forms). DO NOT include the words "Substitute for" or "In lieu of" on the form recipient statement.

(7) Layout and format of the form is at the discretion of the filer. However, IRS encourages the use of statements with boxes so that the statement has the appearance of a form and can be easily distinguished from other nontax statements.

(8) A mutual fund family may separately state on one document (e.g., one piece of paper) the dividend income earned by a recipient from each fund within the family of funds as required by Form 1099-DIV. However, each fund and its earnings must be

separately stated. The form must contain an instruction to the recipient that each fund's dividends and name, not the name of the mutual fund family, must be reported on the recipient's tax return. The form cannot contain an aggregate total of all funds. A mutual fund family may furnish a single statement (as a single filer) for Form 1099-INT, DIV, OID, and PATR information. Each fund and its earnings must be separately stated. The form must contain an instruction to the recipient that each fund's dividends and name, not the name of the mutual fund family, is to be reported on the shareholder's tax return. The form cannot contain an aggregate total of all funds.

.02 COMPOSITE SUBSTITUTE STATEMENTS - FORMS 1099-INT, DIV, OID, AND PATR ONLY. - A composite form recipient statement is permitted for reportable payments of interest, dividends, original issue discount, and/or patronage dividends (Forms 1099-INT, DIV, OID or PATR) when one payer is reporting more than one of these payments during a calendar year to the same form recipient. Generally, do not include any other Form 1099 information (e.g., 1098 or 1099-A), on a composite statement with the forms listed above. **Exception:** A filer may include Form 1099-B information on a composite form with the forms listed above. Although the composite form recipient statement may be on one sheet, the format of the composite form recipient statement must satisfy the following requirements in addition to the requirements listed in Section 7.01 above.

(1) All information pertaining to a particular type of payment must be located and blocked together on the form and must be separate from any information covering other types of payments included on the form. For example, if you are reporting interest and dividends, the Form 1099-INT information must be presented separately from the Form 1099-DIV information.

(2) The tax year, form number, and form name of the official IRS forms for which the composite form recipient statement substitutes must be prominently displayed together in one area at the beginning of each appropriate block of information.

(3) Any information required by the official IRS forms that would otherwise be repeated in each informa-

tion block is only required to be listed once in the first information block on the composite form. For example, there is no requirement to report the name of the filer in each information block. This rule does not apply to any money amounts, e.g., Federal income tax withheld, or to any other information that applies to money amounts.

(4) A composite statement shall be considered an acceptable substitute only if the type of payment and the recipient's tax obligation with respect to the payment are no less clear than if such statement were furnished separately on an official form.

.03 SUBSTITUTE STATEMENTS TO RECIPIENTS - FORMS 1098, 1099-A, 1099-B, 1099-C, 1099-G, 1099-MISC, 1099-R, 1099-S, 5498, W-2G, AND CERTAIN FORMS 1099-INT AND 1099-DIV. Statements to form recipients of payments reportable on Forms 1098, 1099-A, 1099-B, 1099-C, 1099-G, 1099-MISC, 1099-R, 1099-S, 5498, 1099-DIV only for section 404(k) dividends reportable under section 6047, and 1099-INT only for payments of \$600.00 or more made in the course of a trade or business reportable under section 6041 can be, but are not required to be, copies of the official forms. If you do not use the official form as the form recipient statement, the substitute form recipient statement must meet the following requirements:

(1) The tax year, form number, and form name must be the same as the official form, and must be prominently displayed together in one area of the statement. The filer and form recipient identifying information required on the official IRS form must be included.

(2) All applicable money amounts and information, including box numbers, required to be reported to the form recipient must be titled on the form recipient statement in substantially the same manner as those on the official IRS form. The caption "Federal income tax withheld" must be in bold face type on the form recipient statement. **Exception:** If you are reporting a payment as "Other income" in box 3, Form 1099-MISC, you may substitute appropriate explanatory language for the box title. For example, for payments of accrued wages and leave to a beneficiary of a deceased employee, you might change the title of box 3 to "Beneficiary payments" or something similar.

(3) Appropriate instructions to the form recipient, similar to those on the official IRS form, must be provided to aid in the proper reporting of the items on the form recipient's income tax return. For payments reported on **Form 1099-B**, the requirement to include instructions that are substantially similar to those on the official IRS form may be satisfied by providing form recipients with a single set of instructions with respect to all statements required to be furnished in a calendar year. **NOTE:** If Federal income tax withheld is shown on **Form 1099-R** or **W-2G**, Copy B (to be attached to the tax return) and Copy C (for recipient's/winner's records) *must* be furnished to the recipient. If Federal income tax withheld is not shown on **Form 1099-R** or **W-2G**, only Copy C is required to be furnished, but the instructions similar to those contained on the back of the official Copy B of **Form 1099-R** and Copy C must be furnished to the recipient. For convenience, you may choose to provide both Copies B and C to the recipient.

(4) The quality of carbon used to produce statements to recipients must meet new standards as follows:

(a) all copies must be **CLEARLY LEGIBLE**;

(b) all copies must have the capability to be photocopied;

(c) fading must not be of such a degree as to preclude legibility and the ability to photocopy. In general, black chemical transfer inks are preferred; other colors are permitted only if the above standards are met. "Hot wax and cold carbon spots are NOT permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply.

(5) A mutual fund family may separately state on one document (e.g., one piece of paper) the **Form 1099-B** information for a recipient from each fund as required by **Form 1099-B**. The gross proceeds, etc., from each transaction, within a fund must be separately stated. The form must contain an instruction to the recipient that each fund's amount and name, not the name of the mutual fund family, must be reported on the recipient's tax return. The form cannot contain an aggregate total of all funds.

(6) For **Form 1099-S**, Proceeds From Real Estate Transactions, you may use a Uniform Settlement Statement under the Real Estate Settlement

Procedures Act of 1974 (RESPA), as the written statement to the transferor if it is conformed by including on the statement the legend described in (7)(e) and by designating which information on the Uniform Settlement Statement is being reported to IRS on **Form 1099-S**.

(7) Form recipient statements must contain the following legends:

(a) **Form 1098**—(i) "The information in boxes 1, 2 and 3 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points or because you did not report this refund of interest on your return." (ii) "The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person."

(b) **Form 1099-A** and **1099-C**—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported."

(c) **1099-B**, **1099-DIV**, **1099-G**, **1099-INT**, **1099-MISC**, and **W-2G** (Copy C)—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported." Copy B of **Form W-2G** must state "This information is being furnished to the Internal Revenue Service. Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 2, attach this copy to your return."

(d) **Form 1099-R**—"Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the Internal Revenue Service."

(e) **Form 1099-S**—"This is important tax information and is being furnished to Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported."

(f) **Form 5498**—"The information in boxes 1, 2, 3, and 4 is being furnished to the Internal Revenue Service." **Note:** If the trustee does not issue **Form 5498** to a participant because no contributions were made to an IRA for the year, a year-end statement issued to the participant reporting the fair market value of the account must contain a similar legend designating which information is being furnished to IRS.

.04 **COMPOSITE SUBSTITUTE STATEMENT - FORMS SPECIFIED IN 7.03 ONLY.** A composite form recipient statement for forms specified in 7.03 is permitted when one filer is reporting more than one of the related payments during a calendar year to the same form recipient. A composite statement is not allowable for a combination of forms listed in 7.01 and forms listed in 7.03 except that a filer may report **Form 1099-B** information on a composite form with the forms listed in 7.01 as described in 7.02. Although the composite form recipient statement may be on one sheet, the format of the composite form recipient statement must satisfy the requirements listed in items (1), (2), (3) and (4) of 7.02 above in addition to the requirements specified in 7.03. Further, a composite statement shall be considered an acceptable substitute only if the type of payment and the recipient's tax obligation with respect to the payment are no less clear than if such statements were furnished separately. A composite statement of Forms 1098 and 1099-INT (for interest reportable under section 6049) IS NOT ALLOWABLE.

PART B - SPECIFICATIONS FOR SUBSTITUTE FORMS TO BE FILED WITH IRS (EXCEPT FORM W-2G)

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements for **Forms 1096** and Copy A of **Forms 1098**, **1099**, and **5498**. (See Part C for **Form W-2G** specifications.)

.02 The form identifying number (e.g., 9191 for **Form 1099-DIV**) must

be printed in non-reflective black carbon-based ink in print positions 15 through 19 using an OCR A font. The checkboxes located to the right of the form identifying number must be 10-point boxes, the void checkbox is in print position 25 and the corrected checkbox in position 33. These measurements are from the left edge of the paper, not including the perforated strip.

SEC. 2. SPECIFICATIONS FOR FORMS 1096 AND COPY A OF FORMS 1098, 1099 AND 5498

.01 The substitute form must be an exact replica of the official IRS reproduction proof with respect to layout and contents. Hot wax and cold carbon spots are not permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply. Use of chemical transfer paper for Copy A is acceptable. The Government Printing Office (GPO) symbol must be deleted. Specifications for Copy A are provided in Exhibits A through N. Specifications for Form 1096 are provided in Exhibit O.

.02 **NOTE:** The next issuance of Pub. 1179 (1996 revision) will include new verbiage for paper and ink specifications. The new verbiage will be based on the "Scan Optics Series 9000 Scanner" specifications. **ALTHOUGH THE VERBIAGE IN THIS SECTION WILL BE REVISED, THE REQUIREMENTS AND SPECIFICATIONS FOR PRINTING THE FORMS WILL REMAIN THE SAME.**

.03 Color and quality of paper for Copy A (cut sheets and continuous pinfeed forms) as specified by JCP Code 0-25, dated November 29, 1978, must be white 100% bleached chemical wood, optical character recognition (OCR) bond produced in accordance with the following specifications:

NOTE: Reclaimed fiber in any percentage is permitted provided the requirements of this standard are met.

- (1) Acidity: Ph value, average, not less than 4.5
- (2) Basis Weight 17 × 22 500 cut sheets 18-20
Metric equivalent ---g/m² 75
A Tolerance of ± 5 pct. shall be allowed.
- (3) Stiffness: Average, each direction, not less than—milligrams 50

- (4) Tearing strength: Average, each direction, not less than—grams 40
- (5) Opacity: Average, not less than—percent 82
- (6) Thickness: Average—inch—0.0038
Metric equivalent—mm—0.097
A tolerance of + 0.0005 inch (0.0127 mm) shall be allowed.
Paper shall not vary more than 0.0004 inch (0.0102 mm) from one edge to the other.
- (7) Porosity: Average, not less than—seconds 10
- (8) Finish (smoothness): Average, each side—seconds 20-55
For information only, the Sheffield equivalent—units 170-100
- (9) Dirt: Average, each side, not to exceed—parts per million 8

.04 All printing on Forms 1098, 1099, and 5498 must be in red OCR dropout ink, Flint J-6983 (formerly Sinclair-Valentine) or an exact match, except for the 4-digit form identifying numbers, which must be printed in non-reflective carbon-based black ink. The shaded areas of any substitute form should generally correspond to that present on the official form. Printing on Form 1096 above the statement "Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable." must be in red OCR dropout ink (except for the 4 digit form identifying number 6969). All printing including and below this statement may be in any shade or tone of black ink. Black ink should only appear on the lower portion of the reverse side of **Form 1096** where it would not bleed through and interfere with scanning. The instructions to filers are printed on the back of the copy designated for the Payer, Recipient for 1098, Lender for Form 1099-A, Creditor for 1099-C, Filer for 1099-S, or Trustee or Issuer for Form 5498 in any ink color or tone. Separation between fields must be 0.1 inch. Other than the Form 1099-R, the numbered captions are printed as a solid with no shaded background. Other printing requirements are discussed below.

OCR Specifications

The contractor must have or initiate

a quality control program to assure OCR ink density. In addition, the contractor must have access to either a MacBeth PCM-II tester or a Kidder 082A tester to evaluate the ink at regular intervals throughout a shift.

Paper and Ink

Readings will be made when printed on approved 20 lb. white OCR bond with a reflectance of not less than 80%. Black ink used must not have reflectance greater than 15%. These readings are based on requirements of the "REI Input 80 Model C1 & D" Optical Scanner using Flint Ink (formerly known as Sinclair - Valentine J-6983 red ink) or equal.

MacBeth PCM II Tester

The tested Print Contrast Signal (PCS) values when using the MacBeth PCM-II tester on the "C" scale must range from .01 minimum to .06 maximum.

Kidder 082A Tester

The tested Print Contrast Signal (PCS) values when using the Kidder 082A tester on the Infra Red (IR) scale must range from .12 minimum to .21 maximum. White calibration disc must be 100%, sensitivity must be set at one (1).

Alternative Tester

If an alternative tester is used it must be approved by the Government so that tested (PCS) values can be established with this equipment. Approval may be obtained by writing to the following address:

Commissioner of Internal Revenue
Attn: PC:M:T Room 1237
Tax Forms Procurement Analyst
1111 Constitution Avenue, N.W.
Washington, DC 20224

.05 **Typography** - Type must be substantially identical in size and shape with corresponding type on the official form. All rules are either ½-point or ¾-point. Rules must be identical to that on the official IRS form. **NOTE:** The form identifying number must be non-reflective carbon-based black ink in OCR A Font.

.06 **Dimension** - Three Forms 1098, 1099, or 5498 (Copy A) are contained

on a single page, except Form 1099-R which contains two documents per page, which is 8 inches wide (exclusive of any snap-stubs and/or pinfeed holes) by 11 inches deep. There is a .33 inch top margin from the top of the corrected box, and there is a .25 inch right margin. There is a 1/32" (0.0313") tolerance for the right margin. These measurements are constant for all **Forms 1098, 1099 and 5498**. The measurements will be shown only once in the exhibit section of this publication, on the **Form 1098**. Exceptions to these measurements will be shown on the remainder of exhibits. If the right and top margins are properly aligned, the left margin for all forms will be correct. All margins must be free of all printing. See Exhibits A through O in this publication for the correct form measurements.

.07 The depth of the individual trim size of each form on a page must be the same as that of the official form (3 2/3 inches, except 5 1/2 inches for Form 1099-R).

.08 The words "For Paperwork Reduction Act Notice and instructions for completing this form, see *Instructions for Forms 1099, 1098, 5498, and W-2G*" **must** be printed on Copy A (and Copy C). The words "For more information and the Paperwork Reduction Act Notice, see the Instructions for Forms 1099, 1098, 5498, and W-2G must be printed on Form 1096.

.09 The OMB Number *must* be printed on Copies A and Form 1096 in the same location as that on the official form.

.10 *Privately printed continuous substitute forms (Copy A) must be perforated at each 11" (3 per page, or 2 per page for 1099-R) page depth. No perforations are allowed between the 3 2/3" forms (or 5 1/2" for Form 1099-R) on a single copy page of Copy A.*

.11 The words "**DO NOT Cut or Separate Forms on This Page**" must be printed in red dropout ink (as required by form specifications) between the three, or two for **Forms 1099-R**. NOTE: Perforations are required between all the other individual copies (Copies B and C, and Copies 1 and 2 for **Form 1099-R and Form 1099-MISC**, and Copy D for **Form 1099-R**) included in the set.

.12 Chemical transfer paper is permitted for Copy A only if the following standards are met:

(1) Only chemically backed paper is acceptable for Copy A.

(2) Carbon coated forms are not permitted. Front and back chemically treated paper cannot be processed properly by machine.

(3) Chemically transferred images must be black in color.

.13 Hot wax and cold carbon spots are NOT permitted for Copy A. Interleaved carbon should be black and must be of good quality to assure legibility of information on all copies to preclude smudging. All copies must be **CLEARLY LEGIBLE**. Fading must not be of such a degree as to preclude legibility.

.14 Printer's symbol—The GPO symbol must not be printed on substitute Copy A. Instead, the employer identification number (EIN) of the forms printer must be entered in the bottom margin on the face of each individual form of Copy A, or the bottom margin on the reverse side of each Form 1096. **THE FORM MUST NOT CONTAIN THE STATEMENT "IRS APPROVED."**

.15 A postal indicia may be used if it meets the following criteria; a) it is printed in the OCR ink color prescribed for the form; and b) no part of the indicia is within 1 print position of the scannable area.

PART C. SPECIFICATIONS FOR SUBSTITUTE FORMS W-2G TO BE FILED WITH IRS

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements for **Form W-2G—COPY A ONLY**.

.02 A filer may file a substitute **Form W-2G** with the IRS (hereinafter referred to as substitute Copy A). The substitute form (filed with the IRS) must be an exact replica of the official form with respect to layout and contents.

SEC. 2. SPECIFICATIONS FOR COPY A FOR FORMS W-2G

.01 Color and Quality of Paper—Paper for Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 × 22-500), plus or minus 5 percent. The paper must consist substantially of bleached chemical wood pulp and be free from unbleached or ground wood pulp or recycled printed paper. It also must be suitably sized to accept ink without feathering.

.02 Color and Quality of Ink—All printing must be in a high quality non-gloss black ink. Bar codes should be free from picks and voids.

.03 Typography—The type must be substantially identical in size and shape with that on the official form. All rules on the document are either 1/2 point (.007 inch), 1 point (0.015 inch), or 3 point (0.045). Vertical rules must be parallel to the left edge of the document; horizontal rules, parallel to the top edge.

.04 Dimensions—The official form is 8 inches wide × 3 2/3 inches deep, exclusive of a 2/3 inch snap stub on the left side of the form. The snap feature is not required on substitutes. The top and right margins must be 1/4 inch plus or minus .0313. If the top and right margins are properly aligned, the left margin for all forms will be correct. All margins must be free of any printing. If the substitute forms are in continuous or strip form, they must be burst and stripped to conform to the size specified for a single form.

(1) The width of a substitute Copy A must be 8 inches. The left margin must be free of all printing other than that shown on the official form.

(2) The depth of a substitute Copy A must be 3 2/3 inches.

.05 Hot wax and cold carbon spots are not permitted on any of the internal form piles. These spots are permitted on the back of a mailer top envelope ply. Interleaved carbons, if used, should be black and of good quality to preclude smudging.

.06 Printer's Symbol—The Government Printing Office (GPO) symbol must not be printed on substitute Forms W-2G. Instead the employer identification number (EIN) of the forms printer must be printed in the bottom margin on the face of each individual form of Copy A of such substitute forms. **THE FORM MUST NOT CONTAIN THE STATEMENT "IRS APPROVED."**

PART D. ADDITIONAL INSTRUCTIONS FOR FORMS 1098, 1099, 5498, AND W-2G

SEC. 1. OTHER COPIES

.01 Copies B, C, and in some cases D, 1, and 2, are included in the official assembly for the convenience of the filer. There is no legal requirement that privately printed substitute forms include all these copies. Copies B, and in

some cases Copies C, will satisfy the requirement of the law and regulations concerning the statement of information that is required to be furnished to the form recipient. **NOTE:** If Federal income tax withheld is shown on **Form W-2G or 1099-R**, Copy B (to be attached to the tax return) and Copy C **must** be furnished to the recipient. Copy D (**Forms 1099-R and W-2G**) may be desired as a filer record copy. Only Copy A should be filed with the IRS.

.02 Arrangement of Assembly—The parts of the assembly must be arranged, from top to bottom, as follows: (a) All forms—Copy A “For Internal Revenue Service Center.” (b) Form 1098—Copy B “For Payer”; Copy C “For Recipient.” (c) Form 1099-A—Copy B “For Borrower”; Copy C “For Lender.” (d) Form 1099-C—Copy B “For Debtor”; Copy C “For Creditor”; (e) Forms 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-OID, and 1099-PATR—Copy B “For Recipient”; Copy C “For Payer.” (f) Form 1099-MISC—Copy 1 “For State Tax Department”; Copy B “For Recipient”; Copy 2 “To be filed with recipient’s state income tax return, when required.”; Copy C “For Payer.” (g) Form 1099-R—Copy 1 “For State, City, or Local Tax Department”; Copy B “Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return.”; Copy C “For Recipient’s Records”; Copy 2 “File this copy with your state, city, or local income tax return, when required.”; Copy D “For Payer.” (h) Form 1099-S—Copy B “For Transferor”; Copy C “For Filer.” (i) Form 5498—Copy B “For Participant”; Copy C “For Trustee or Issuer.” (j) Form W-26—Copy 1 “For State Tax Depart-

ment”; Copy B “Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 2, attach this copy to your return.” Copy C “For Winner’s Records”; Copy 2 “Attach this copy to your state income tax return, if required.”; Copy D “For Payer.”

.03 Perforations are required between forms on all copies except Copy A to enable the separation of individual forms. Copy A of Form W-2G may be perforated.

SEC. 2. OMB REQUIREMENTS

.01 Office of Management and Budget (OMB) Requirements for Substitute Forms—Public Law 96-511 requires that: (1) OMB approve Internal Revenue Service tax forms, (2) each form show (in the upper right corner) the OMB approval number, and (3) the form (or its instructions) state why IRS is collecting the information, how it will be used and whether it must be given to IRS. The official IRS forms or instructions contain this information and any substitute must contain it also.

.02 The OMB requirements for substitute IRS forms are:

(1) All substitute forms, including substitute statements to recipients, must show the OMB number as it appears on the official IRS form;

(2) For Copy A, the OMB number must appear exactly as shown on the official IRS form;

(3) For any copy other than Copy A the OMB number must use one of the following formats:

(a) OMB No. XXXX-XXXX (preferred) or;

(b) OMB # XXXX-XXXX.

(4) All substitute forms must set forth the reasons for IRS collection, use, and requirements, as stated in the “Instructions for Forms 1099, 1098, 5498, and W-2G.”

.03 The official OMB numbers may be obtained from reproduction proofs or official IRS printed forms.

SEC. 3. REPRODUCTION PROOFS

.01 Reproduction Proofs—IRS Publication 1192, Catalog of Reproducible Forms and Instructions, containing order blanks and a list of items available for reproduction proofs are mailed annually to requesters of record and to other users upon request. Printers and others wishing to obtain reproduction proofs may send their requests to:

Internal Revenue Service
Attn: Repro Coordinator
4300 Carolina Ave
Richmond, VA 23222

.02 Pub. 1192 states the appropriate charge for each form, instruction, and publication. Order blanks must be filled out and submitted along with a total payment for all items ordered. Orders will be filled as the reproduction proofs become available. Orders without the correct payment will be returned.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 94-35, 1994-1 C.B. 658, covering paper returns and statements for payments made during the 1994 calendar year is hereby superseded.

Exhibit A

Exhibit B

Exhibit C

Exhibit D

Exhibit E

Exhibit F

Exhibit G

Exhibit H

Exhibit I

Exhibit J

Exhibit K

Exhibit L

Exhibit M

Exhibit N

Exhibit 0

Rev. Proc. 95-31

SECTION 1. PURPOSE

This revenue procedure provides issuers of qualified mortgage bonds, as defined in § 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in § 25(c), with a list of qualified census tracts for Puerto Rico and the Virgin Islands.

SEC. 2. BACKGROUND

.01 Section 103(a) provides that, except as provided in § 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that § 103(a) shall not apply to any private activity bond that is not a "qualified bond" within the meaning of § 141. Section 141(e) provides that the term "qualified bond" includes any private activity bond if that bond (1) is a qualified mortgage bond, (2) meets the volume cap requirements under § 146, and (3) meets the applicable requirements under § 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of § 143; (iii) the issue does not meet the private business tests of paragraphs (1) and (2) of § 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance,

repayments of \$250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 An issue of bonds meets the requirements of subsection (h) of § 143 only if at least 20 percent of the proceeds of the issue is made available for owner-financing of "targeted area residences" for at least 1 year after the date on which owner-financing is first made available with respect to targeted area residences. Subsection (h)(2) provides, however, that the amount made available need not exceed 40 percent of the average annual aggregate principal amount of mortgages executed during the immediately preceding 3 calendar years for single-family, owner-occupied residences located in targeted areas within the jurisdiction of the issuing authority.

.04 Targeted area residences are defined in § 143(j)(1)(A) to include residences in a qualified census tract. A "qualified census tract", according to § 143(j)(2)(A), is a census tract in which 70 percent or more of the families have income that is 80 percent or less of the statewide median family income. Section 143(j)(2)(B) provides that the determination that a census tract is a "qualified census tract" must be based on the most recent decennial census for which data are available.

.05 Section 6a.103A-2(b)(4)(ii) of the Temporary Income Tax Regulations provides that, with respect to any particular bond issue, the determination that a census tract is a "qualified census tract" may be based upon the decennial census data available 3 months prior to the date of issuance and shall not be affected by official changes to the data during or after that 3-month period.

.06 Qualified census tracts for the states and the District of Columbia, based on the 1990 census, were most

recently published in Rev. Proc. 93-38, 1993-2 C.B. 483.

.07 Section 143(k)(2)(A) provides that the term "statistical area" means (i) a metropolitan statistical area (MSA), and (ii) any county (or the portion thereof) that is not within an MSA.

.08 An MSA is an area that contains a city of at least 50,000 population, or an urbanized area of at least 50,000 with a total metropolitan population of at least 100,000. See Office of Management and Budget Release No. OMB-93-05, dated December 28, 1992.

.09 A state or local government may elect to exchange all or part of its qualified mortgage bond authority for authority to issue mortgage credit certificates. In general, the recipient of a mortgage credit certificate may claim a federal income tax credit equal to the product of the certificate credit rate and the interest paid or accrued during the tax year on the remaining principal of the certified indebtedness amount. Section 25(c)(2)(A)(iii)(V) provides that the indebtedness certified by mortgage credit certificates must meet the requirements of § 143(h) concerning the portion of loans to be placed in targeted areas.

.10 The list of qualified census tracts is developed by HUD for publication by the Service. HUD's determination is based upon decennial census data received by HUD from the Bureau of the Census.

SEC. 3. APPLICATION

The qualified census tracts for Puerto Rico and the Virgin Islands as listed below are based on the 1990 census. In 1990, the Bureau of the Census provided data for all areas. Thus, the list of qualified census tracts includes tracts in Block Numbering Areas (BNA) in nonmetropolitan counties as well as tracts in MSAs. Previously, the Bureau of the Census provided tract-level data only for metropolitan areas.

| <i>County or Equivalent</i> | <i>Qualified Census Tracts</i> | | | |
|--------------------------------|--------------------------------|---------|---------|---------|
| PUERTO RICO | | | | |
| Adjuntas Municipio | 9563.00 | 9565.00 | | |
| Aguadilla Municipio | 4008.00 | | | |
| Arecibo Municipio | 3013.00 | | | |
| Catano Municipio | 0204.04 | | | |
| Juana Diaz Municipio | 0719.02 | | | |
| Lares Municipio | 9583.00 | | | |
| Mayaguez Municipio | 0809.00 | 0812.01 | 0812.02 | 0812.03 |
| Ponce Municipio | 0704.00 | 0708.00 | 0713.00 | 0716.02 |

| | | | | | | | | | |
|---------------------------------|--------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|
| <i>County or Equivalent</i> | <i>Qualified Census Tracts</i> | | | | | | | | |
| San Juan Municipio | 0002.00 | 0006.00 | 0013.00 | 0029.00 | 0035.01 | 0040.00 | 0048.00 | 0054.02 | 0082.01 |
| San Sebastian Municipio | 9686.00 | | | | | | | | |
| VIRGIN ISLANDS | | | | | | | | | |
| | 9703.00 | | | | | | | | |

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 93-38 is supplemented.

SEC. 5. EFFECTIVE DATES

.01 An issuer may rely on the list of qualified census tracts contained in this revenue procedure with respect to a commitment to provide financing if, in the case of a commitment made on or before the date of purchase of the residence, the commitment is made during the period specified in this section 5.01 or, in the case of a commitment made after the purchase date, the residence was purchased during the period specified in this section 5.01. The period begins on July 10, 1995, the date of publication of this revenue procedure in the Internal Revenue Bulletin, and ends on the date as of which the list of qualified census tracts is rendered obsolete by a new revenue procedure.

.02 Notwithstanding section 5.01 of this revenue procedure, issuers may continue to rely on prior independent determinations of qualified census tracts for Puerto Rico and the Virgin Islands for mortgages financed with proceeds of bonds that were sold, or for certificates issued with respect to bond authority that was exchanged, on or before October 9, 1995, the date that is 3 months after publication of this revenue procedure in the Internal Revenue Bulletin, if the commitments to provide financing for the mortgages or to issue certificates are made on or before December 8, 1995, the date that is 5 months after publication of this revenue procedure in the Internal Revenue Bulletin.

26 CFR 601.201: Rulings and determination letters. (Also Part I, Sections 25, 103, 143; 1.25-4T, 1.103-1, 6a.103A-2.)

Rev. Proc. 95-32

SECTION 1. PURPOSE

This revenue procedure provides guidance concerning the United States

and area median gross income figures that are to be used by issuers of qualified mortgage bonds, as defined in section 143(a) of the Internal Revenue Code, and issuers of mortgage credit certificates, as defined in section 25(c), in computing the housing cost/income ratio described in section 143(f)(5).

SEC. 2. BACKGROUND

.01 Section 103(a) of the Code provides that, except as provided in section 103(b), gross income does not include interest on any state or local bond. Section 103(b)(1) provides that section 103(a) shall not apply to any private activity bond that is not a "qualified bond" within the meaning of section 141. Section 141(e) provides that the term "qualified bond" includes any private activity bond that (1) is a qualified mortgage bond, (2) meets the volume cap requirements under section 146, and (3) meets the applicable requirements under section 147.

.02 Section 143(a)(1) provides that the term "qualified mortgage bond" means a bond that is issued as part of a "qualified mortgage issue". Section 143(a)(2)(A) provides that the term "qualified mortgage issue" means an issue of one or more bonds by a state or political subdivision thereof, but only if (i) all proceeds of the issue (exclusive of issuance costs and a reasonably required reserve) are to be used to finance owner-occupied residences; (ii) the issue meets the requirements of subsections (c), (d), (e), (f), (g), (h), (i), and (m)(7) of section 143; (iii) the issue does not meet the private business tests of paragraphs (1) and (2) of section 141(b); and (iv) with respect to amounts received more than 10 years after the date of issuance, repayments of \$250,000 or more of principal on financing provided by the issue are used not later than the close of the first semi-annual period beginning after the date the prepayment (or complete repayment) is received to redeem bonds that are part of the issue.

.03 Section 143(f) of the Code imposes eligibility requirements concern-

ing the maximum income of mortgagors for whom financing may be provided by qualified mortgage bonds. Section 25(c)(2)(A)(iii)(IV) provides that recipients of mortgage credit certificates must meet the income requirements of section 143(f). Generally, under sections 143(f)(1) and 25(c)(2)(A)(iii)(IV), these income requirements are met only if all owner-financing under a qualified mortgage bond and all certified indebtedness amounts under a mortgage credit certificate program are provided to mortgagors whose family income is 115 percent or less of the applicable median family income. Under section 143(f)(6), the income limitation is reduced to 100 percent of the applicable median family income if there are fewer than three individuals in the family of the mortgagor.

.04 Section 143(f)(4) provides that the term "applicable median family income" means the greater of (A) the area median gross income for the area in which the residence is located, or (B) the statewide median gross income for the state in which the residence is located.

.05 Section 143(f)(5) of the Code provides for an upward adjustment of the income limitations in certain high housing cost areas. Under section 143(f)(5)(C), a high housing cost area is a statistical area for which the housing cost/income ratio is greater than 1.2. The housing cost/income ratio is determined under section 143(f)(5)(D) by dividing (a) the applicable housing price ratio by (b) the ratio that the area median gross income bears to the median gross income for the United States. The applicable housing price ratio is the new housing price ratio (new housing average purchase price for the area divided by the new housing average purchase price for the United States) or the existing housing price ratio (existing housing average area purchase price divided by the existing housing average purchase price for the United States), whichever results in the housing cost/income ratio being closer to 1. This income adjustment applies only to bonds issued and nonissued bond amounts elected after December 31, 1988.

.06 The Department of Housing and Urban Development (HUD) has computed the median gross income for the United States, the states, and statistical areas within the states. The income information was released to the HUD regional offices on January 18, 1995, and may be obtained by calling the HUD reference service at 1-800-245-2691 or, in the Washington, D.C., area, at 301-251-5154. The Internal Revenue Service annually publishes only the median gross income for the United States.

.07 The most recent nationwide average purchase prices and average area purchase price safe harbor limitations were published on September 6, 1994, in Rev. Proc. 94-55, 1994-2 C.B. 716.

SEC. 3. APPLICATION

.01 When computing the housing cost/income ratio under section 143(f)(5) of the Code, issuers of qualified mortgage bonds and mortgage credit certificates must use \$40,200 as the median gross income for the United States. See section 2.06 of this revenue procedure.

.02 When computing the housing cost/income ratio under section 143(f)(5) of the Code, issuers of qualified mortgage bonds and mortgage credit certificates must use the area median gross income figures released by HUD on January 18, 1995. See section 2.06 of this revenue procedure.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

.01 Rev. Proc. 94-66, 1994-2 C.B. 799, is obsolete except as provided in section 5.02 of this revenue procedure.

.02 This revenue procedure does not affect the effective date provisions of Rev. Rul. 86-124, 1986-2 C.B. 27. Those effective date provisions will remain operative at least until the Service publishes a new revenue ruling that conforms the approach to effective dates set forth in Rev. Rul. 86-124 to the general approach taken in this revenue procedure.

SEC. 5. EFFECTIVE DATES

.01 Issuers must use the United States and area median gross income figures specified in section 3 of this revenue procedure for commitments to

provide financing that are made, or (if the purchase precedes the financing commitment) for residences that are purchased, in the period that begins on January 18, 1995, the date HUD released the income figures, and ends on the date when these United States and area median gross income figures are rendered obsolete by a new revenue procedure.

.02 Notwithstanding section 5.01 of this revenue procedure, issuers may continue to rely on the United States and area median gross income figures specified in Rev. Proc. 94-66 with respect to bonds originally sold and nonissued bond amounts elected not later than August 9, 1995, if the commitments or purchases described in section 5.01 are made not later than October 9, 1995.

26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part I, §§ 263A, 446, 481; 1.263A-1, 1.446-1, 1.481-1.)

Rev. Proc. 95-33

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SECTION 1. PURPOSE

This revenue procedure provides the exclusive procedure for a "small reseller," a "formerly small reseller," or a "reseller-producer" within the scope of this revenue procedure (as provided in section 4) to obtain consent to change its method of accounting for costs subject to § 263A of the Internal Revenue Code (the "UNICAP method"). A taxpayer complying with all the applicable provisions of this revenue procedure will be deemed to have obtained the consent of the Commissioner of Internal Revenue to change its method of accounting under § 446(e).

SEC. 2. DEFINITIONS

.01 "Reseller" means a taxpayer that acquires real or personal property described in § 1221(1) for resale.

.02 "Small reseller" means a reseller whose average annual gross receipts for the three immediately preceding taxable years (or fewer, if the taxpayer has not been in existence during the three preceding taxable years) do not exceed \$10,000,000.

.03 "Formerly small reseller" means a reseller that no longer qualifies as a small reseller.

.04 "Producer" means a taxpayer that produces real or tangible personal property.

.05 "Reseller-producer" means a taxpayer that is both a producer and a reseller.

.06 "Permissible UNICAP method" means a method of capitalizing costs that is permissible under § 263A.

.07 "Permissible non-UNICAP inventory capitalization method" means a method of capitalizing inventory costs that is permissible under § 471.

SEC. 3. BACKGROUND

.01 Section 263A of the Internal Revenue Code generally requires producers of real or tangible personal property and resellers of real or personal property described in § 1221(1) to capitalize the direct costs of such property and certain indirect costs allocable to such property, including "additional § 263A costs."

.02 “Additional § 263A costs” are the indirect costs, other than interest, that must be capitalized under § 263A, but that were not capitalized under the taxpayer’s method of accounting immediately prior to the effective date of § 263A.

.03 Sections 1.263A-2(b) and 1.263A-3(d) provide a simplified production method and a simplified resale method, respectively, for determining the additional § 263A costs that must be capitalized to ending inventory (or to the current-year increment in the case of a taxpayer using the last-in, first-out (LIFO) inventory method) or other property on hand at the end of the year. Under these simplified methods, a taxpayer determines the additional § 263A costs that must be capitalized by multiplying § 471 costs (as defined in § 1.263A-1(d)(2)) remaining on hand at year end (or reflected in the current-year increment in the case of a taxpayer using the LIFO inventory method) by an absorption ratio. In general, the absorption ratio is total additional § 263A costs incurred during the taxable year, divided by total § 471 costs incurred during the taxable year.

.04 Section 1.263A-2(b)(2) provides that a taxpayer electing to use a simplified production method for any trade or business generally must use a simplified production method for all production and resale activities. Section 1.263A-3(a)(4)(ii) provides, however, that a reseller-producer otherwise permitted to use a simplified resale method may use a simplified resale method if its production activities are considered *de minimis* under § 1.263A-3(a)(2)(iii) and are incident to its resale of personal property described in § 1221(1). In addition, § 1.263A-3(a)(4)(iii) provides that a reseller-producer otherwise permitted to use a simplified resale method may use a simplified resale method for personal property produced for it under a contract with an unrelated person if the taxpayer enters into the contract incident to its resale activities and the property is sold to its customers.

.05 Sections 263A(b)(2)(B) and 1.263A-3(b)(1) provide that the UNICAP method does not apply to any personal property acquired for resale during any taxable year if the taxpayer’s average annual gross receipts for the three previous taxable years do not exceed \$10 million. Section 1.263A-3(a)(3) provides that a small

reseller is not required to capitalize additional § 263A costs associated with any personal property acquired for resale, including personal property produced for the taxpayer under a contract with an unrelated person if the taxpayer enters into the contract incident to its resale activities and the property is sold to its customers. In addition, § 1.263A-3(a)(2)(ii) provides that a small reseller is not required to capitalize additional § 263A costs associated with any personal property that the taxpayer produces incident to its resale activities if the production activities are considered *de minimis* under § 1.263A-3(a)(2)(iii).

.06 Section 1.263A-7T(e)(11)(i) of the temporary Income Tax Regulations (formerly § 1.263A-1T(e)(11)(i)) provides that a taxpayer who is required to change its method of accounting under § 263A may change automatically under the provisions of § 1.263A-7T(e)(11). The regulation further provides, however, that the Commissioner may prescribe additional procedures, at the time and in the manner that the Commissioner may determine, for a taxpayer seeking to change its method of accounting under § 1.263A-7T(e)(11).

.07 Sections 446(e) and 1.446-1(e)-(2)(i) state that, except as otherwise expressly provided, a taxpayer must obtain the consent of the Commissioner to change a method of accounting for federal income tax purposes.

.08 Section 1.446-1(e)(3)(i) requires that in order to obtain this consent, a Form 3115, Application for Change in Accounting Method, generally must be filed within 180 days after the beginning of the taxable year in which the proposed change is to be made.

.09 Section 1.446-1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change its method of accounting in accordance with § 446(e).

.10 Section 481(a) requires that those adjustments necessary to prevent amounts from being duplicated or omitted must be taken into account when the taxpayer’s taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year.

.11 Sections 481(c) and 1.481-5 provide that the adjustments required by

§ 481(a) must be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer.

.12 Rev. Proc. 92-20, 1992-1 C.B. 685, provides the general procedures under § 1.446-1(e) for obtaining the consent of the Commissioner to change a method of accounting for federal income tax purposes. Section 2.04 of Rev. Proc. 92-20 provides that, unless other published guidance provides terms and conditions that must be used in making a specific type of accounting method change, a change in method of accounting will be made pursuant to the terms and conditions provided in Rev. Proc. 92-20.

.13 Rev. Proc. 94-49, 1994-2 C.B. 705, provides an automatic consent procedure for a taxpayer changing its method of accounting under §§ 1.263A-1, 1.263A-2, and 1.263A-3 for its first taxable year beginning on or after January 1, 1994. However, section 3.02(4) of Rev. Proc. 94-49 expressly excludes from the scope of its automatic consent procedures any changes in method of accounting for a taxpayer that subsequently qualifies as a small reseller or that subsequently ceases to qualify as a small reseller.

SEC. 4. SCOPE

.01 Except as provided in sections 4.02, 4.03, or 4.04 below, this revenue procedure applies to:

(1) a small reseller of personal property changing from a permissible UNICAP method to a permissible non-UNICAP inventory capitalization method in any taxable year that it qualifies as a small reseller;

(2) a formerly small reseller changing from a permissible non-UNICAP inventory capitalization method to a permissible UNICAP method in the first taxable year that it does not qualify as a small reseller;

(3) a reseller-producer changing from a permissible UNICAP method for both its production and resale activities to a simplified resale method in any taxable year that it qualifies under § 1.263A-3(a)(4) to use a simplified resale method for both its production and resale activities; and

(4) a reseller-producer changing from a simplified resale method for both its production and resale activities to a permissible UNICAP method for

both its production and resale activities in the first taxable year that it does not qualify under § 1.263A-3(a)(4) to use a simplified resale method for both its production and resale activities.

.02 This revenue procedure does not apply to a taxpayer making a historic absorption ratio election under § 1.263A-2(b)(4) or 1.263A-3(d)(4). See Rev. Proc. 95-25, 1995-1 C.B. 701, for a taxpayer making a historic absorption ratio election during the three-year transition period for taxable years beginning on or after January 1, 1994.

.03 This revenue procedure does not apply to any change in accounting method, except to the extent necessary to effect the changes described in section 4.01 of this revenue procedure. See Rev. Proc. 92-20 for the general rules regarding changes in accounting methods.

.04 This revenue procedure does not apply to a taxpayer that is the subject of a pending criminal investigation or proceeding concerning (1) any issue directly or indirectly related to the taxpayer's federal tax liability for any taxable year, or (2) the possibility of false or fraudulent statements made by the taxpayer regarding any issue related to its federal tax liability for any taxable year, unless the taxpayer obtains the written consent of Criminal Investigation to change its method under this revenue procedure. The taxpayer must attach the written consent from Criminal Investigation to its Form 3115 required by section 5.02.

SEC. 5. APPLICATION

.01 *Consent.* In accordance with § 1.446-1(e)(3)(ii), the requirement to file an application on Form 3115 within the 180-day period is waived for any application for change in method of accounting filed pursuant to this revenue procedure. In addition, under § 1.446-1(e)(2)(i), the consent of the Commissioner is hereby granted to any taxpayer within the scope of this revenue procedure to change its method of accounting for costs subject to § 263A. This consent is conditioned, however, on the taxpayer filing a current Form 3115 in the manner described in section 5.02 of this revenue procedure and otherwise complying with the provisions of this revenue procedure.

.02 *Filing procedure.* A taxpayer changing a method of accounting pur-

suant to this revenue procedure must complete and file a current Form 3115 in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change. For taxable years beginning in 1994, however, a taxpayer can attach the Form 3115 to an amended return filed on or before October 15, 1995. In all cases a copy of the Form 3115 must be filed with the National Office and addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Income Tax and Accounting) CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044, no later than when the original of the Form 3115 is filed with the federal income tax return for the year of change. No user fee is required for a Form 3115 filed under this section 5.02, and a Form 3115 filed under this section 5.02 will not be acknowledged.

.03 *Section 481(a) adjustment.* The § 481(a) adjustment generally must be taken into account in computing taxable income in the manner provided in section 5.04 of this revenue procedure. A change in method of accounting under this revenue procedure is treated as a voluntary change in method of accounting that is initiated by the taxpayer, and, therefore, the § 481(a) adjustment is not restricted to post-1953 items.

.04 *Section 481(a) adjustment period.* Beginning with the year of change, a taxpayer changing its method of accounting for costs pursuant to this revenue procedure generally must take any applicable § 481(a) adjustment into account ratably over the same number of taxable years, not to exceed four, that the taxpayer used its former method of accounting. See sections 5.05 and 5.09 of this revenue procedure for exceptions to this general rule.

.05 *De minimis rule.* If the § 481(a) adjustment is less than \$25,000, the taxpayer may elect to take the adjustment into account in the year of change instead of over the adjustment period otherwise prescribed by section 5.04 of this revenue procedure. A taxpayer that makes this election must attach to its original Form 3115 a statement indicating that it is electing the *de minimis* rule pursuant to section 5.05 of this revenue procedure.

.06 *Application of § 1.263A-7T(e).* Section 1.263A-7T(e) provides procedures that a taxpayer must use to

revalue the items or costs included in its inventory for the first taxable year it is subject to § 263A. The following provisions of § 1.263A-7T(e) apply to a change in method of accounting made pursuant to this revenue procedure for a taxpayer described in section 4.01(2), 4.01(3), or 4.01(4) of this revenue procedure:

(1) Section 1.263A-7T(e)(1), which provides the general rule that a taxpayer must revalue the items or costs included in its beginning inventory and also requires a taxpayer filing a consolidated federal income tax return to revalue deferred gains or losses resulting from deferred intercompany transactions;

(2) Section 1.263A-7T(e)(6), which provides procedures for a taxpayer to use in revaluing its inventory, including a facts and circumstances revaluation method, a weighted average revaluation method for a taxpayer using either the first-in, first-out (FIFO) or the specific goods LIFO inventory method, and a 3-year average revaluation method for a taxpayer using the dollar-value LIFO method (see section 5.07 of this revenue procedure for rules regarding the establishment of a new base year);

(3) Sections 1.263A-7T(e)(7), (8), and (9), which provide the procedures that a taxpayer using either the weighted average revaluation method or the 3-year average revaluation method may use to make adjustments to its inventory costs from prior years to prevent the capitalization of costs not incurred in earlier years; and

(4) Sections 1.263A-7T(e)(11)(iii) and (iv), which provide the definition of a change in method of accounting required to be made under § 263A, and the ordering rules when there are changes in methods of accounting other than those required by § 263A.

.07 *New base year.* The following rules apply only to a taxpayer using the dollar-value LIFO inventory method.

(1) *Taxpayers described in sections 4.01(1) and 4.01(3) of this revenue procedure.* A taxpayer described in section 4.01(1) (a small reseller changing from the UNICAP method to a non-UNICAP method) or section 4.01(3) (a reseller-producer changing from a UNICAP method to a simplified resale method) of this revenue procedure that is not currently using a simplified method for capitalizing the additional § 263A costs must

restate its base year costs and LIFO carrying values by subtracting from each inventory layer the amount of additional § 263A costs in that layer. The taxpayer, however, may not change its base year.

(2) *Taxpayers described in sections 4.01(2) and 4.01(4) of this revenue procedure.*

(a) *In general.* A taxpayer described in section 4.01(2) (a formerly small reseller changing from a non-UNICAP method to the UNICAP method) or section 4.01(4) (a reseller-producer changing from a simplified resale method to a UNICAP method) of this revenue procedure changing to a non-simplified method for capitalizing additional § 263A costs must restate its base year costs and LIFO carrying values by adding to each inventory layer the amount of additional § 263A costs applicable to that layer, as provided in § 1.263A-7T(e)(6).

(b) *Base years.* A taxpayer described in section 5.07(2)(a) of this revenue procedure generally may not change its base year. However, if the taxpayer uses the 3-year average method under § 1.263A-7T(e)(6)(iv), the taxpayer must treat the year immediately preceding the year of change as its new base year.

.08 *Applicability of Notice 88-23.* Consistent with the principle of Notice 88-23, 1988-1 C.B. 490, a taxpayer changing its method of accounting under this revenue procedure, and also desiring to discontinue its use of the LIFO method of accounting for inventories in the same taxable year, may choose to change from the LIFO method before it makes the change in method of accounting pursuant to this revenue procedure.

.09 *Applicability of Rev. Proc. 92-20.* Except as otherwise provided in this revenue procedure, the following definitions and provisions of Rev. Proc. 92-20 apply to a change in method of accounting made pursuant to this revenue procedure:

(1) sections 3.01 through 3.04, which provide definitions for the following terms: "taxpayer," "year of change," and "filed";

(2) section 8.01(2), which modifies the adjustment period if 90 percent or more of the § 481(a) adjustment is attributable to the taxable year immediately preceding the year of change;

(3) section 8.01(4), which generally requires cooperatives to take the

entire § 481(a) adjustment into account in the year of change;

(4) section 8.02, which provides that a short taxable year is treated as a separate taxable year; and

(5) section 8.03, which provides situations where the § 481(a) adjustment period that is computed under section 5.04 of this revenue procedure will be accelerated.

.10 *Additional procedural requirements.*

(1) *Agreement to terms.* In addition to providing all the information required on the Form 3115, a taxpayer must attach to the Form 3115 a written statement providing that it agrees to all the terms and conditions of this revenue procedure.

(2) *Label.* In order to assist in the processing of changes in method of accounting under this revenue procedure, reference to this revenue procedure must be made a part of the Form 3115 either by typing or legibly printing the following statement at the top of page 1 of each Form 3115: "FILED UNDER REV. PROC. 95-33."

(3) *Signature.* The Form 3115 and the statement described in section 5.10(1) of this revenue procedure must be signed by or on behalf of the taxpayer requesting the change by an individual with the authority to bind the taxpayer in such matters. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a partnership, a trustee on behalf of a trust, or an individual on behalf of a sole proprietorship. See the signature requirements in the General Instructions for Form 3115. If the taxpayer is a member of a consolidated group, a Form 3115 submitted on behalf of the taxpayer must also be signed by a duly authorized officer of the common parent. See § 1.1502-77.

(4) *Authorized representative.* If an agent is authorized to represent a taxpayer before the Service, to receive the original or a copy of correspondence concerning the request, or to perform any other act(s) regarding the Form 3115 on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the Form 3115. A taxpayer's representative without a power of attorney to represent the taxpayer will not be given any information regarding the Form 3115.

.11 *No protection from examination changes.* A taxpayer that receives consent to change its method of accounting

under this revenue procedure does not thereby obtain protection from examination changes for taxable years prior to the taxable year for which the change is made.

.12 *Example.* The following example illustrates the principles of this revenue procedure for small resellers and formerly small resellers.

Assume Corp X, a reseller of personal property incorporated January 2, 1989, adopted a taxable year ending December 31. Corp X determines that its average annual gross receipts for the three taxable years (or fewer, if applicable) immediately preceding taxable years 1989 through 1998 are as shown in the table below:

| Current Taxable Year | AVERAGE Annual Gross Receipts for the Three Taxable Years Immediately Preceding the Current Taxable Year |
|----------------------|--|
| 1989 | \$ 0 |
| 1990 | 5,000,000 |
| 1991 | 6,000,000 |
| 1992 | 7,000,000 |
| 1993 | 11,000,000 |
| 1994 | 11,000,000 |
| 1995 | 9,000,000 |
| 1996 | 8,000,000 |
| 1997 | 11,000,000 |
| 1998 | 12,000,000 |

Furthermore, Corp X, which adopted the dollar-value LIFO inventory method, has the following LIFO inventory balances determined without considering the effects of the UNICAP method:

| | Beginning | Ending |
|------|-------------|-------------|
| 1993 | \$1,000,000 | \$1,100,000 |
| 1994 | 1,100,000 | 1,200,000 |
| 1995 | 1,200,000 | 1,300,000 |
| 1996 | 1,300,000 | 1,400,000 |
| 1997 | 1,400,000 | 1,500,000 |
| 1998 | 1,500,000 | 1,600,000 |

Corp X was required by § 263A to change to the UNICAP method for 1993 because its average annual gross receipts for the three taxable years immediately preceding 1993 were \$11,000,000, which exceeded the \$10,000,000 ceiling permitted by the small reseller exception. Assume that Corp X was required to capitalize \$80,000 of "additional § 263A costs" to the cost of its 1993 beginning inventory because of this change in inventory method. In addition, Corp X was required to determine the appropriate adjustment period for the corresponding positive § 481(a) adjustment. Because Corp X used its former inventory method for four taxable years immediately preceding 1993 (that is, 1989, 1990, 1991, and 1992), Corp X was required to include one-fourth of the § 481(a) adjustment when computing taxable income for each of the four taxable years beginning with 1993. Thus, Corp X was required to include a \$20,000 positive § 481(a) adjustment in its 1993 taxable income.

Corp X elected to use the simplified resale method under § 1.263A-1T(d)(3) for determining the amount of additional § 263A costs to be capitalized to each LIFO layer. Assume that Corp X was required to add \$10,000 of

additional § 263A costs to the cost of its 1993 ending inventory because of the \$100,000 increment for 1993.

Corp X's 1993 Ending Inventory:

| | |
|---|--------------------|
| Beginning Inventory
(Without UNICAP costs) | \$1,000,000 |
| 1993 Increment | 100,000 |
| Additional § 263A Costs on
Beginning Inventory | 80,000 |
| Additional § 263A Costs on
1993 Increment | 10,000 |
| Total 1993 Ending Inventory | <u>\$1,190,000</u> |

Corp X's Unamortized 1993 § 481(a)

Adjustment:

| | |
|--|-----------------|
| 1993 § 481(a) Adjustment | \$80,000 |
| Amount Included in 1993 | |
| Taxable Income | <20,000> |
| Unamortized 1993 § 481(a)
Adjustment—12/31/93 | <u>\$60,000</u> |

Because Corp X failed to satisfy the small reseller exception for 1994, Corp X was required to continue using the UNICAP method for its inventory costs. Furthermore, Corp X was required to include \$20,000 of the unamortized 1993 § 481(a) adjustment in 1994 taxable income. Assume that Corp X was required to add \$10,000 of additional § 263A costs to the cost of its 1994 ending inventory because of the \$100,000 increment for 1994.

Corp X's 1994 Ending Inventory:

| | |
|--|--------------------|
| Beginning Inventory
(With UNICAP costs) | \$1,190,000 |
| 1994 Increment | 100,000 |
| Additional § 263A Costs on
1994 Increment | 10,000 |
| Total 1994 Ending Inventory | <u>\$1,300,000</u> |

Corp X's Unamortized 1993 § 481(a)

Adjustment:

| | |
|--|-----------------|
| Unamortized 1993 § 481(a)
Adjustment—12/31/93 | \$60,000 |
| Amount Included in 1994 | |
| Taxable Income | <20,000> |
| Unamortized 1993 § 481(a)
Adjustment—12/31/94 | <u>\$40,000</u> |

Because Corp X satisfies the small reseller exception for 1995, Corp X may change voluntarily from the UNICAP method to a permissible non-UNICAP inventory capitalization method under this revenue procedure. To reflect the removal of the additional § 263A costs from the cost of its 1995 beginning inventory, Corp X must compute a corresponding § 481(a) adjustment, which is negative \$100,000 (\$1,200,000 - \$1,300,000). Because Corp X used the UNICAP method for only two years (that is, 1993 and 1994), Corp X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1995. Thus, Corp X must include a \$50,000 negative § 481(a) adjustment in 1995 taxable income. In addition, Corp X must include \$20,000 of the unamortized 1993 § 481(a) adjustment in 1995 taxable income.

Corp X's 1995 Ending Inventory:

| | |
|--|-------------|
| Beginning Inventory
(With UNICAP costs) | \$1,300,000 |
|--|-------------|

| | |
|--|--------------------|
| 1995 Increment | 100,000 |
| 1995 § 481(a) Adjustment
<Negative> | <100,000> |
| Total 1995 Ending
Inventory | <u>\$1,300,000</u> |

Corp X's Unamortized 1993 § 481(a)

Adjustment:

| | |
|--|-----------------|
| Unamortized 1993 § 481(a)
Adjustment—12/31/94 | \$40,000 |
| Amount Included in 1995 | |
| Taxable Income | <20,000> |
| Unamortized 1993 § 481(a)
Adjustment—12/31/95 | <u>\$20,000</u> |

Corp X's Unamortized 1995 § 481(a)

Adjustment:

| | |
|--|--------------------------|
| 1995 § 481(a) Adjustment
<Negative> | <100,000> |
| Amount Included in 1995 | |
| Taxable Income | 50,000 |
| Unamortized 1993 § 481(a)
Adjustment—12/31/95 | <u>\$< 50,000></u> |

Corp X also satisfies the small reseller exception for 1996 and, therefore, is not required to return to the UNICAP method for 1996. Corp X, however, must include \$20,000 of the unamortized 1993 § 481(a) adjustment and \$50,000 of the unamortized 1995 § 481(a) adjustment in 1996 taxable income.

Corp X's 1996 Ending Inventory:

| | |
|---|--------------------|
| Beginning Inventory
(Without UNICAP costs) | \$1,300,000 |
| 1996 Increment | 100,000 |
| Total 1996 Ending
Inventory | <u>\$1,400,000</u> |

Corp X's Unamortized 1993 § 481(a)

Adjustment:

| | |
|--|-------------|
| Unamortized 1993 § 481(a)
Adjustment—12/31/95 | \$20,000 |
| Amount Included in 1996 | |
| Taxable Income | <20,000> |
| Unamortized 1993 § 481(a)
Adjustment—12/31/96 | <u>\$ 0</u> |

Corp X's Unamortized 1995 § 481(a)

Adjustment:

| | |
|--|-------------|
| Unamortized 1995 § 481(a)
Adjustment—12/31/95 | \$<50,000> |
| Amount Included in 1996 | |
| Taxable Income | 50,000 |
| Unamortized 1995 § 481(a)
Adjustment—12/31/96 | <u>\$ 0</u> |

In 1997, Corp X fails to satisfy the small reseller exception and, therefore, must return to the UNICAP method as provided under this revenue procedure. Corp X changes to the simplified resale method without a historic absorption ratio election under § 1.263A-3(d)(3). Assume that Corp X must capitalize \$120,000 of additional § 263A costs to the cost of its 1997 beginning inventory because of this change in inventory method. In addition, Corp X must determine the appropriate adjustment period for the corresponding positive § 481(a) adjustment. Because Corp X used its former inventory method for two taxable years before 1997 (that

is, 1995 and 1996), Corp X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1997. Thus, Corp X must include a \$60,000 positive § 481(a) adjustment in its 1997 taxable income. Assume that Corp X must add \$10,000 of additional § 263A costs to the cost of its 1997 ending inventory because of the \$100,000 increment for 1997.

Corp X's 1997 Ending Inventory:

| | |
|---|--------------------|
| Beginning Inventory
(Without UNICAP costs) | \$1,400,000 |
| 1997 Increment | 100,000 |
| Additional § 263A costs on
Beginning Inventory | 120,000 |
| Additional § 263A costs on
1997 Increment | 10,000 |
| Total 1997 Ending
Inventory | <u>\$1,630,000</u> |

Corp X's Unamortized 1997 § 481(a)

Adjustment:

| | |
|--|------------------|
| 1997 § 481(a) Adjustment | \$120,000 |
| Amount Included in 1997 | |
| Taxable Income | < 60,000> |
| Unamortized 1997 § 481(a)
Adjustment—12/31/97 | <u>\$ 60,000</u> |

Because Corp X fails to satisfy the small reseller exception for 1998, Corp X must continue using the UNICAP method for its inventory costs. Furthermore, Corp X is required to include \$60,000 of the unamortized 1997 § 481(a) adjustment in 1998 taxable income. Assume that Corp X is required to add \$10,000 of additional § 263A costs to the cost of its 1998 ending inventory because of the \$100,000 increment for 1998.

Corp X's 1998 Ending Inventory:

| | |
|--|--------------------|
| Beginning Inventory
(With UNICAP costs) | \$1,630,000 |
| 1998 Increment | 100,000 |
| Additional § 263A Costs on
1998 Increment | 10,000 |
| Total 1998 Ending
Inventory | <u>\$1,740,000</u> |

Corp X's Unamortized 1997 § 481(a)

Adjustment:

| | |
|--|-------------|
| Unamortized 1997 § 481(a)
Adjustment—12/31/97 | \$60,000 |
| Amount Included in 1998 | |
| Taxable Income | <60,000> |
| Unamortized 1997 § 481(a)
Adjustment—12/31/98 | <u>\$ 0</u> |

SEC. 6. EXCLUSIVE PROCEDURE

For changes in method of accounting to which this revenue procedure applies, this is the exclusive procedure available to a taxpayer for obtaining the Commissioner's consent to change its method of accounting. If a taxpayer to which this revenue procedure applies

changes its method of accounting without complying with all the conditions of this revenue procedure, the taxpayer will be deemed to have initiated the change in method of accounting without obtaining the consent of the Commissioner as required by § 446(e).

SEC. 7. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Income Tax and Accounting) CC:DOM:IT&A, 1111 Constitution Avenue, NW., Washington, D.C. 20224.

SEC. 8. EFFECTIVE DATE

The provisions of this revenue procedure are effective for taxable years beginning on or after January 1, 1994. The Service will return any Form 3115, pending on June 21, 1995, or received thereafter, that is filed with the National Office pursuant to the Code, regulations, or administrative guidance other than this revenue procedure if the change in method of accounting is within the scope of this revenue procedure.

SEC. 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94-49 is modified so that it does not apply to any taxpayer filing an application for a change in method of accounting within the scope of this revenue procedure.

26 CFR 601.201: Rulings and determination letters.

Rev. Proc. 95-34

SECTION 1. PURPOSE

.01 This revenue procedure provides a simplified method for sponsors of master and prototype plans ("M&P"), regional prototype plans, volume submitter specimen plans, individually designed plans (including volume submitter plans), and simplified employee pension plans ("SEPs"), that have received favorable opinion, notification, advisory, determination, or ruling letters that take into account the requirements of the Tax Reform Act of 1986, Pub. L. No. 99-514 ("TRA '86"), to

amend their plans to use the simplified method of determining highly compensated employees ("HCEs") provided in Rev. Proc. 93-42, 1993-2 C.B. 540, by adopting either model plan language or a non-model amendment for approval by the Internal Revenue Service (the "Service").

.02 This revenue procedure makes conforming changes to Rev. Proc. 93-12, 1993-1 C.B. 479, Rev. Proc. 93-47, 1993-2 C.B. 578, Rev. Proc. 94-13, 1994-1 C.B. 566, as modified by Rev. Proc. 95-12, 1995-1 C.B. 508, and Rev. Proc. 95-6, 1995-1 C.B. 452.

.03 This revenue procedure modifies section 4.03 of Rev. Proc. 93-42, relating to plans that must be amended to use the simplified method of determining HCEs.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 Rev. Proc. 93-42 provides guidelines for substantiating compliance with the following nondiscrimination requirements: nondiscrimination as to coverage under § 410(b) of the Internal Revenue Code, including the determination of whether an employer operates qualified separate lines of business under § 414(r); nondiscrimination in the amount of contributions or benefits and the current availability of benefits, rights and features under § 401(a)(4); and nondiscrimination with regard to an alternative definition of compensation under § 1.414(s)-1(d)(3) of the Income Tax Regulations.

.02 Rev. Proc. 93-42 allows an employer to use alternative methods for substantiating compliance with the nondiscrimination requirements. Because these methods are intended to demonstrate whether there is a high likelihood that the plan satisfies the nondiscrimination requirements, Rev. Proc. 93-42 provides that the Service will treat a plan as satisfying the nondiscrimination requirements where the employer demonstrates compliance with those alternative methods.

.03 Section 3 of Rev. Proc. 93-42 permits an employer to substantiate compliance with the nondiscrimination requirements on the basis of snapshot testing, that is, on the basis of the employer's workforce on a single day during the plan year (the "snapshot day"), provided that day is reasonably representative of the employer's work-

force and the plan's coverage throughout the year. The snapshot day selected generally must be consistent from year to year.

.04 Section 4 of Rev. Proc. 93-42 provides a simplified method of determining HCEs for purposes of testing for compliance with the nondiscrimination requirements. An employer that uses this simplified method of determining HCEs may choose also to apply the method on the basis of the employer's workforce as of a snapshot day. Rev. Proc. 93-42 allows the use of reasonably approximated or projected compensation as part of the simplified method of determining HCEs.

.05 Rev. Proc. 93-12 provides a model amendment and a limited amendment procedure for certain plan sponsors to amend their plans to comply with the requirements of § 401(a)(31), which was added by the Unemployment Compensation Amendments of 1992, Pub. L. 102-318.

.06 Rev. Proc. 93-47 provides a model amendment for certain plan sponsors to amend their plans to reflect the modifications made by Notice 93-26, 1993-1 C.B. 308, to the 30-day notice requirement under § 1.411(a)-11(c).

.07 Rev. Proc. 94-13, as modified by Rev. Proc. 95-12, provides a model amendment and a limited amendment procedure for certain plan sponsors to amend their plans to comply with the requirements of § 401(a)(17), which was amended by the Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66 ("OBRA '93").

SECTION 3. GENERAL INSTRUCTIONS FOR AMENDMENTS

.01 Generally, a sponsor wishing to amend a plan must comply with the instructions in Rev. Proc. 89-9, 1989-1 C.B. 780, Rev. Proc. 89-13, 1989-1 C.B. 801, Rev. Proc. 93-39, 1993-2 C.B. 513, and Rev. Proc. 95-6, as appropriate, and pay the user fee set forth in Rev. Proc. 95-8, 1995-1 C.B. 485.

.02 Pursuant to section 4 of this revenue procedure, certain sponsors may adopt the model amendment set forth in the appendix to use the simplified method of determining HCEs and incur no user fee.

.03 Pursuant to section 5 of this revenue procedure, in lieu of the model amendment:

1 M&P, M&P mass submitter, and regional prototype mass submitter sponsors may adopt non-model language, as described in section 5(A), to use the simplified method of determining HCEs.

2 Regional prototype sponsors may adopt non-model language, as described in section 5(B), to use the simplified method of determining HCEs.

3 Volume submitter specimen plan sponsors may adopt non-model language, as described in section 5(C), to use the simplified method of determining HCEs.

4 Adopters of individually designed plans, including previously approved volume submitter plans, may adopt non-model language, as described in section 5(D), to use the simplified method of determining HCEs.

5 SEP sponsors may adopt non-model language, as described in section 5(E), to use the simplified method of determining HCEs.

SECTION 4. USE OF THE MODEL AMENDMENT

.01 All plans—Sponsors described in subsection .02 may amend their plans by adopting the model language in the appendix to this revenue procedure on a word-for-word basis, in accordance with the instructions in this revenue procedure. If a sponsor to whom the model language is available pursuant to subsection .02 adopts the model language, neither application to the Service nor a user fee is required. The Service will not issue new opinion, notification, advisory, or determination letters for plans that are amended solely to add the model language described in this section.

.011 The model language in the appendix contains 2 options for sponsors electing to use the simplified method of determining HCEs. Option 1 provides model language for sponsors that choose to apply this simplified method on the basis of the employer's workforce as of a snapshot day. If option 1 is selected, a snapshot day must be specified in the provided blank that is reasonably representative of the employer's workforce and the plan's coverage throughout the plan year. Option 2 may be used by sponsors that are not applying this method on the basis of a snapshot day. Neither option provides for the use of reasonably approximated or projected compensa-

tion as part of the simplified method of determining HCEs.

.02 The only sponsors to whom the model language is available are sponsors of M&P, regional prototype, volume submitter specimen, and individually designed plans (including volume submitter plans) and SEPs that have received favorable opinion, notification, advisory, determination, or ruling letters that take into account the requirements of TRA '86 under Rev. Proc. 87-50, 1987-2 C.B. 647, as modified; Rev. Proc. 89-9, as modified; Rev. Proc. 89-13, as modified; Rev. Proc. 90-20, 1990-1 C.B. 495; Rev. Proc. 91-41, 1991-2 C.B. 697; Rev. Proc. 91-66, 1991-2 C.B. 870; or Rev. Proc. 93-39.

.021 Sponsors of individually designed plans that are adopting the model language in the appendix must select between options 1 and 2 for inclusion in their plans. M&P and regional prototype plan sponsors may adopt both options and allow adopting employers to elect between those options in the adoption agreement.

.03 M&P and Regional Prototype Sponsors—M&P and regional prototype plan sponsors that use the model language must send copies of the amended plan or, if more convenient, the changed pages, to the appropriate Key District Director in accordance with section 10.10 of Rev. Proc. 89-9 and section 14 of Rev. Proc. 89-13 in order to notify the Service that they are using the model language. Sponsors should include a copy of the opinion or notification letter previously issued with "Highly Compensated Employee Model Amendment" printed clearly on the top of the copy of the letter. In addition, mass submitters must certify that all identical adopters of M&P mass submitter plans and regional prototype sponsors that use the mass submitter's plan will adopt the plan as amended. Sponsors must notify all adopting employers of the changes to their plans. If sponsors that either are identical adopters of an M&P mass submitter's plan or use a regional prototype mass submitter's plan do not adopt the plan as amended by the mass submitter, the adopting employer's plan will become individually designed.

.04 Volume Submitter Specimen Plans—Sponsors of volume submitter specimen plans that use the model language must send copies of the amended plan or, if more convenient, changed pages, to the appropriate Key

District Director. Volume submitter specimen plan sponsors may only offer the amended specimen plan prospectively, as volume submitter specimen plan sponsors do not have the power to adopt amendments on behalf of employers. However, an employer that adopted a volume submitter specimen plan prior to this amendment of the specimen plan may individually adopt the model amendment and will not need to obtain a new determination letter.

SECTION 5. ALTERNATIVE AMENDMENT PROCEDURES FOR NON-MODEL AMENDMENTS

(A) LIMITED AMENDMENT PROCEDURES FOR M&P, M&P MASS SUBMITTER, AND REGIONAL PROTOTYPE MASS SUBMITTER PLANS

.01 This section 5(A) provides a limited amendment procedure under which sponsors of M&P, M&P mass submitter, and regional prototype mass submitter plans that have received a favorable opinion or notification letter can amend their plans to include the simplified method of determining HCEs using non-model language.

.02 An M&P, M&P mass submitter, or regional prototype mass submitter sponsor (other than an identical adopter of an M&P mass submitter plan) must apply to the National Office of the Service for approval of the non-model language. The application should include both the pink and white copies of page 1 of Form 4461 or Form 4461-A with "Highly Compensated Employee Amendment" printed clearly on the top of the white copy and a user fee of \$400.00. Only one user fee is required for all plans submitted simultaneously by each sponsor, regardless of the number of plans affected.

.03 All changes made to include the simplified method of determining HCEs must be clearly described in a cover letter. A copy of the plan or, if more convenient, changed pages, must also be submitted. In addition, a copy of the most recent opinion or notification letter(s) must be included. All applicants must certify that no changes have been made other than those made to include the simplified method of determining HCEs under this revenue procedure, or those made under the limited amendment procedures described in section 6. Plans with amend-

ments other than amendments provided in the preceding sentence will be returned to the sponsor. In addition, mass submitters must certify that all identical adopters of M&P mass submitter plans, and regional prototype sponsors that use the mass submitter's plan, will adopt the plan as amended.

.04 Upon receipt of an application, the National Office will issue an acknowledgement letter that confirms receipt of the application and informs the sponsor that the Service will notify the sponsor if any changes need to be made to the non-model language. If the Service does not notify the sponsor within 90 days of the date of the acknowledgement letter that changes to the non-model language are necessary, the sponsor may treat the non-model language as approved. In such case, the sponsor will receive no further correspondence from the Service regarding the aforementioned non-model language.

.05 Sponsors that either are identical adopters of an M&P mass submitter's plan or use a regional prototype mass submitter's plan must adopt the plan as amended by the mass submitter. If the mass submitter's amendment is treated as approved under subsection .04 above, the identical adopter may also treat the amendment as approved without submitting a separate application.

.06 Sponsors must notify all adopting employers of the change to their plans and must send copies of the amended plan or, if more convenient, changed pages, to the appropriate Key District Directors in accordance with Rev. Procs. 89-9 and 89-13.

(B) LIMITED AMENDMENT PROCEDURE FOR REGIONAL PROTOTYPE PLANS

.01 This section 5(B) provides a limited amendment procedure under which sponsors of regional prototype plans that have received favorable notification letters can amend their plans to include the simplified method of determining HCEs using non-model language.

.02 A regional prototype sponsor must apply to the Key District Office that issued the plan's notification letter for approval of the non-model language. The application should be addressed to the attention of the Volume Submitter Coordinator. The application should include both the pink and white copies of page 1 of Form 4461 or Form

4461-A with "Highly Compensated Employee Amendment" printed clearly on the top of the white copy, Form 8717 with a January 1994 revision date or later, and a user fee of \$400.00.

.03 All changes made to include the simplified method of determining HCEs must be clearly described in a cover letter. A copy of the plan or, if more convenient, changed pages, must also be submitted. In addition, a copy of the most recent notification letter must be included. All applicants must certify that no changes have been made other than those made to include the simplified method of determining HCEs under this revenue procedure, or those made under the limited amendment procedures described in section 6. Plans with amendments other than amendments described in the preceding sentence will be returned to the sponsor.

.04 Upon approval of the non-model language submitted by a regional prototype sponsor, the Key District Office will issue a notification letter.

.05 Sponsors must notify all adopting employers of the change to their plans and must send copies of the amended plan or, if more convenient, changed pages, to the Key District Directors in accordance with Rev. Proc. 89-13.

(C) LIMITED AMENDMENT PROCEDURE FOR VOLUME SUBMITTER SPECIMEN PLANS

.01 This section 5(C) provides a limited amendment procedure under which sponsors of volume submitter specimen plans that have received favorable advisory letters can amend their plans to include the simplified method of determining HCEs using non-model language.

.02 A sponsor of a volume submitter specimen plan must apply to each of the Key District Offices that issued the original advisory letter(s) for approval of the non-model language. The application should be addressed to the attention of the Volume Submitter Coordinator identified in the advisory letter(s) and must include a cover letter with "Highly Compensated Employee Amendment" printed clearly on the top, Form 8717 with a January 1994 revision date or later, and a user fee of \$400.00.

.03 All changes made to include the simplified method of determining

HCEs must be clearly described in a cover letter. A copy of the plan or, if more convenient, changed pages, must also be submitted. In addition, a copy of the most recent advisory letter must be included. All applicants must certify that no changes have been made other than those made to include the simplified method of determining HCEs under this revenue procedure, or those made under the limited amendment procedures described in section 6. Plans with amendments other than amendments provided in the preceding sentence will be returned to the sponsor.

.04 Upon approval of the non-model language submitted by a volume submitter specimen plan sponsor, the Key District Office will issue an advisory letter.

.05 Volume submitter specimen plan sponsors may offer the amended specimen plan prospectively only, as volume submitter specimen plan sponsors do not have the power to adopt amendments on behalf of employers. However, an employer that adopted a volume submitter specimen plan prior to this amendment of the specimen plan may individually adopt non-model language in accordance with section 5(D) of this revenue procedure.

(D) LIMITED AMENDMENT PROCEDURE FOR ADOPTERS OF INDIVIDUALLY DESIGNED PLANS INCLUDING PREVIOUSLY APPROVED VOLUME SUBMITTER PLANS

.01 This section 5(D) provides a limited amendment procedure under which an employer that maintains an individually designed plan, including a previously approved volume submitter plan, that has received a favorable determination letter that takes into account TRA '86 and later laws, can amend its plan to include the simplified method of determining HCEs using non-model language. Section 4.01(2) of Rev. Proc. 93-42 permits the compensation used in the simplified method of determining HCEs to be compensation that reasonably approximates the employee's § 414(q)(7) compensation for the plan year. Section 4.02(2) of Rev. Proc. 93-42 provides that, if the determination of HCEs is made earlier than the last day of the plan year, the employee's compensation must be projected for a plan year under a reasonable method established by the employer. In order for approximated or

projected compensation to be used as part of the simplified method of determining HCEs, the plan language incorporating the simplified method must specifically describe the method by which compensation will be approximated or projected by the employer in a manner that satisfies the requirement in § 1.401-1(b) that a plan provide for the payment of definitely determinable retirement benefits.

.02 An employer maintaining an individually designed plan must apply to the Key District Director for the district in which the principal place of business of the employer (within the meaning of § 414(b), (c), and (m)) is located for approval of the non-model language. If the employer's principal place of business is not located within the United States, the application should be filed with the District Director of the Baltimore Key District Office. The application should include both the pink and white copies of page 1 of Form 6406 with "Highly Compensated Employee Amendment" printed clearly on the top of the white copy, Form 8717 with a January 1994 revision date or later, and a user fee of \$125.00. For purposes of section 10 of Rev. Proc. 95-6, an amendment that merely adds the simplified method of determining HCEs to the plan is not considered a "complex amendment" that would render an employer ineligible to use the Form 6406, Short Form Application for Determination for Amendment of Employee Benefit Plan.

.03 An employer that has previously adopted a volume submitter's specimen plan, and that wishes to use the version of the specimen plan that includes the non-model amendment provided in section 5(C), must apply to the Key District Office for the district in which the principal place of business of the employer (within the meaning of § 414(b), (c), and (m)) is located for approval of the non-model language. The application should include both the pink and white copies of page 1 of Form 5307 with "Highly Compensated Employee Amendment" printed clearly on the top of the white copy, Form 8717 with a January 1994 revision date or later, and a user fee of \$125.00.

.04 All changes to the plan must be clearly described in a cover letter. A copy of the plan or, if more convenient, changed pages, must also be submitted. In addition, a copy of the most recent determination letter must be included. All applicants must certify

that no changes have been made other than those made to include the simplified method of determining HCEs under this revenue procedure or those made under the limited amendment procedures described in section 6. Plans with amendments other than amendments described in the preceding sentence will be returned to the employer.

.05 Upon approval of the non-model language submitted by an adopting employer, the Key District Office will issue a favorable determination letter.

.06 Adopting employers must notify interested parties of the application to the Service for an advance determination regarding the qualification of the amended plan in accordance with Section II of Rev. Proc. 95-6.

(E) LIMITED AMENDMENT PROCEDURES FOR SEPS

.01 This section 5(E) provides limited amendment procedures under which sponsors of SEPs (other than employers that have adopted model SEP Form 5305-SEP or 5305A-SEP) that have received favorable opinion or ruling letters can amend their plans to include the simplified method of determining HCEs using non-model language.

.02 A sponsor of a prototype SEP or SEP mass submitter must apply to the National Office for approval of the non-model language. The application should include the first page of Form 5306-SEP with "Highly Compensated Employee Amendment" printed clearly on the top of the Form and a user fee of \$400.00. For all plans submitted simultaneously by each sponsor, only one user fee is required regardless of the number of plans affected.

.03 An employer that has adopted an individually designed SEP must apply to the National Office for a ruling letter on the non-model language in accordance with Rev. Proc. 87-50, as modified by Rev. Proc. 91-44, 1991-2 C.B. 733, and Rev. Proc. 95-4, 1995-1 C.B. 397, and pay a user fee of \$400.00.

.04 All changes to include the simplified method of determining HCEs must clearly be described in a cover letter. A copy of the SEP or, if more convenient, changed pages, must also be submitted. In addition, a copy of the most recent opinion or ruling letter must be included. All applicants must certify that no changes have been made

other than those made to include the simplified method of determining HCEs under this revenue procedure, or those made under the limited amendment procedures described in section 6. Plans with amendments other than amendments described in the preceding sentence will be returned to the employer.

.05 Upon receipt of an application for a SEP or SEP mass submitter, the National Office will issue an acknowledgement letter that confirms receipt of the application and informs the sponsor that the Service will notify the sponsor if any changes need to be made to the non-model language. If the Service does not notify the sponsor within 90 days of the date of the acknowledgement letter that changes to the non-model language are necessary, the sponsor may treat the non-model language as approved. In this case, the sponsor will receive no further correspondence from the Service regarding the aforementioned non-model language.

.06 Sponsors who use a SEP mass submitter's plan must adopt the plan as amended by the mass submitter. If the mass submitter's amendment is treated as approved under subsection .05 above, the identical adopter may also treat the amendment as approved without submitting a separate application.

.07 Sponsors must notify all adopting employers of the change to their plans and must send copies of the amended plan or, if more convenient, changed pages, to the applicable Key District Directors in accordance with Rev. Proc. 87-50, as modified.

SECTION 6. PLANS AMENDED UNDER THE LIMITED AMENDMENT PROCEDURES OF REV. PROCS. 93-12, 94-13, AND THIS REVENUE PROCEDURE

A single submission for Service approval may be made for plan amendments to include the simplified method of determining HCEs pursuant to the limited amendment procedures contained in sections 5(A) through 5(E) of this revenue procedure and to include plan language required under § 401(a)-(31) pursuant to the limited amendment procedures contained in sections 7 through 10 of Rev. Proc. 93-12, and to reflect the OBRA '93 changes to § 401(a)(17) pursuant to the limited amendment procedures contained in

section E of Part IV of Rev. Proc. 94-13. In such a case, only one application and the user fee for a single amendment need be submitted. Applicants should print clearly "Highly Compensated Employee Amendment", "401(a)(17) Amendment" and "401(a)(31) Amendment", as applicable, on the top of the second copy of page 1 (the white copy) of the application.

SECTION 7. RELIANCE

Plans that are amended in accordance with sections 4 and 5 of this revenue procedure will not lose their otherwise applicable extended reliance period under Rev. Procs. 89-9 and 89-13, as modified by Rev. Proc. 93-9, 1993-1 C.B. 474, or section 13 of Rev. Proc. 93-39. Employers entitled to rely on an opinion, notification, advisory, determination, or ruling letter will not lose reliance on the letter merely because of these amendments. However, the model language in option 1 in the appendix to this revenue procedure may not be relied upon as to whether the snapshot day selected by the employer is reasonably representative of the employer's workforce and the plan's coverage throughout the plan year.

SECTION 8. MODIFICATION OF REV. PROC. 93-42

.01 Section 4.03 of Rev. Proc. 93-42 provides that, if a plan contains a definition of HCEs, an employer that uses the simplified method of determining HCEs under section 4 of Rev. Proc. 93-42 must amend the plan to incorporate this method, including the use of a snapshot day if applicable. This requirement applies even if HCE status does not affect the contributions or benefits provided under the plan.

.02 This revenue procedure modifies section 4.03 of Rev. Proc. 93-42 to apply only in those cases in which HCE status can affect an employee's contributions or benefits under a plan, or the availability of other rights or features under the plan whether or not the plan contains a definition of HCE. For example, the results of the ADP test and the ACP test can affect the contributions of HCEs under a plan subject to those tests. If the simplified method of determining HCEs is used to determine contributions or benefits under the plan, or the availability of the other rights or features under the plan, the plan must include the simplified method.

.03 Section 4.03 of Rev. Proc. 93-42 is modified to read as follows:

“.03 If HCE status affects an employee's contribution or benefits under a plan, or the availability of other rights or features under the plan, and if the employer chooses to use the simplified method of determining HCEs under this section for purposes of contributions, benefits, or other rights or features under the plan, the employer must amend the plan to incorporate this simplified method, including the use of the snapshot day if applicable. Thus, for example, if the simplified method of determining HCEs is used for purposes of the "ADP" test or the "ACP" test in section 401(k)(3) or (m)(2), the plan must be amended to incorporate this simplified method.”

SECTION 9. MODIFICATIONS TO REV. PROCS. 93-12, 93-47, AND 94-13 REGARDING NOTICE TO INTERESTED PARTIES

.01 Rev. Proc. 93-12 is modified by deleting sections 6.05, 7.07, and 8.06 therein.

.02 Section 10.05 of Rev. Proc. 93-12 is modified to read as follows: "Adopting employers must notify interested parties of the application to the Service for an advance determination regarding the qualification of the amended plan in accordance with Section II of Rev. Proc. 95-6.”

.03 Rev. Proc. 93-47 is modified by deleting section 3.04 therein.

.04 Rev. Proc. 94-13 is modified by deleting sections V.E.(1).07 and V.E.(2).06.

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Procs. 89-9, 89-13, 93-12, 93-39, 93-42, 93-47, 94-13, and 95-8 are modified.

SECTION 11. EFFECTIVE DATE

This revenue procedure is effective July 17, 1995.

APPENDIX

MODEL LANGUAGE

(Note to Sponsor: The following two options are designed to be used by sponsors of plans with salary reduction,

matching, or after-tax features that wish to amend their plans to use the simplified method of determining HCEs provided for in section 4 of Rev. Proc. 93-42, but may be used by sponsors of other plans. A plan sponsor may adopt either option 1 or option 2. Option 1 provides model language for sponsors using the simplified method of determining HCEs that choose to apply this simplified method on the basis of the employer's workforce as of a snapshot day. If option 1 is selected, the provided blank must be filled in with a snapshot day that is reasonably representative of the employer's workforce and the plan's coverage throughout the plan year. Option 2 may be used by sponsors that are not applying this method on the basis of a snapshot day. In determining whether the employee is a HCE, both options use compensation as defined under § 414(q)(7), and neither option allows the employer to use compensation that reasonably approximates the employee's § 414(q)(7) compensation for the plan year.

(The model language contains 2 separate optional provisions. M&P and regional prototype plan sponsors may adopt both options and allow adopting employers to elect between those options in the adoption agreement. Sponsors of volume submitter specimen plans may prospectively offer both options in their specimen plan for adopting employers. Sponsors of individually designed plans (including adopters of previously approved volume submitter plans) should adopt only one option.)

Option 1—Model Amendment to Use the Simplified Method of Determining Highly Compensated Employees and a Snapshot Day for Determining Highly Compensated Employees

This amendment is effective beginning on the first day of the following plan year: _____.

The group of highly compensated employees ("HCEs") includes any employee who is employed by the employer on the snapshot day and who (i) is a 5-percent owner on the snapshot day, (ii) receives compensation for the plan year in excess of the § 414(q)(1)-(B) amount for the plan year, (iii) receives compensation for the plan year in excess of the § 414(q)(1)(C) amount for the plan year and is a member of the top paid group of employees within the meaning of § 414(q)(4), or (iv) is an officer on the snapshot day

and receives compensation during the plan year that is greater than 50 percent of the dollar limitation in effect under § 415(b)(1)(A). If no officer satisfies the compensation requirement of (iv) above, the highest paid officer for such plan year shall be treated as a HCE.

For purposes of determining who is a HCE, compensation means compensation within the meaning of § 415(c)(3) as set forth in the plan for purposes of determining the § 415 limits, except that amounts excluded pursuant to §§ 125, 402(e)(3), 402(h)(1)(B) and 403(b) are included. If compensation used for purposes of determining the § 415 limits under the plan is not defined as total compensation as provided under § 415(c)(3) and the regulations thereunder, then for purposes of determining who is a HCE, compensation means compensation within the meaning of § 1.415-2(d)-(11)(i) of the Income Tax Regulations, except that amounts excluded pursuant to §§ 125, 402(e)(3), 402(h)(1)(B) and 403(b) are included.

If, as of the snapshot day, an employee is a family member of either a 5-percent owner (whether active or former) or a HCE who is one of the 10 most HCEs ranked on the basis of compensation paid by the employer during such year, then the family member and the 5-percent owner or top-ten HCE shall be aggregated. In such case, the family member and 5-percent owner or top-ten HCE shall be treated as a single employee receiving compensation and plan contributions or benefits equal to the sum of the compensation and contributions and benefits of the family member and 5-percent owner or top-ten HCE. For purposes of this section, family member includes the spouse, lineal ascendants and descendants of the employee or former employee, and the spouses of such ascendants and descendants.

The snapshot day will be _____. (The date selected must be a single day during the plan year that is reasonably representative of the employer's workforce and the plan's coverage throughout the plan year. In addition, if the employer uses a snapshot day in substantiating compliance with the nondiscrimination requirements of §§ 401(a)(4), 410(b), or 414(s), the same snapshot day must be used for purposes of determining the HCEs.)

The group of HCEs will also include any employee who during the plan year:

(a) terminated employment prior to the snapshot day and was a HCE in the prior plan year;

(b) terminated employment prior to the snapshot day and (i) was a 5-percent owner, or (ii) has compensation for the plan year which is greater than or equal to the compensation of any employee who is treated as a HCE on the snapshot day (except for employees who are HCEs solely because they are 5-percent owners or officers), or (iii) was an officer and has compensation greater than or equal to the compensation of any other officer who is a HCE on the snapshot day solely because that person is an officer; or

(c) becomes employed subsequent to the snapshot day during the plan year and (i) is a 5-percent owner, or (ii) has compensation for the plan year that is greater than or equal to the compensation of any employee who is treated as a HCE on the snapshot day (except employees who are HCEs solely because they are 5-percent owners or officers), or (iii) is an officer and has compensation that is greater than or equal to the compensation of any other officer who is a HCE on the snapshot day solely because that person is an officer.

The determination of who is a HCE, including the determinations of the number and identity of employees in the top paid group, the number of employees treated as officers and the compensation that is taken into account, will be made in accordance with § 414(q) and § 1.414(q)-1T of the temporary Income Tax Regulations to the extent they are not inconsistent with the method established above.

Option 2—Model Amendment to Use the Simplified Method of Determining Highly Compensated Employees

This amendment is effective beginning on the first day of the following plan year: _____.

The group of highly compensated employees ("HCEs") includes any employee who during the plan year performs services for the employer and who (i) is a 5-percent owner, (ii) receives compensation for the plan year in excess of the § 414(q)(1)(B) amount for the plan year, (iii) receives compensation for the plan year in excess of the § 414(q)(1)(C) amount for the plan year and is a member of the top paid group of employees within the meaning of § 414(q)(4), or (iv) is an officer and

receives compensation during the plan year that is greater than 50 percent of the dollar limitation in effect under § 415(b)(1)(A). If no officer satisfies the compensation requirement during the plan year, the highest paid officer for such year shall be treated as a HCE.

For purposes of determining who is a HCE, compensation means compensation within the meaning of § 415(c)(3) as set forth in the plan for purposes of determining the § 415 limits, except that amounts excluded pursuant to §§ 125, 402(e)(3), 402(h)(1)(B) and 403(b) are included. If compensation used for purposes of determining the § 415 limits under the plan is not defined as total compensation as provided under § 415(c)(3) and the regulations thereunder, then for purposes of determining who is a HCE, compensation means compensation within the meaning of § 1.415-2(d)(11)(i) of the Income Tax Regulations, except that amounts excluded pursuant to §§ 125, 402(e)(3), 402(h)(1)(B) and 403(b) are included.

If an employee is a family member of either a 5-percent owner (whether active or former) or a HCE who is one of the 10 most HCEs ranked on the basis of compensation paid by the employer during such year, then the family member and the 5-percent owner or top-ten HCE shall be aggregated. In such case, the family member and 5-percent owner or top-ten HCE shall be treated as a single employee receiving compensation and plan contributions or benefits equal to the sum of the compensation and benefits of the family member and 5-percent owner or top-ten HCE. For purposes of this section, family member includes the spouse, lineal ascendants and descendants of the employee or former employee, and the spouses of such lineal ascendants and descendants.

The determination of who is a HCE, including the determinations of the number and identity of employees in the top paid group, the number of employees treated as officers and the compensation that is taken into account, shall be made in accordance with the § 414(q) and § 1.414(q)-1T of the temporary Income Tax Regulations to the extent they are not inconsistent with the method established above.

Rev. Proc. 95-35¹

SECTION 1. PURPOSE

This revenue procedure provides guidance to organizations exempt from taxation under § 501(a) of the Internal Revenue Code of 1986 on the application of amendments made to §§ 162(e) and 6033(e) by § 13222 of the Omnibus Budget Reconciliation Act of 1993. The revenue procedure identifies certain tax-exempt organizations that will be treated as satisfying the requirements of § 6033(e)(3). Those organizations will not be subject to the reporting and notice requirements of § 6033(e)(1) or the tax imposed by § 6033(e)(2). Procedures for other exempt organizations to establish that they satisfy the requirements of § 6033(e)(3) are also provided.

SEC. 2. BACKGROUND

Section 6033(e) imposes reporting and notice requirements on tax-exempt organizations (other than § 501(c)(3) organizations) that incur lobbying and political expenditures to which § 162(e) applies (“nondeductible lobbying expenditures”). Section 162(e) denies a deduction, otherwise allowable under § 162(a) as an ordinary and necessary trade or business expense, for certain lobbying and political expenditures. Section 162(e)(3) denies a deduction for the dues (or other similar amounts) paid to certain tax-exempt organizations to the extent that the organization, at the time the dues are assessed or paid, notifies the dues payer that the dues are allocable to nondeductible lobbying expenditures.

Section 6033(e)(1) requires a tax-exempt organization that pays or incurs nondeductible lobbying expenditures to notify its members, at the time the dues (or other similar amounts) are assessed or paid, of its reasonable estimate of the portion of the dues that is allocable to those expenditures. Section 6033(e)(1) does not, however, apply to tax-exempt organizations described in § 501(c)(3), or to organizations that establish to the satisfaction of the

Secretary that substantially all the dues they receive are not deductible without regard to § 162(e). In addition, organizations whose lobbying and political expenditures consist solely of certain in-house expenditures for nondeductible lobbying and whose total such expenditures do not exceed \$2,000 in a taxable year are not subject to the reporting and notice requirements of § 6033(e)(1).

Section 6033(e)(2)(A) provides that if a tax-exempt organization fails to provide the notices required by § 6033(e)(1), or if the notices underestimate the actual amount of dues allocable to nondeductible lobbying expenditures, the organization is subject to tax (at the highest rate imposed by § 11) on the aggregate amount of dues allocable to nondeductible lobbying expenditures paid during the taxable year that was not reported on the notices. However, § 6033(e)(2)(B) provides that if a tax would be imposed on the organization because its estimate of the nondeductible portion of the dues was less than the actual amount allocable to nondeductible lobbying expenditures, the Secretary may waive the tax if the organization agrees to increase the amount reasonably estimated to be nondeductible for the following taxable year by the amount of the underestimate.

Section 6033(e)(3) provides that § 6033(e)(1)(A) shall not apply to an exempt organization that establishes to the satisfaction of the Secretary that substantially all the dues or similar amounts paid by persons to the organization are not deductible without regard to § 162(e). The tax imposed by § 6033(e)(2)(A) only applies to organizations subject to the notice requirements of § 6033(e)(1)(A).

SEC. 3. SCOPE

This revenue procedure (i) sets forth specific circumstances in which certain tax-exempt organizations are treated as meeting the requirements of § 6033(e)(3), and (ii) provides guidance to other exempt organizations regarding how they may establish that they satisfy the requirements of § 6033(e)(3).

SEC. 4. APPLICATION

.01 *Exempt Organizations Automatically Excepted Under § 6033(e)(3).* Organizations recognized by the Serv-

ice as exempt from taxation under § 501(a), other than (i) social welfare organizations described in § 501(c)(4) that are not veterans organizations, (ii) agricultural and horticultural organizations described in § 501(c)(5), and (iii) organizations described in § 501(c)(6), are treated as satisfying the requirements of § 6033(e)(3).

.02 *Section 501(c)(4) Social Welfare Organizations and Section 501(c)(5) Agricultural and Horticultural Organizations.* Social welfare organizations recognized by the Service as exempt from taxation under § 501(c)(4) and agricultural and horticultural organizations recognized by the Service as exempt from taxation under § 501(c)(5) are treated as satisfying the requirements of § 6033(e)(3) if either (i) more than 90 percent of all annual dues (or similar amounts) are received from persons, families, or entities who each pay annual dues (or similar amounts) of \$50 or less, (ii) more than 90 percent of all annual dues (or similar amounts) are received from organizations described in § 501(c)(3), state governments, local governments, entities whose income is exempt from tax under § 115, or organizations excepted under section 4.01 of this revenue procedure.

.03 *Section 501(c)(6) Organizations.* Organizations recognized by the Service as exempt from taxation under § 501(c)(6) shall be treated as meeting the requirements of § 6033(e)(3) if more than 90 percent of all annual dues (or similar amounts) are received from organizations described in § 501(c)(3), state governments, local governments, entities whose income is exempt from tax under § 115, or organizations excepted under section 4.01 of this revenue procedure.

SEC. 5. DEFINITIONS AND PROCEDURES

.01 *Annual Dues (or Similar Amounts).* For purposes of this revenue procedure, the term “annual dues” means the amount an organization requires a person, family, or entity to pay to be recognized by the organization as a member for an annual period. For purposes of this revenue procedure, “similar amounts” includes, but is not limited to, voluntary payments made by persons, families, or entities, assessments made by the organization to cover basic operating costs, and special assessments imposed by the organization to conduct lobbying activities.

¹As corrected by Rev. Proc. 95-35A, page 392, this Bulletin.

.02 *Member.* For purposes of this revenue procedure, “member” is used in its broadest sense and is not limited to persons with voting rights in the organization.

.03 *Treatment of Affiliated Organizations.* For purposes of this revenue procedure, if more than one organization described in §§ 501(c)(4), 501(c)(5), or 501(c)(6) share a name, charter, historic affiliation or similar characteristics and coordinate their activities, all such organizations shall be treated as parts of a single organization. Only dues (or similar amounts) paid by persons other than the organizations treated as being parts of the single organization shall be considered for purposes of applying this revenue procedure. All annual dues payments made by each person outside the organizational structure to any organization within the single organization are considered for purposes of applying this revenue procedure to be paid to the single organization for a single membership. If, under this revenue procedure, the single organization is considered to meet the requirements of § 6033(e)(3), then all the organizations that are treated as parts of the single organization are considered to meet the requirements of § 6033(e)(3). For purposes of this revenue procedure, if organizations within the affiliated structure are on different taxable years, the organizations may base their calculations of annual dues on any single reasonable taxable year.

.04 *Example of An Affiliated Organization.* A group of social welfare organizations, each of which is recognized by the Service as being described in § 501(c)(4), share a common name and work jointly to promote a single purpose. Each organization operates at either the national, state, or local level. Individuals and families that are interested in the purpose promoted by the organizations pay annual dues of \$40 to one of the local organizations. The total amount of dues collected from individuals and families is \$950x. Also, a number of corporations are members of the national organization and pay annual dues of \$500 directly to it. The total amount of dues received from corporations is \$50x. The organizations are linked by a structure that makes the local organizations members of the appropriate state organizations and of the national organization. Accordingly, each local organization transfers a portion of the dues it collects to the

appropriate state organization and another portion to the national organization as dues. These transfer amounts are significantly greater than \$50. Because the organizations share a name and coordinate their activities, they are treated as parts of a single organization for purposes of determining whether they satisfy the requirements of § 6033(e)(3). Therefore, only the dues (or similar amounts) paid by persons other than the organizations treated as being parts of the single organization are considered for purposes of applying this revenue procedure. The total amount of annual dues paid by individuals and families at the \$40 level is more than 90 percent of all annual dues paid to both the local affiliated organizations by individuals and families, and to the national organization by corporations. Therefore, the single organization satisfies the requirements of § 6033(e)(3), which means that all the affiliated local and state organizations, and the national organization, are each considered to have satisfied the requirements of § 6033(e)(3).

.05 *Fifty Dollar Amount to be Indexed for Inflation.* The \$50 amount for annual dues in section 4.02 will be increased for taxable years beginning after December 31, 1995, by a cost-of-living adjustment under § 1(f)(3) of the Code, rounded to the next highest dollar.

.06 *Establishing that an Organization is Described in § 6033(e)(3).* Any exempt organization that is not treated as satisfying the requirements of § 6033(e)(3) under section 4 of this revenue procedure may still establish that it satisfies the requirements of § 6033(e)(3) by: (i) maintaining records establishing that 90 percent or more of the annual dues (or similar amounts) paid to the organization are not deductible without regard to § 162(e), and (ii) notifying the Service that it is described in § 6033(e)(3) on any Form 990 (Return of Organization Exempt From Income Tax) that it is required to file. Unless an organization complies with both of the above requirements, it will not have established to the satisfaction of the Service that it meets the requirements of section 6033(e)(3). Additionally, an organization may request a private letter ruling that substantially all the annual dues (or similar amounts) paid to the organization are not deductible, either directly or indirectly, without regard to § 162(e). To receive a favorable private letter ruling, the

organization must provide the Service with evidence establishing that 90 percent or more of all annual dues (or similar amounts) are not deductible, either directly or indirectly, without regard to § 162(e). If an organization receives a favorable private letter ruling, the Service will not contest the organization’s entitlement to exemption under § 6033(e)(3) for a subsequent year so long as the character of the organization’s membership is substantially similar to its membership at the time of the ruling. Ruling requests should be submitted to the Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: CP:E:EO, Internal Revenue Service, P.O. Box 120, Ben Franklin Station, Washington, D.C. 20044, in accordance with Rev. Proc. 95-4, 1995-1 C.B. 397 (or as revised).

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also §§ 162, 501, 6033.)

Rev. Proc. 95-35A

Rev. Proc. 95-35, page 391, this Bulletin, clarifies the application of § 6033(e) to organizations exempt from taxation under § 501(a) of the Internal Revenue Code. In describing social welfare organizations recognized by the Service as exempt under § 501(c)(4) and agricultural and horticultural organizations recognized by the Service as exempt under § 501(c)(5) that are excepted from the requirements of § 6033(e), Rev. Proc. 95-35 inadvertently limited one of the exceptions to organizations that receive more than 90 percent of all annual dues (or similar amounts) from persons, families, or entities who each pay annual dues (or similar amounts) of less than \$50. This revenue procedure modifies Rev. Proc. 95-35 by changing the amount of annual dues (or similar amounts) that may be received by such organizations without becoming subject to the requirements of § 6033(e) to \$50 or less.

Section 4.02 of Rev. Proc. 95-35 is modified as follows: The phrase “less than \$50” is replaced by “\$50 or less”.

EFFECT ON OTHER DOCUMENTS

Rev. Proc. 95-35 is modified.

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, § 42; 1.42-14.)

Rev. Proc. 95-36

SECTION 1. PURPOSE

This revenue procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 1995.

SECTION 2. BACKGROUND

Rev. Proc. 92-31, 1992-1 C.B. 775, provides guidance to state housing credit agencies of qualified states on the procedure for requesting an allocation of unused housing credit carryover under § 42(h)(3)(D). Section 4.06 of Rev. Proc. 92-31 provides that the Internal Revenue Service will publish in the Internal Revenue Bulletin the amount of unused housing credit carryovers allocated to qualified states for a calendar year from a national pool of unused credit authority (the National Pool). This revenue procedure publishes these amounts for calendar year 1995.

SECTION 3. PROCEDURE

The unused housing credit carryover amount allocated from the National Pool by the Secretary to each qualified state for calendar year 1995 is as follows:

| <i>Qualified State</i> | <i>Amount Allocated</i> |
|------------------------|-------------------------|
| Alaska | \$ 45,101 |
| Arizona | 303,281 |
| California | 2,339,248 |
| Colorado | 272,097 |
| Delaware | 52,544 |
| District of Columbia | 42,422 |
| Florida | 1,038,450 |
| Georgia | 525,067 |
| Hawaii | 87,747 |
| Idaho | 84,323 |
| Illinois | 874,641 |
| Indiana | 428,092 |
| Iowa | 210,548 |
| Kansas | 190,081 |
| Kentucky | 284,824 |
| Maine | 92,287 |
| Maryland | 372,571 |

| <i>Qualified State</i> | <i>Amount Allocated</i> |
|------------------------|-------------------------|
| Massachusetts | 449,601 |
| Michigan | 706,738 |
| Minnesota | 339,898 |
| Mississippi | 198,640 |
| Missouri | 392,814 |
| Nebraska | 120,792 |
| Nevada | 108,437 |
| New Jersey | 588,254 |
| New Mexico | 123,099 |
| New York | 1,352,225 |
| North Carolina | 526,184 |
| North Dakota | 47,483 |
| Ohio | 826,265 |
| South Carolina | 272,693 |
| South Dakota | 53,660 |
| Tennessee | 385,149 |
| Texas | 1,367,780 |
| Utah | 142,003 |
| Vermont | 43,166 |
| Virginia | 487,632 |
| Washington | 397,652 |
| Wisconsin | 378,227 |
| Wyoming | 35,426 |

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 1995.

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, §§ 936, 1504, 1563; 1.936-7.)

Rev. Proc. 95-37

SECTION 1. PURPOSE

This document provides procedures for making certain elections required by the amendments to § 936 of the Internal Revenue Code by the Omnibus Budget Reconciliation Act of 1993 (OBRA), § 13227, 1993-3 C.B. 3, 77. Specifically, this revenue procedure provides rules for electing the § 936(a)(4)(B) percentage limitation in post-1993 tax years and describes how certain affiliated possessions corporations may elect to compute the § 936(a)(4)(A) economic activity limitation on a consolidated basis in post-1993 tax years pursuant to § 936(i)(5). The revenue procedure also provides rules for revoking a possessions corpora-

tion's § 936(a) election and changing a § 936(h) intangible property income allocation method in post-1993 tax years.

SEC. 2. BACKGROUND

.01 Section 936(a)(1)(A) provides that a qualified possessions corporation electing the application of § 936 is allowed a credit against its U.S. tax liability equal to the portion of such tax attributable to taxable income from the active conduct of a trade or business within a U.S. possession or the sale or exchange of substantially all of the assets used by the taxpayer in the active conduct of such trade or business.

.02 OBRA amended § 936 by adding §§ 936(a)(4) and 936(i). Section 936(a)(4) imposes one of two alternative limitations on the § 936 credit with respect to § 936(a)(1)(A) active business income in post-1993 tax years: the § 936(a)(4)(A) economic activity limitation and the § 936(a)(4)(B) percentage limitation. The economic activity limitation applies unless the taxpayer elects the percentage limitation. The amount of the post-1993 § 936 credit is limited to the lesser of the § 936(a)(4) credit limitation amount or the amount of the § 936 credit as computed without regard to the limitation under § 936(a)(4). These limitations apply to possessions corporations which are defined in § 936(i)(6) as domestic corporations for which the election provided in § 936(a) is in effect.

.03 The economic activity limitation of § 936(a)(4)(A) provides that the credit determined with respect to income referred to in § 936(a)(1)(A) shall not exceed the sum of the following amounts: (1) sixty percent of the aggregate amount of a possessions corporation's qualified possession wages and allocable fringe benefit expenses for the taxable year; (2) fifteen percent of the corporation's annual depreciation allowance with respect to short-life qualified tangible property; (3) forty percent of the annual depreciation allowance with respect to medium-life qualified tangible property; (4) sixty-five percent of the annual depreciation allowance with respect to long-life qualified tangible property; and (5) in the case of a possessions corporation that does not elect the profit split method of allocating intangible property income under § 936(h)(5)(C)(ii), § 936(a)(4)(A)(iii)

provides that the economic activity limitation base also includes certain possession income taxes allocable to nonsheltered income.

.04 A possessions corporation which elects the profit split method of allocating intangible property income is not permitted to include possession income taxes in the economic activity limitation base. However, under § 936(i)-(3)(B), such a corporation is allowed a deduction for certain possession taxes.

.05 Sections 936(i)(5)(A) and (B) provide that an affiliated group may elect to treat all possessions corporations which would be members of such group but for §§ 1504(b)(3) or (4) as one corporation. Thus, the economic activity limitation may be determined on a consolidated basis and allocated among such possessions corporations in such manner as the Secretary may prescribe. An election to compute the economic activity limitation on a consolidated basis shall apply to the taxable year for which made and all succeeding taxable years unless revoked with the consent of the Secretary.

.06 The percentage limitation of § 936(a)(4)(B) provides that the credit determined with respect to income referred to in § 936(a)(1)(A) shall be the applicable percentage of the credit which would otherwise have been determined under § 936(a)(1) with respect to such income.

.07 Section 936(a)(4)(B) further provides that a possessions corporation electing the percentage limitation method is entitled to a deduction, as determined under § 936(i)(3)(B), for taxes allocable (on a pro rata basis) to taxable income the tax on which is not offset by reason of the percentage limitation.

.08 Sections 936(a)(4)(B)(iii)(I) and (II) require that an election to use the percentage limitation be made by a possessions corporation for its first taxable year beginning after December 31, 1993 for which it is a possessions corporation. The election applies to the taxable year for which made and all subsequent years unless revoked.

.09 Section 936(a)(4)(B)(iii)(III) provides that if, for any taxable year, an election is not in effect for any possessions corporation which is a member of an affiliated group, any § 936(a)(4)(B)(iii) election for any other member of such group is revoked for that taxable year and all subsequent

taxable years. For this purpose, members of an affiliated group shall be determined without regard to the exceptions contained in § 1504(b) and as if the constructive ownership rules of § 1563(e) applied for purposes of § 1504(a).

.10 Section 936(e)(2) provides that an election under § 936(a) may be revoked for any taxable year beginning before the expiration of the ninth taxable year following the year for which such election first applies only with the consent of the Secretary. Section 936(h) provides that intangible property income may be accounted for under the general rules of §§ 936(h)(1) to (h)(3), or, if properly elected, under the cost sharing or profit split methods specified in § 936(h)(5)(C). The Secretary is directed to take into account the significant nature of the modifications made by OBRA to the operation of § 936 in cases where a possessions corporation seeks to revoke its election to use the § 936 credit or change its method of allocating income from intangible property under § 936(h). H.R. Conf. Rep. No. 213, 103rd Cong., 1st Sess. 622 (1993), 1993-3 C.B. 393, 509 (Conference Report).

.11 Section 1504(a) defines an affiliated group as one or more chains of includible corporations connected with a common parent corporation which is an includible corporation if: (1) the common parent owns directly at least 80 percent of the total voting power of the stock and 80 percent of the total value of the stock of at least one other includible corporation; and (2) at least 80 percent of the total voting power of the stock and 80 percent of the total value of the stock of each includible corporation (except the common parent) is owned directly by one or more of the other includible corporations.

.12 Section 1504(b) provides that the term includible corporation means any corporation except: (1) corporations exempt from taxation under § 501; (2) insurance companies subject to taxation under § 801; (3) foreign corporations; (4) corporations with respect to which an election under § 936 (relating to possession tax credit) is in effect for the taxable year; (5) regulated investment companies and real estate investment trusts subject to tax under subchapter M of chapter 1; and (6) a DISC (as defined in § 992(a)(1)).

.13 Section 1563(e) attributes ownership of stock to an option holder; proportionate ownership of stock held

by or for a partnership to a partner having a capital or profits interest in the partnership of 5 percent or more; certain ownership of stock held by a trust or estate to a beneficiary having an actuarial interest in such stock of 5 percent or more; ownership of stock held by or for a grantor trust to the grantor or other substantial owner; proportionate ownership of stock held by or for a corporation to a shareholder owning 5 percent or more of the stock value; and certain ownership of stock held by an individual's spouse, children, grandchildren, parents, and grandparents.

SEC. 3. SCOPE

This revenue procedure applies to possessions corporations electing the percentage limitation, affiliated possessions corporations electing to compute the economic activity limitation on a consolidated basis, and possessions corporations revoking their § 936(a) election or changing § 936(h) income allocation methods in post-1993 tax years. The rules for electing the percentage limitation are set forth in § 4 of this revenue procedure. Sections 5 and 6 provide rules and conditions for computing and electing to compute the economic activity limitation on a consolidated basis. Section 7 provides rules for revoking § 936(a) elections and changing methods under § 936(h) in post-1993 tax years.

SEC. 4. THE PERCENTAGE LIMITATION ELECTION

.01 *In General*—A possessions corporation shall use the procedures described in this section to elect the § 936(a)(4)(B) percentage limitation in its first post-1993 tax year.

.02 *Rules of General Application*

(1) A possessions corporation may elect the percentage limitation by marking the box provided for this purpose in Part III of a timely filed (including extensions) Form 5735 (Possessions Corporation Tax Credit Allowed Under § 936) for its first taxable year beginning after December 31, 1993. If the percentage limitation is not timely elected, the corporation will be deemed to use the economic activity limitation.

(2) Once a possessions corporation elects to use the percentage limitation, it must continue to compute its § 936 credit under that limitation for all

subsequent years unless the election is revoked. A possessions corporation may revoke its percentage limitation election in any post-1993 tax year without the consent of the Commissioner. However, once revoked, the percentage limitation may not be re-elected.

.03 Application of the Consistency Rules

(1) *Affiliated Group Definition*—For purposes of this section, the term “affiliated group” has the same meaning as in § 1504(a) except that the § 1504(b) exclusions from the includible corporation definition are inoperative. Additionally, stock owned by attribution under § 1563(e) is treated as owned directly for purposes of § 1504(a). A possessions corporation (as defined in § 936(i)(6)) treated as a member of an affiliated group under this paragraph is referred to in this section as a “possession affiliate.”

Example—X, a foreign corporation, owns 100 percent of the voting stock and value of P, a U.S. holding company. P, in turn, owns 100 percent of the voting stock and value of A, B, and C. A is a U.S. corporation that wholly owns two possessions corporations. B is also a U.S. corporation that wholly owns three possessions corporations. C, a domestic insurance company, is a partner in the CD partnership and holds an 80-percent capital and profits interest therein. The CD partnership holds 100 percent of the voting stock and value of F, a possessions corporation. Pursuant to § 936(a)(4)(B)(iii)(III), X, C and the possessions corporations that are subsidiaries of A and B are treated as includible corporations. The stock of F is also treated as directly owned by C in proportion to its partnership interest in CD. The 80-percent ownership requirements are met for all includible entities. Thus, for purposes of § 936(a)(4)(B)(iii)(III), X is the common parent of an affiliated group consisting of X, P, A, B, C, F and the possessions corporations that are subsidiaries of A and B. Accordingly, all six possessions corporations are possession affiliates and all must use either the economic activity limitation or the percentage limitation for purposes of computing the § 936 credit.

(2) If the percentage limitation is elected by one possession affiliate, all possession affiliates in the affiliated group must make the percentage limitation election, and a Form 5735 indicat-

ing such election must be filed by each such affiliate in accordance with § 4.02(1).

(3) The failure of one possession affiliate to make the election will invalidate the election of the other possession affiliates unless the common parent (or designated affiliate) can demonstrate that it made a good faith effort to provide notice of the election to all possession affiliates and the failure of the possession affiliate to elect was due to inadvertence.

(4) Subsequently created or acquired possession affiliates are bound by the election (or lack thereof) of the affiliated group. Thus, if a possessions corporation electing the percentage limitation becomes a member of an affiliated group which uses the economic activity limitation, the corporation which becomes a member is deemed to have revoked its election to use the percentage limitation. Further, if a possessions corporation using the economic activity limitation becomes a member of an affiliated group using the percentage limitation, the corporation which becomes a member is deemed to elect the percentage limitation even if it is acquired subsequent to its first post-1993 tax year and must indicate such election on a Form 5735 filed in accordance with § 4.02(1). If, however, an affiliated group is formed or availed of for a principal purpose of obtaining the application of this § 4.03(4) to enable a subsequently acquired possession affiliate either to revoke its election to use the percentage limitation or to elect the percentage limitation, then the affiliated group will instead be bound by the prior election (or lack thereof) of the acquired possession affiliate.

SEC. 5. COMPUTATION OF THE ECONOMIC ACTIVITY LIMITATION ON A CONSOLIDATED BASIS

.01 *General Rule*—Section 936(i)(5) allows an affiliated group to elect to determine the economic activity limitation on a consolidated basis. The rules for computing the economic activity limitation on a consolidated basis are provided in this section. Section 6 provides rules regarding the manner of making the § 936(i)(5) election.

.02 *Definition of Affiliated Group*—For purposes of §§ 5 and 6 of this revenue procedure, the term “affiliated

group” has the same meaning as under § 1504(a) except that the §§ 1504(b)(3) and (4) exclusions from the includible corporation definition are inoperative. Thus, possessions corporations meeting the ownership requirements of § 1504(a) are treated as members of an affiliated group for purposes of § 936(i)(5) notwithstanding that a foreign corporation is the common parent or a member of the affiliated group. However, a possessions corporation treated as a member of an affiliated group under this section is not an includible corporation of an affiliated group for purposes of joining in the filing of a consolidated income tax return under § 1501. A possessions corporation treated as a member of an affiliated group under this paragraph is referred to in §§ 5 and 6 as a “possession affiliate.”

Example—F, a foreign corporation, wholly owns two possessions corporations, X and Y. Pursuant to § 936(i)(5), X, Y, and F are considered includible corporations for purposes of § 1504(a). X and Y are treated as members of an affiliated group since, under § 1504(a), F, the common parent, directly owns 100 percent of the voting power and value of both corporations. Accordingly, X and Y are possession affiliates, and their economic activity limitation may be determined under this § 5.

.03 Determination of the economic activity limitation on a consolidated basis

(1) *Separate computation of initial credit and economic activity limitation amounts*—Each possession affiliate shall separately compute the following amounts for its taxable year:

(a) *Initial credit*—The § 936 credit allowable with respect to each affiliate’s § 936(a)(1)(A) active business income shall be determined without regard to the limitation under § 936(a)(4);

(b) *Economic activity limitation amount*—The economic activity limitation amount shall be computed for each affiliate in accordance with § 936(a)(4)(A) but without regard to the §§ 936(a)(4)(A)(iii) and 936(i)(3)(A) credit for possession income taxes or the § 936(i)(3)(B) deduction for possession income taxes;

(c) *Excess initial credit or excess economic activity limitation amount*—A possession affiliate has an “excess initial credit” to the extent that the amount determined under (a) exceeds the amount determined under (b). The

possession affiliate has an “excess economic activity limitation amount” to the extent that the amount determined under (b) exceeds the amount determined under (a).

(2) *Allocation of excess economic activity limitation amount to other group members*—The excess economic activity limitation amount of any affiliate (excess limitation affiliate) may be allocated to one or more other affiliates with excess initial credits (excess credit affiliates) on any reasonable basis, provided that the taxable year of the excess limitation affiliate ends with or within the taxable year of the excess credit affiliate for which its credit is determined. However, an excess economic activity limitation amount may be allocated to an affiliate only to

the extent that the excess economic activity limitation amount has not been used by another affiliate. Thus, assume that A, B, and C are possession affiliates. A’s taxable year ends on December 31, B’s taxable year ends on March 31, and C’s taxable year ends on July 31. A has an excess economic activity limitation amount of \$10,000 for its taxable year ending December 31, 1994. B has a excess initial credit of \$5,000 for its taxable year ending March 31, 1995. In this case, \$5,000 of A’s excess economic activity limitation amount may be allocated to B for B’s taxable year ending March 31, 1995. This allocation will reduce A’s excess economic activity limitation amount to \$5,000. For its taxable year ending July 31, 1995, C may use up to \$5,000 of

A’s excess economic activity limitation amount, to the extent that C has an excess initial credit. However, the remaining \$5,000 of A’s excess economic activity limitation amount cannot be used by A, B or C for any taxable year beginning after December 31, 1994, because A’s 1994 taxable year does not end with or within such a later taxable year.

The allocation of any excess economic activity limitation amount to an excess credit affiliate must be made prior to the determination of the credit or deduction for possession income taxes, as provided under § 5.03(3). For purposes of applying this § 5.03(2), one reasonable method of apportionment is as follows:

Excess initial credit of affiliate for the taxable year for which the credit is determined

Total excess initial credits of the group for taxable years ending with or within the taxable year for which the credit is determined

×

Excess economic activity limitation amounts of the group for taxable years ending with or within the taxable year for which the credit is determined

(3) *Determination of credit or deduction for possession income taxes*—The credit for possession income taxes provided by §§ 936(a)(4)(A)(iii) and 936(i)(3)(A) and the deduction for possession income taxes provided under § 936(i)(3)(B) shall be determined separately for each possession affiliate after allocation of the excess economic activity limitation amount.

(4) *Example*—This example is illustrative of one reasonable method of

apportionment for purposes of § 5.03(2). X, a U.S. corporation, wholly owns three possessions corporations, A, B, and C. A and B elected the cost sharing method, and C elected the profit split method for their 1994 taxable year. X, A, B, and C are calendar year taxpayers. X timely made the election to compute the economic activity limitation for the group on a consolidated basis. Possession income taxes for all three affiliates are assumed

to be 8 percent which is imposed on affiliate income subject to tax by the U.S. possession (taxable income). A’s taxable income is \$28,571,428 (resulting in taxes of \$2,285,714), B’s taxable income is \$20,000,000 (resulting in taxes of \$1,600,000), and C’s taxable income is \$28,571,428 (resulting in taxes of \$2,285,714). The initial credit and the economic activity limitation (EAL) amount for each affiliate is as follows:

| | A | B | C |
|------------------------|--------------|-------------|--------------|
| Initial credit | \$10,000,000 | \$7,000,000 | \$10,000,000 |
| EAL amount | 15,000,000 | 3,000,000 | 4,000,000 |
| Excess EAL | 5,000,000 | | |
| Excess initial credits | | 4,000,000 | 6,000,000 |

The \$5 million excess economic activity limitation amount of A may be allocated to B and C on the basis of their excess initial credits for the calendar year. Accordingly, two million will be allocated to B ($4/10 \times 5,000,000 = 2,000,000$) and \$3 million will be allocated to C ($6/10 \times 5,000,000 = 3,000,000$). The credit for each possession affiliate amount is adjusted to reflect this allocation.

The credit and deduction for possession taxes allocable to nonsheltered income is determined for A, B, and C as follows:

$$(A) \frac{10,000,000 - 10,000,000}{10,000,000} \times 2,285,714 = \$0$$

$$\begin{array}{rcl}
 \text{(B)} & \frac{7,000,000 - 5,000,000}{7,000,000} & \times 1,600,000 = \$457,143 \\
 \text{(C)} & \frac{10,000,000 - 7,000,000}{10,000,000} & \times 2,285,714 = \$685,714
 \end{array}$$

The credit for each possession affiliate is adjusted to reflect these determinations. Since A has no non-sheltered income, there is no deduction or credit for possession income taxes. A's § 936 credit is \$10,000,000. B's credit is \$5,457,143 comprised of its original economic activity limitation amount of \$3,000,000, its \$2,000,000 pro-rata share of A's excess economic activity limitation amount, and, since B has elected cost sharing, a \$457,143 credit for taxes imposed on its nonsheltered income. C's credit is \$7,000,000 which includes its original economic activity limitation amount of \$4,000,000 and its \$3,000,000 pro-rata share of A's excess economic activity limitation amount. The \$685,714 in possession taxes imposed on C's non-sheltered income is not creditable since C has elected the profit split method. However, C is entitled to a deduction for these taxes.

SEC. 6. MANNER OF ELECTING AND STATEMENTS REQUIRED TO COMPUTE THE ECONOMIC ACTIVITY LIMITATION ON A CONSOLIDATED BASIS

.01 The election to compute the economic activity limitation on a consolidated basis shall be made for the affiliated group by the common parent corporation. The common parent shall make the election by filing an election statement with its timely filed (including extensions) tax return for the first taxable year for which the election is made. Where the common parent and the possession affiliates have different taxable years, the election shall be made for the year of the common parent with which or within which the year of the excess limitation possession affiliate ends.

.02 The election statement shall contain the name, taxpayer information number, and address of each possession affiliate on whose behalf the election is made.

.03 In the event that the common parent corporation is a foreign corporation that does not have a U.S. tax return filing obligation, the foreign parent shall designate a possession

affiliate to file the original election statement with that affiliate's tax return for the first taxable year for which the election is made.

.04 The election is not valid unless all possession affiliates consent to it. By consenting to the election, all possession affiliates agree to provide information necessary to substantiate the credit computation and allocation. A failure to provide such information will invalidate the election.

.05 The common parent corporation or its designate shall file an amended election statement with its timely filed tax return to reflect any changes in the status or group membership of the possession affiliates for any taxable year after the first taxable year to which the election applies.

.06 Subsequently created or acquired possession affiliates are bound by the initial election. An election may be revoked for the group by the common parent corporation only with the consent of the Commissioner.

.07 Each excess credit affiliate that is allocated the excess economic activity limitation amount of an excess limitation affiliate must attach to its tax return a statement indicating the identity of the excess limitation affiliate, the taxable year in which the excess limitation arose, and the amount of that limitation allocated to the excess credit affiliate.

SEC. 7. REVOCATION OF § 936(a) ELECTIONS AND CHANGE IN § 936(h) METHODS IN POST-1993 YEARS

.01 Generally, an election under § 936(a) may be revoked during the first ten years of § 936 status only with the consent of the Commissioner. However, § 936(a) revocations for post-1993 tax years must be considered in light of the significant statutory changes made by OBRA. Accordingly, the Commissioner hereby consents to all requests for revocation that are made with respect to a possessions corporation's first taxable year beginning after December 31, 1993 provided that the § 936(a) election was in effect

for the last taxable year beginning before January 1, 1994 and provided that the corporation agrees not to re-elect § 936(a) prior to its first taxable year beginning after December 31, 1998.

.02 A possessions corporation that wishes to revoke a § 936(a) election under the terms of the blanket revocation provided by § 7.01 must attach a "Statement of Revocation—§ 936" to its timely filed return (including extensions) and must state that, in revoking the election, the corporation agrees not to re-elect § 936(a) prior to its first taxable year beginning after December 31, 1998.

.03 A possessions corporation may not change its method under § 936(h)(5) or adopt the method under §§ 936(h)(1) to (h)(3) due to the changes made by § 936(a)(4) without the consent of the Commissioner. The possessions corporation must demonstrate to the Commissioner that, unless consent to a change in method is granted, its current use of a foregoing method would be adversely affected by the changes under OBRA.

SEC. 8. EFFECTIVE DATE

This revenue procedure is effective for taxable years beginning after December 31, 1993.

26 CFR 601.204: Changes in accounting periods and in methods of accounting. (Also Part I, §§ 61, 446, 481, 1231; 1.61-6, 1.61-8, 1.446-1, 1.481-1, 1.1231-1.)

Rev. Proc. 95-38

SECTION 1. PURPOSE

This revenue procedure implements an administrative decision of the Commissioner to provide an optional method of accounting for certain rent-to-own contracts (as defined in section 3).

SEC. 2. BACKGROUND

.01 Sections 61(a)(3) and (5) of the Internal Revenue Code provide that,

except as otherwise provided by law, gross income means all income from whatever source derived, including gains derived from dealings in property and rents.

.02 Section 1.61-6 of the Income Tax Regulations provides that gross income includes gain realized on the sale or exchange of tangible property.

.03 Section 1.61-8 provides that gross income includes rentals received or accrued for the use of personal property.

.04 Section 1231 provides for the treatment of § 1231 gain as capital gain and § 1231 loss as ordinary loss.

.05 Gain or loss on the disposition of property held both for sale and lease is not treated as section 1231 gain or loss. See Rev. Rul. 80-37, 1980-1 C.B. 51.

.06 The characterization of a transaction as a sale or a lease for federal income tax purposes is based on the facts and circumstances of each transaction, including factors such as the intent of the parties as evidenced by the contract entered into by them and whether the burdens and benefits of ownership of the property have passed to the purported purchaser. See, e.g., *Larsen v. Commissioner*, 89 T.C. 1229, 1267 (1987); *Haggard v. Commissioner*, 24 T.C. 1124, 1129 (1955); see also Rev. Rul. 55-540, 1955-2 C.B. 39. This characterization is determined by an examination of each individual transaction.

.07 In a typical rent-to-own transaction, a rent-to-own dealer enters into a contract with an individual for the use of consumer durable property for a period of not more than three years. The individual is under no legal obligation to make all the scheduled payments under the contract, but may acquire the property if all the payments are made. Typically, a substantial portion (and in many cases, a majority) of a rent-to-own dealer's contracts terminate with the return of the property to the rent-to-own dealer.

SEC. 3. DEFINITIONS

.01 A "rent-to-own dealer" is a person that, in the ordinary course of business, regularly enters into "rent-to-own contracts" with customers for the use of "consumer durable property," provided that a substantial portion of those contracts terminate and the property is returned to such person before

the receipt of all payments required to transfer ownership of the property from such person to the customer.

.02 "Consumer durable property" is tangible personal property generally used in the home, including televisions, video cassette recorders, stereos, camcorders, appliances, furniture, washing machines and dryers, refrigerators, and other similar consumer property. Consumer durable property does not include, for example, real property, aircraft, boats, motor vehicles, or trailers.

.03 A "rent-to-own contract"

(1) is a contract between a rent-to-own dealer and a customer who is an individual;

(2) is for the use of an item or items of consumer durable property;

(3) is titled "Rent-to-Own Agreement" or "Lease Agreement with Ownership Option," or uses other similar language;

(4) denominates the rent-to-own dealer as the "lessor" and the customer as the "lessee," or uses other similar language;

(5) provides for a weekly or monthly payment period and a level payment rate;

(6) provides that legal title to an item of consumer durable property remains with the rent-to-own dealer until the customer makes all the weekly, or monthly, or early purchase payments required under the contract to acquire legal title to the item of property;

(7) provides a beginning date and a maximum period of time for which the contract may be in effect that does not exceed 156 weeks or 36 months from such beginning date (including renewals or options to extend);

(8) provides for level payments within the 156-week or 36-month period that, in the aggregate, generally exceed the normal retail price of the consumer durable property plus interest;

(9) provides for payments under the contract that, in the aggregate, do not exceed \$10,000 per item of consumer durable property;

(10) provides that the customer does not have any legal obligation to make all the weekly or monthly level payments set forth under the contract, and that at the end of each week or month the customer may either (a) continue to use the consumer durable property by making the next weekly or monthly

payment, or (b) return such property to the rent-to-own dealer in good working order, in which case the customer does not incur any further obligations under the contract and is not entitled to a return of any payments previously made under the contract; and

(11) provides that the customer has no right to sell, sublease, mortgage, pawn, pledge, encumber, or otherwise dispose of the consumer durable property until all the payments stated in the contract have been made.

SEC. 4. SCOPE

This revenue procedure is limited solely to rent-to-own contracts entered into by rent-to-own dealers for consumer durable property, as these terms are defined in section 3.

SEC. 5. TAX TREATMENT

.01 A rent-to-own dealer may report the income, gains, and losses from rent-to-own contracts within the scope of this revenue procedure as follows:

(1) Income (other than gain or loss described in section 5.01(2)) derived from those contracts is included in gross income as rental income pursuant to §§ 61(a)(5) and 1.61-8; and

(2) Gain or loss on the sale or other disposition of consumer durable property (including gain or loss from an early purchase payment described in section 3.03(6)) subject to those contracts is not treated as § 1231 gain or loss.

.02 The tax consequences of transactions structured by the parties as leases will be analyzed under applicable law without regard to this revenue procedure if:

(1) The transactions are not within the scope of this revenue procedure;

(2) The rent-to-own dealer does not report all items of income, gain, and loss from the rent-to-own contracts as specified in section 5.01; or

(3) The rent-to-own dealer does not apply the tax treatment described in section 5.01 of this revenue procedure to all its rent-to-own contracts within the scope of this revenue procedure.

SEC. 6. COST RECOVERY

See Rev. Rul. 95-52, this Bulletin, with respect to the recovery through the deduction for depreciation of the

cost or other basis of consumer durable property subject to rent-to-own contracts.

SEC. 7. MANNER OF MAKING CHANGE OF ACCOUNTING METHOD

The tax treatment of rent-to-own contracts provided in this revenue procedure constitutes a method of accounting. A rent-to-own dealer currently treating its rent-to-own contracts in a manner inconsistent with this revenue procedure (e.g., as sale transactions) must seek the Commissioner's consent if the dealer wants to change its method of accounting to treat such contracts as provided in this revenue procedure. A change in method of accounting for rent-to-own contracts within the scope of this revenue procedure is a change of accounting method to which §§ 446(e) and 481 apply, and must be made in accordance with Rev. Proc. 92-20, 1992-1 C.B. 685.

SEC. 8. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Income Tax and Accounting) CC:DOM:IT&A, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

26 CFR 601.201: Rulings and determination letters.
(Also §§ 1502, 1504; 1.1502-75, 1.1504-1.)

Rev. Proc. 95-39

SECTION 1. PURPOSE

.01 This revenue procedure grants permission to discontinue filing consolidated returns to the consolidated groups specified in section 3.01 below. To obtain permission, (a) a consolidated group must file an application with the Internal Revenue Service ("Service") on or before June 30, 1996, and (b) each member of the group must enter into a closing agreement. Permission to discontinue filing consolidated returns will be effective for the first taxable year that begins on or after July 12, 1995.

.02 Permission to discontinue filing consolidated returns may be granted, on a case-by-case basis, to those consoli-

dated groups specified in section 3.02 below.

SEC. 2. BACKGROUND

.01 Section 1.1502-75(a)(2) of the Income Tax Regulations generally provides that a group that filed (or was required to file) a consolidated return for the immediately preceding taxable year is required to file a consolidated return for subsequent taxable years unless it has received permission to discontinue filing consolidated returns.

.02 Under § 1.1502-75(c)(2)(i), the Service has discretion to grant all groups permission to discontinue filing consolidated returns if an amendment to the Internal Revenue Code or regulations could have a substantial adverse effect on the filing of consolidated returns by substantially all groups, relative to the filing of separate returns. Ordinarily, the permission to discontinue applies with respect to the taxable year of each group that includes the effective date of the amendment.

.03 On July 12, 1995, final regulations were filed with the Federal Register as T.D. 8597 ("final regulations"). The final regulations amend the intercompany transaction system of the consolidated return regulations. The final regulations also revise the regulations under § 267(f) of the Internal Revenue Code, limiting losses and deductions from transactions between members of a controlled group. The amendments to the consolidated return regulations reflected in T.D. 8597 generally apply to transactions in tax years beginning on or after July 12, 1995.

.04 The Preamble to T.D. 8597 states that guidance is intended to be issued pursuant to which groups may receive permission to deconsolidate. The Preamble also states that permission to deconsolidate will be granted under terms and conditions similar to those set forth in Rev. Proc. 95-11, 1995-1 C.B. 505.

.05 The Service has determined that it is generally appropriate to grant permission to discontinue filing consolidated returns as a result of the amendments made by the final regulations. To lessen taxpayer burden and ease administrability, the Service has decided to grant all electing consolidated groups permission, subject to the terms of this revenue procedure, to discontinue filing consolidated returns.

.06 With respect to corporations that cease to be members of consolidated groups, §§ 1502 and 1504 authorize the Secretary to determine the tax liability of the corporations after the period of consolidation and to determine whether the corporations may thereafter be included in a consolidated group. The Service has determined that it is generally appropriate to prohibit the members of a consolidated group electing to discontinue filing consolidated returns under this revenue procedure from joining in a consolidated return for 60 consecutive months immediately following the beginning of the first taxable year that begins on or after July 12, 1995 (the "60-month period").

.07 This revenue procedure provides the exclusive means for obtaining permission to discontinue filing consolidated returns by reason of the application of T.D. 8597 for the first taxable year that begins on or after July 12, 1995, or any subsequent year.

SEC. 3. SCOPE

.01 This revenue procedure generally applies to any consolidated group that files (or is required to file) a consolidated tax return for the taxable year preceding the first taxable year that begins on or after July 12, 1995.

.02 This revenue procedure generally does not apply to any consolidated group that is subject to § 1.338(h)(10)-1(e)(6) for taxable years beginning on or after July 12, 1995. However, permission for such groups to discontinue filing consolidated returns will be considered on a case-by-case basis.

.03 For purposes of this revenue procedure:

(1) The definitions contained in the regulations under § 1502 and in T.D. 8597 generally apply.

(2) The term "electing consolidated group" means the consolidated group that has elected to discontinue filing consolidated returns pursuant to this revenue procedure.

(3) The term "former member" means any corporation that would have been a member of an electing consolidated group on any day beginning with the first day of the first taxable year that begins on or after July 12, 1995, and ending on the date the closing agreement described in section 4 below is executed, if the electing consolidated group had not elected to discontinue filing consolidated returns.

(4) The term “successor” means a person that, during the 60-month period, acquires any material asset of a former member if that person’s basis in the asset is determined in whole or in part, directly or indirectly, by reference to the former member’s basis in the asset.

(5) Unless the context otherwise requires, any reference to “former member” includes any successor to the former member.

(6) The term “new group” means an affiliated group that, during the 60-month period, includes at least one former member and less than all of whose members are former members of the same electing consolidated group.

(7) The term “material asset” means an asset (or group of assets) that is material to either the person acquiring the asset or the person disposing of the asset.

(8) Any reference to the term “return” includes an amended return, as appropriate.

SEC. 4. PROCEDURAL REQUIREMENTS

.01 Applications.

(1) A consolidated group that wishes to elect to discontinue filing consolidated returns pursuant to this revenue procedure must file an application with the Service. The application must be sent to the Internal Revenue Service, Associate Chief Counsel (Domestic), Attention CC:DOM:CORP:T, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. See Rev. Proc. 95-1, 1995-1 C.B. 313, for information regarding the payment of a user fee. An electing consolidated group will be required to pay only a single user fee.

(2) Any application to elect to discontinue filing consolidated returns pursuant to this revenue procedure must be filed on or before June 30, 1996.

(3) Each application under this revenue procedure must be captioned “Application to Discontinue Filing Consolidated Returns Pursuant to Rev. Proc. 95-39.”

.02 Closing Agreement Required.

(1) Each former member of an electing consolidated group must enter into a closing agreement with the Service.

The Service will provide a standard form closing agreement. The closing agreement will include the terms listed in section 4.03 below and any other terms that the Service determines to be necessary (e.g., terms relating to the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 1990-1 C.B. 204).

(2) The closing agreement will be entered into under the authority of § 7121 and pursuant to section 2.02 of Rev. Proc. 95-1.

.03 Requirements of Closing Agreement.

The closing agreement required by section 4.02 above will include:

(1) A schedule of (a) the name, address, employer identification number, and filing jurisdiction of each former member, and (b) the location of all the District Offices that will have examination jurisdiction over the separate returns that will be filed by each former member after the electing consolidated group has elected to discontinue filing consolidated returns.

(2) A penalties of perjury statement, as described in section 8.01(13) of Rev. Proc. 95-1.

(3) An agreement to extend the statute of limitations applicable to:

(a) years for which consolidated returns were filed by the electing consolidated group and for which the statute of limitations has not expired on the date the closing agreement is executed, and

(b) years for which returns are filed during the 60-month period.

Under this agreement, the periods of limitation provided in §§ 6501 and 6502 on the making of an assessment and the collection by levy or proceeding in court, with respect to any deficiency (including interest and additions to tax) with respect to the above years, shall not expire prior to the end of two years following the later of (a) the end of the 60-month period, or (b) the date any notice required by section 4.03(4) below is received by the Service. Such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection. This agreement extends a statute of limitations as provided above but will never shorten the otherwise applicable statute of limitations.

(4) An agreement to notify the Service if during the 60-month period:

(a) Any person who is not a former member becomes a successor to the former member.

(b) The former member becomes a member of a new group.

(c) The former member, while a member of a new group, acquires (in any manner, directly or indirectly) any stock or any material asset of any other member (including a new member) of the new group.

(d) The new group of which the former member is a member has a new common parent (as defined in section 4.03(5)(b) below).

(5) An agreement:

(a) To cause any person (other than a former member) that becomes a successor to the former member to enter into a supplemental closing agreement, as provided in section 4.04 below, prior to the acquisition by the successor of the asset(s) of the former member.

(b) To cause any corporation (if it is not a former member) that becomes the common parent of a new group (“new common parent”) after the date the former member becomes a member of such group to enter into a supplemental closing agreement, as provided in section 4.04 below, prior to the former member becoming a member of the new group.

(c) To cause the new common parent (if it is not a former member) of a new group to enter into a supplemental closing agreement, as provided in section 4.04 below, prior to becoming the new common parent of the new group.

(6) An agreement either

(a) to advise any person:

(i) acquiring, directly or indirectly, any equity interest in the former member, or

(ii) that would be required to enter into a supplemental closing agreement (e.g., by becoming a successor to the former member) that the former member is a former member within the meaning of this revenue procedure prior to the time that the person acquires such equity interest or is required to enter into a supplemental closing agreement, or

(b) to permit the Service to publish a notice in the Internal Revenue Bulletin stating that the former member is a former member within the meaning of this revenue procedure.

(7) An agreement to be bound by section 5 below.

.04 Supplemental Closing Agreement.

Under section 4.03(5) above, each successor, common parent or new common parent of a new group must enter into a supplemental closing agreement that satisfies the requirements of section 4.03 above as if the successor, common parent or new common parent were the former member.

.05 Notices.

(1) Any notice required by section 4.03(4) above must (a) be sent to the Service at the address specified in section 4.01(1) above; (b) be captioned "Information Submitted Pursuant to Rev. Proc. 95-39"; and (c) include a copy of the closing agreement or supplemental closing agreement.

(2) Any notice required by section 4.03(4)(a) above must (a) include the name, address, employer identification number and filing jurisdiction of the successor; (b) describe the transaction by which the successor will acquire the asset(s) of the former member; (c) be sent to the appropriate District Director; and (d) be filed prior to the acquisition by the successor of the asset(s) of the former member.

(3) Any notice required by section 4.03(4)(b), (c), or (d) above must (a) include the name, address, employer identification number, and filing jurisdiction of the common parent of the new group and state whether the new group files a consolidated return; (b) describe the transaction by which the former member became a member of the new group or by which the new common parent became the common parent of the new group; (c) if any member of the new group joined (or was required to join) in a consolidated return for the taxable year immediately preceding the taxable year in which the former member became a member of the new group (including a consolidated return of the new group), identify such member(s) (by name, address and employer identification number) and specify the ownership structure of the group; (d) identify by name, address, and employer identification number any member of the new group that is a former member; (e) include the information required by section 5 of Rev.

Proc. 91-71, 1991-2 C.B. 900 (pertaining to a waiver of the five-year restriction on reconsolidation under § 1504(a)(3)); and (f) be filed before 60 days after the former member (or new common parent) (i) became a member of the new group (or became the new common parent) or (ii) acquired the stock or assets of the other member of the group (whichever is applicable).

SEC. 5. EFFECTS OF ELECTING TO DISCONTINUE

.01 In General.

Except as provided in this section 5, each former member of an electing consolidated group must file separate returns during the 60-month period.

.02 Ability to Join Consolidated Return.

(1) If, during the 60-month period, a former member becomes a member of a new group, the former member may not join in any consolidated return filed by the new group during the 60-month period unless the Service permits, or requires, the former member to join. See sections 5.03 and 5.04 below. Further, if the new group is permitted, or required, to file consolidated returns during the 60-month period without the former member, for purposes of applying the consolidated return regulations, the former member must be treated as not being an includible corporation.

(2) If the former member is the common parent of the new group, the new group must treat the former member as an includible corporation. Because the former member generally may not join in the filing of a consolidated return during the 60-month period, the new group may not file consolidated returns during the 60-month period unless the Service permits, or requires, the former member to join.

(3) If the former member is a subsidiary of the new group, the former member must be treated as not being an includible corporation during the 60-month period (unless the Service permits, or requires, the former member to be treated as an includible corporation) for purposes of determining whether the common parent of the new group may file consolidated returns with any other member(s) of the new group. For

purposes of determining whether any other subsidiary of the new group may join in a consolidated return (other than one filed by the common parent of the new group) during the 60-month period, the former member must be treated as an includible corporation.

(4) For example, assume P is the common parent of an affiliated group that has a single chain of wholly owned subsidiaries: S1, S2, S3, and S4. If the former member merges into S2, P may elect to file consolidated returns with S1. If the P group files consolidated returns, S2, S3, and S4 generally may not join in the P group consolidated returns because S2 is generally treated as not being an includible corporation for purposes of determining which corporations may join in those returns. However, if the Service permits, or requires, S2 to join in the P group consolidated returns, S3 and S4 must also join in those returns. See sections 5.03 and 5.04 below. If the Service does not permit, or require, S2 to join in the P group consolidated returns, S3 and S4 may not file consolidated returns.

.03 Permission to File Consolidated Returns.

(1) If the new group wishes to file consolidated returns with the former member during the 60-month period, it must obtain permission from the Service. Requests for rulings granting such permission will be subject to all applicable procedures and requirements in effect at the time of the request. In the request for the ruling, the new group must include the information required by section 5 of Rev. Proc. 91-71 (pertaining to a waiver of the five-year restriction on reconsolidation under § 1504(a)(3)).

(2) The Service will act on the request within 6 months after the date it is received unless the new group agrees to extend the time. If the Service does not act on the request within 6 months (plus any extensions), the former member may not join in any consolidated returns filed by the new group during the 60-month period.

.04 Requirement to Join Consolidated Returns.

(1) The Service, in its sole discretion, may require the former member to

join in any consolidated returns filed by the new group by notifying the new group and the former member in writing.

(2) The Service will make any such determination within 6 months after receiving any notification described in section 4.03(4) above. If the Service requests any information it deems necessary to make that determination, the running of this period will be suspended until the information is received. If the Service does not notify the new group and the former member within the 6-month period, the former member may not join in any consolidated returns filed by the new group during the 60-month period. A separate 6-month period will apply to each notification described in section 4.03(4) above.

.05 Effect of Discontinuing.

(1) The members of an electing consolidated group are subject to all the consequences that apply when a group discontinues filing consolidated returns. *See, e.g.*, § 1.1502-19(c) as contained in the 26 CFR part 1 edition revised as of April 1, 1995 (inclusion of excess loss account with respect to stock of another member).

(2) Each member of an electing consolidated group will be treated as having ceased to be a member of the group on the last day of the taxable year immediately preceding the first taxable year that begins on or after July 12, 1995. *See* §§ 1.1502-13 and 1.1502-32 as contained in the 26 CFR part 1 edition revised as of April 1, 1995.

(3) The electing consolidated group must file a return for the taxable year immediately preceding the first taxable

year that begins on or after July 12, 1995. This return must be captioned "Final Consolidated Return of a Group that Discontinued Filing Consolidated Returns Pursuant to Rev. Proc. 95-39." The former common parent is the agent for purposes of filing this return. *See* § 1.1502-77(a).

.06 Discretion to Make Appropriate Adjustments.

If the information or representations provided in any closing agreement (or supplemental closing agreement) is incorrect or if a former member or common parent fails to comply with the closing agreement (or supplemental closing agreement), the Service may revoke the permission to discontinue filing consolidated returns granted pursuant to this revenue procedure at any time or make such other adjustments as may be appropriate. Any revocation may, in the sole discretion of the Service, be effective beginning with the first taxable year that begins on or after July 12, 1995 (*i.e.*, the first taxable year for which permission to discontinue was granted).

.07 Affiliation.

Except as provided in section 5.02 above for purposes of applying the consolidated return regulations, the determination of whether any former member is a member of an affiliated group within the meaning of § 1504 is not affected by this revenue procedure.

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective on August 28, 1995, the date it is published in the Internal Revenue Bulletin.

Rev. Proc. 95-40

SECTION 1. PURPOSE

This revenue procedure prescribes the loss payment patterns and discount factors for the 1995 accident year. These factors will be used for computing discounted unpaid losses under § 846 of the Internal Revenue Code. *See* Rev. Proc. 92-47, 1992-1 C.B. 980, for background concerning the loss payment patterns and application of the discount factors.

SEC. 2. SCOPE

This revenue procedure applies to any taxpayer that is required to discount its unpaid losses under § 846 for a line of business using discount factors published by the Secretary.

SEC. 3. TABLES OF DISCOUNT FACTORS

.01 The following tables present separately for each line of business the discount factors under § 846 for accident year 1995. All the discount factors presented in this section were determined using the applicable interest rate under § 846(c) for 1995, which is 6.99 percent, and by assuming all loss payments occur in the middle of the calendar year.

.02 If the groupings of individual lines of business on the annual statement changes, taxpayers must discount the unpaid losses on the resulting lines of business in accordance with the discounting patterns that would have applied to those unpaid losses based on their classification on the 1990 annual statement.

.03 Tables

Tables of Unpaid Losses Discount Factors

Section 846

- 1995 -

Interest rate: 6.99 percent

Homeowners/Farmowners

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 66.8753 | 66.8753 | 30.5145 | 33.1247 | 92.1201 |
| AY+ 1 | 90.4633 | 23.5880 | 8.2490 | 9.5367 | 86.4973 |
| AY+ 2 | 93.3914 | 2.9281 | 5.7969 | 6.6086 | 87.7173 |
| AY+ 3 | 95.7081 | 2.3167 | 3.8058 | 4.2919 | 88.6737 |
| AY+ 4 | 97.4081 | 1.7000 | 2.3134 | 2.5919 | 89.2550 |
| AY+ 5 | 98.6271 | 1.2190 | 1.2143 | 1.3729 | 88.4425 |
| AY+ 6 | 99.1528 | 0.5257 | 0.7553 | 0.8472 | 89.1570 |
| AY+ 7 | 99.5425 | 0.3897 | 0.4051 | 0.4575 | 88.5347 |
| AY+ 8 | 99.7318 | 0.1893 | 0.2376 | 0.2682 | 88.5749 |
| AY+ 9 | 99.8063 | 0.0745 | 0.1771 | 0.1937 | 91.4309 |
| AY+10 | N/A | 0.0745 | 0.1124 | 0.1192 | 94.3114 |
| AY+11 | N/A | 0.0745 | 0.0432 | 0.0447 | 96.6782 |
| AY+12 | N/A | 0.0447 | 0.0000 | 0.0000 | N/A |

Private Passenger Auto Liability/Medical

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 34.7617 | 34.7617 | 58.6034 | 65.2383 | 89.8297 |
| AY+ 1 | 66.2963 | 31.5346 | 30.0816 | 33.7037 | 89.2531 |
| AY+ 2 | 81.2140 | 14.9177 | 16.7540 | 18.7860 | 89.1837 |
| AY+ 3 | 89.8272 | 8.6132 | 9.0160 | 10.1728 | 88.6286 |
| AY+ 4 | 94.4549 | 4.6277 | 4.8595 | 5.5451 | 87.6363 |
| AY+ 5 | 96.8788 | 2.4239 | 2.6920 | 3.1212 | 86.2493 |
| AY+ 6 | 98.1526 | 1.2738 | 1.5626 | 1.8474 | 84.5846 |
| AY+ 7 | 98.6962 | 0.5436 | 1.1096 | 1.3038 | 85.1024 |
| AY+ 8 | 99.0485 | 0.3523 | 0.8227 | 0.9515 | 86.4661 |
| AY+ 9 | 99.2667 | 0.2182 | 0.6545 | 0.7333 | 89.2589 |
| AY+10 | N/A | 0.2182 | 0.4746 | 0.5151 | 92.1356 |
| AY+11 | N/A | 0.2182 | 0.2821 | 0.2969 | 95.0040 |
| AY+12 | N/A | 0.2182 | 0.0761 | 0.0787 | 96.6782 |
| AY+13 | N/A | 0.0787 | 0.0000 | 0.0000 | N/A |

Commercial Auto/Truck Liability/Medical

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 20.8439 | 20.8439 | 68.5319 | 79.1561 | 86.5782 |
| AY+ 1 | 47.3136 | 26.4697 | 45.9431 | 52.6864 | 87.2011 |
| AY+ 2 | 65.6475 | 18.3340 | 30.1906 | 34.3525 | 87.8849 |
| AY+ 3 | 79.0481 | 13.4005 | 18.4400 | 20.9519 | 88.0109 |
| AY+ 4 | 86.8945 | 7.8465 | 11.6129 | 13.1055 | 88.6109 |
| AY+ 5 | 92.4503 | 5.5558 | 6.6779 | 7.5497 | 88.4532 |
| AY+ 6 | 95.5751 | 3.1247 | 3.9126 | 4.4249 | 88.4218 |
| AY+ 7 | 97.3052 | 1.7302 | 2.3965 | 2.6948 | 88.9310 |
| AY+ 8 | 98.1469 | 0.8417 | 1.6934 | 1.8531 | 91.3826 |
| AY+ 9 | 98.8549 | 0.7080 | 1.0794 | 1.1451 | 94.2672 |
| AY+10 | N/A | 0.7080 | 0.4226 | 0.4371 | 96.6782 |
| AY+11 | N/A | 0.4371 | 0.0000 | 0.0000 | N/A |

Workers' Compensation

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 22.3366 | 22.3366 | 63.7037 | 77.6634 | 82.0254 |
| AY+ 1 | 50.6941 | 28.3575 | 38.8248 | 49.3059 | 78.7426 |
| AY+ 2 | 66.1886 | 15.4945 | 25.5117 | 33.8114 | 75.4530 |
| AY+ 3 | 74.4228 | 8.2342 | 18.7778 | 25.5772 | 73.4164 |
| AY+ 4 | 79.5663 | 5.1434 | 14.7702 | 20.4337 | 72.2836 |
| AY+ 5 | 83.7227 | 4.1564 | 11.5034 | 16.2773 | 70.6716 |
| AY+ 6 | 86.1316 | 2.4089 | 9.8159 | 13.8684 | 70.7786 |
| AY+ 7 | 88.4452 | 2.3136 | 8.1089 | 11.5548 | 70.1776 |
| AY+ 8 | 88.9625 | 0.5173 | 8.1406 | 11.0375 | 73.7542 |
| AY+ 9 | 89.9266 | 0.9641 | 7.7124 | 10.0734 | 76.5623 |
| AY+10 | N/A | 0.9641 | 7.2543 | 9.1093 | 79.6363 |
| AY+11 | N/A | 0.9641 | 6.7642 | 8.1453 | 83.0447 |
| AY+12 | N/A | 0.9641 | 6.2398 | 7.1812 | 86.8913 |
| AY+13 | N/A | 0.9641 | 5.6788 | 6.2171 | 91.3413 |
| AY+14 | N/A | 0.9641 | 5.0785 | 5.2530 | 96.6782 |
| AY+15 | N/A | 5.2530 | 0.0000 | 0.0000 | N/A |

Commercial Multiple Peril

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 33.4193 | 33.4193 | 56.3257 | 66.5807 | 84.5977 |
| AY+ 1 | 59.1296 | 25.7103 | 33.6692 | 40.8704 | 82.3804 |
| AY+ 2 | 67.4080 | 8.2784 | 27.4598 | 32.5920 | 84.2533 |
| AY+ 3 | 75.7571 | 8.3491 | 20.7433 | 24.2429 | 85.5645 |
| AY+ 4 | 83.8673 | 8.1102 | 13.8044 | 16.1327 | 85.5678 |
| AY+ 5 | 89.5799 | 5.7126 | 8.8604 | 10.4201 | 85.0322 |
| AY+ 6 | 93.4124 | 3.8325 | 5.5156 | 6.5876 | 83.7271 |
| AY+ 7 | 95.6455 | 2.2331 | 3.5914 | 4.3545 | 82.4739 |
| AY+ 8 | 96.9571 | 1.3116 | 2.4857 | 3.0429 | 81.6885 |
| AY+ 9 | 97.4497 | 0.4926 | 2.1500 | 2.5503 | 84.3008 |
| AY+10 | N/A | 0.4926 | 1.7907 | 2.0577 | 87.0232 |
| AY+11 | N/A | 0.4926 | 1.4063 | 1.5651 | 89.8548 |
| AY+12 | N/A | 0.4926 | 0.9951 | 1.0725 | 92.7826 |
| AY+13 | N/A | 0.4926 | 0.5551 | 0.5799 | 95.7275 |
| AY+14 | N/A | 0.4926 | 0.0844 | 0.0873 | 96.6782 |
| AY+15 | N/A | 0.0873 | 0.0000 | 0.0000 | N/A |

Medical Malpractice

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 3.7026 | 3.7026 | 68.5523 | 96.2974 | 71.1881 |
| AY+ 1 | 11.5535 | 7.8510 | 65.2234 | 88.4465 | 73.7433 |
| AY+ 2 | 21.9296 | 10.3761 | 59.0499 | 78.0704 | 75.6368 |
| AY+ 3 | 32.8555 | 10.9259 | 51.8762 | 67.1445 | 77.2605 |
| AY+ 4 | 46.6164 | 13.7609 | 41.2687 | 53.3836 | 77.3058 |
| AY+ 5 | 60.9092 | 14.2928 | 29.3694 | 39.0908 | 75.1313 |
| AY+ 6 | 69.2349 | 8.3257 | 22.8106 | 30.7651 | 74.1443 |
| AY+ 7 | 71.6574 | 2.4225 | 21.8993 | 28.3426 | 77.2663 |
| AY+ 8 | 73.7610 | 2.1036 | 21.2542 | 26.2390 | 81.0022 |
| AY+ 9 | 77.8395 | 4.0786 | 18.5211 | 22.1605 | 83.5775 |
| AY+10 | N/A | 4.0786 | 15.5971 | 18.0819 | 86.2580 |
| AY+11 | N/A | 4.0786 | 12.4686 | 14.0033 | 89.0403 |
| AY+12 | N/A | 4.0786 | 9.1215 | 9.9248 | 91.9061 |
| AY+13 | N/A | 4.0786 | 5.5403 | 5.8462 | 94.7684 |
| AY+14 | N/A | 4.0786 | 1.7089 | 1.7676 | 96.6782 |
| AY+15 | N/A | 1.7676 | 0.0000 | 0.0000 | N/A |

Special Liability (Ocean Marine, Aircraft (all Perils), Boiler and Machinery)

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 31.2231 | 31.2231 | 60.8234 | 68.7769 | 88.4358 |
| AY+ 1 | 68.2247 | 37.0016 | 26.8020 | 31.7753 | 84.3485 |
| AY+ 2 | 80.2858 | 12.0611 | 16.1999 | 19.7142 | 82.1739 |
| AY+ 3 | 85.4166 | 5.1308 | 12.0252 | 14.5834 | 82.4582 |
| AY+ 4 | 89.4028 | 3.9862 | 8.7426 | 10.5972 | 82.4993 |
| AY+ 5 | 93.2493 | 3.8465 | 5.3750 | 6.7507 | 79.6222 |
| AY+ 6 | 94.0515 | 0.8022 | 4.9210 | 5.9485 | 82.7268 |
| AY+ 7 | 95.8901 | 1.8386 | 3.3632 | 4.1099 | 81.8317 |
| AY+ 8 | 97.7995 | 1.9093 | 1.6233 | 2.2005 | 73.7694 |
| AY+ 9 | 97.9920 | 0.1925 | 1.5376 | 2.0080 | 76.5759 |
| AY+10 | N/A | 0.1925 | 1.4460 | 1.8155 | 79.6478 |
| AY+11 | N/A | 0.1925 | 1.3479 | 1.6230 | 83.0538 |
| AY+12 | N/A | 0.1925 | 1.2430 | 1.4304 | 86.8974 |
| AY+13 | N/A | 0.1925 | 1.1308 | 1.2379 | 91.3442 |
| AY+14 | N/A | 0.1925 | 1.0107 | 1.0454 | 96.6782 |
| AY+15 | N/A | 1.0454 | 0.0000 | 0.0000 | N/A |

Other Liability

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 9.9737 | 9.9737 | 67.5119 | 90.0263 | 74.9913 |
| AY+ 1 | 21.8819 | 11.9082 | 59.9137 | 78.1181 | 76.6962 |
| AY+ 2 | 32.5583 | 10.6764 | 53.0584 | 67.4417 | 78.6729 |
| AY+ 3 | 41.4543 | 8.8960 | 47.5655 | 58.5457 | 81.2450 |
| AY+ 4 | 56.3583 | 14.9040 | 35.4742 | 43.6417 | 81.2851 |
| AY+ 5 | 71.6763 | 15.3180 | 22.1096 | 28.3237 | 78.0602 |
| AY+ 6 | 78.0397 | 6.3635 | 17.0729 | 21.9603 | 77.7445 |
| AY+ 7 | 82.2566 | 4.2168 | 13.9046 | 17.7434 | 78.3647 |
| AY+ 8 | 85.2754 | 3.0188 | 11.7540 | 14.7246 | 79.8253 |
| AY+ 9 | 87.4014 | 2.1260 | 10.3765 | 12.5986 | 82.3624 |
| AY+10 | N/A | 2.1260 | 8.9029 | 10.4727 | 85.0103 |
| AY+11 | N/A | 2.1260 | 7.3261 | 8.3467 | 87.7729 |
| AY+12 | N/A | 2.1260 | 5.6392 | 6.2207 | 90.6521 |
| AY+13 | N/A | 2.1260 | 3.8344 | 4.0948 | 93.6413 |
| AY+14 | N/A | 2.1260 | 1.9034 | 1.9688 | 96.6782 |
| AY+15 | N/A | 1.9688 | 0.0000 | 0.0000 | N/A |

Special Property (Fire, Allied Lines, Inland Marine, Earthquake, Glass, Burglary, and Theft)

| Tax Year | Cumulative
Losses
Paid
(%) | Estimated
Losses Paid
Each Year
(%) | Discounted
Unpaid
Losses at
Year End
(%) | Unpaid
Losses at
Year End
(%) | Discount
Factor
(%) |
|----------|-------------------------------------|--|--|--|---------------------------|
| AY+ 0 | 57.7817 | 57.7817 | 39.7351 | 42.2183 | 94.1183 |
| AY+ 1 | 88.3390 | 30.5573 | 10.9053 | 11.6610 | 93.5200 |
| AY+ 2 | N/A | 5.8305 | 5.6368 | 5.8305 | 96.6782 |
| AY+ 3 | N/A | 5.8305 | 0.0000 | 0.0000 | N/A |

Auto Physical Damage

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 84.1827 | 84.1827 | 15.1871 | 15.8173 | 96.0159 |
| AY+ 1 | 98.8697 | 14.6870 | 1.0571 | 1.1303 | 93.5200 |
| AY+ 2 | N/A | 0.5651 | 0.5464 | 0.5651 | 96.6782 |
| AY+ 3 | N/A | 0.5651 | 0.0000 | 0.0000 | N/A |

Fidelity, Surety, Financial Guaranty, Mortgage Guaranty

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 25.1728 | 25.1728 | 68.4145 | 74.8272 | 91.4300 |
| AY+ 1 | 57.6281 | 32.4553 | 39.6262 | 42.3719 | 93.5200 |
| AY+ 2 | N/A | 21.1859 | 20.4822 | 21.1859 | 96.6782 |
| AY+ 3 | N/A | 21.1859 | 0.0000 | 0.0000 | N/A |

Other (including Credit, Accident and Health)

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 63.6725 | 63.6725 | 34.0913 | 36.3275 | 93.8444 |
| AY+ 1 | 88.8927 | 25.2202 | 10.3875 | 11.1073 | 93.5200 |
| AY+ 2 | N/A | 5.5536 | 5.3691 | 5.5536 | 96.6782 |
| AY+ 3 | N/A | 5.5536 | 0.0000 | 0.0000 | N/A |

International (Composite)

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 30.8006 | 30.8006 | 58.1664 | 69.1994 | 84.0562 |
| AY+ 1 | 56.9235 | 26.1229 | 35.2118 | 43.0765 | 81.7424 |
| AY+ 2 | 68.6906 | 11.7671 | 25.5016 | 31.3094 | 81.4504 |
| AY+ 3 | 76.7697 | 8.0791 | 18.9275 | 23.2303 | 81.4777 |
| AY+ 4 | 83.5336 | 6.7639 | 13.2543 | 16.4664 | 80.4927 |
| AY+ 5 | 88.9725 | 5.4390 | 8.5549 | 11.0275 | 77.5781 |
| AY+ 6 | 91.6218 | 2.6493 | 6.4126 | 8.3782 | 76.5390 |
| AY+ 7 | 93.4305 | 1.8087 | 4.9899 | 6.5695 | 75.9567 |
| AY+ 8 | 94.3638 | 0.9333 | 4.3734 | 5.6362 | 77.5950 |
| AY+ 9 | 95.0595 | 0.6957 | 3.9595 | 4.9405 | 80.1440 |
| AY+10 | N/A | 0.6957 | 3.5167 | 4.2448 | 82.8469 |
| AY+11 | N/A | 0.6957 | 3.0430 | 3.5492 | 85.7374 |
| AY+12 | N/A | 0.6957 | 2.5361 | 2.8535 | 88.8767 |
| AY+13 | N/A | 0.6957 | 1.9938 | 2.1578 | 92.3982 |
| AY+14 | N/A | 0.6957 | 1.4136 | 1.4622 | 96.6782 |
| AY+15 | N/A | 1.4622 | 0.0000 | 0.0000 | N/A |

Reinsurance A

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 35.8044 | 35.8044 | 58.5035 | 64.1956 | 91.1332 |
| AY+ 1 | 72.2671 | 36.4628 | 24.8773 | 27.7329 | 89.7034 |
| AY+ 2 | 79.1294 | 6.8622 | 19.5182 | 20.8706 | 93.5200 |
| AY+ 3 | N/A | 10.4353 | 10.0887 | 10.4353 | 96.6782 |
| AY+ 4 | N/A | 10.4353 | 0.0000 | 0.0000 | N/A |

Reinsurance B (Composite)

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 30.8006 | 30.8006 | 58.1664 | 69.1994 | 84.0562 |
| AY+ 1 | 56.9235 | 26.1229 | 35.2118 | 43.0765 | 81.7424 |
| AY+ 2 | 68.6906 | 11.7671 | 25.5016 | 31.3094 | 81.4504 |
| AY+ 3 | 76.7697 | 8.0791 | 18.9275 | 23.2303 | 81.4777 |
| AY+ 4 | 83.5336 | 6.7639 | 13.2543 | 16.4664 | 80.4927 |
| AY+ 5 | 88.9725 | 5.4390 | 8.5549 | 11.0275 | 77.5781 |
| AY+ 6 | 91.6218 | 2.6493 | 6.4126 | 8.3782 | 76.5390 |
| AY+ 7 | 93.4305 | 1.8087 | 4.9899 | 6.5695 | 75.9567 |
| AY+ 8 | 94.3638 | 0.9333 | 4.3734 | 5.6362 | 77.5950 |
| AY+ 9 | 95.0595 | 0.6957 | 3.9595 | 4.9405 | 80.1440 |
| AY+10 | N/A | 0.6957 | 3.5167 | 4.2448 | 82.8469 |
| AY+11 | N/A | 0.6957 | 3.0430 | 3.5492 | 85.7374 |
| AY+12 | N/A | 0.6957 | 2.5361 | 2.8535 | 88.8767 |
| AY+13 | N/A | 0.6957 | 1.9938 | 2.1578 | 92.3982 |
| AY+14 | N/A | 0.6957 | 1.4136 | 1.4622 | 96.6782 |
| AY+15 | N/A | 1.4622 | 0.0000 | 0.0000 | N/A |

Reinsurance C

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 23.0513 | 23.0513 | 68.7310 | 76.9487 | 89.3206 |
| AY+ 1 | 47.1565 | 24.1051 | 48.6019 | 52.8435 | 91.9732 |
| AY+ 2 | 73.1742 | 26.0177 | 25.0875 | 26.8258 | 93.5200 |
| AY+ 3 | N/A | 13.4129 | 12.9673 | 13.4129 | 96.6782 |
| AY+ 4 | N/A | 13.4129 | 0.0000 | 0.0000 | N/A |

Miscellaneous Casualty (Composite)

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 73.9503 | 73.9503 | 24.6061 | 26.0497 | 94.4581 |
| AY+ 1 | 93.7601 | 19.8099 | 5.8355 | 6.2399 | 93.5200 |
| AY+ 2 | N/A | 3.1199 | 3.0163 | 3.1199 | 96.6782 |
| AY+ 3 | N/A | 3.1199 | 0.0000 | 0.0000 | N/A |

Long Lines (Composite)

| Tax Year | Cumulative Losses Paid (%) | Estimated Losses Paid Each Year (%) | Discounted Unpaid Losses at Year End (%) | Unpaid Losses at Year End (%) | Discount Factor (%) |
|----------|----------------------------|-------------------------------------|--|-------------------------------|---------------------|
| AY+ 0 | 30.8006 | 30.8006 | 58.1664 | 69.1994 | 84.0562 |
| AY+ 1 | 56.9235 | 26.1229 | 35.2118 | 43.0765 | 81.7424 |
| AY+ 2 | 68.6906 | 11.7671 | 25.5016 | 31.3094 | 81.4504 |
| AY+ 3 | 76.7697 | 8.0791 | 18.9275 | 23.2303 | 81.4777 |
| AY+ 4 | 83.5336 | 6.7639 | 13.2543 | 16.4664 | 80.4927 |
| AY+ 5 | 88.9725 | 5.4390 | 8.5549 | 11.0275 | 77.5781 |
| AY+ 6 | 91.6218 | 2.6493 | 6.4126 | 8.3782 | 76.5390 |
| AY+ 7 | 93.4305 | 1.8087 | 4.9899 | 6.5695 | 75.9567 |
| AY+ 8 | 94.3638 | 0.9333 | 4.3734 | 5.6362 | 77.5950 |
| AY+ 9 | 95.0595 | 0.6957 | 3.9595 | 4.9405 | 80.1440 |
| AY+10 | N/A | 0.6957 | 3.5167 | 4.2448 | 82.8469 |
| AY+11 | N/A | 0.6957 | 3.0430 | 3.5492 | 85.7374 |
| AY+12 | N/A | 0.6957 | 2.5361 | 2.8535 | 88.8767 |
| AY+13 | N/A | 0.6957 | 1.9938 | 2.1578 | 92.3982 |
| AY+14 | N/A | 0.6957 | 1.4136 | 1.4622 | 96.6782 |
| AY+15 | N/A | 1.4622 | 0.0000 | 0.0000 | N/A |

26 CFR 601.201: Rulings and determination letters
(Also Part I, Sections 832, 846; 1.832-4, 1.846-1.)

Rev. Proc. 95-41

SECTION 1. PURPOSE

This revenue procedure prescribes the salvage discount factors for the 1995 accident year. These factors will be used for computing discounted estimated salvage recoverable under § 832 of the Internal Revenue Code.

SEC. 2. BACKGROUND

Section 832(b)(5)(A) requires that all estimated salvage recoverable (including that which cannot be treated as an asset for state accounting purposes) be taken into account in computing the deduction for losses incurred. Under

§ 832(b)(5)(A), paid losses are to be reduced by salvage and reinsurance recovered during the taxable year. This amount is adjusted to reflect changes in discounted unpaid losses on nonlife insurance contracts and in unpaid losses on life insurance contracts. An adjustment is then made to reflect any changes in discounted estimated salvage recoverable and in reinsurance recoverable.

Pursuant to § 832(b), the amount of estimated salvage is determined on a discounted basis in accordance with procedures established by the Secretary.

SEC. 3. SCOPE

This revenue procedure applies to any taxpayer that is required to discount estimated salvage recoverable under § 832.

SEC. 4. APPLICATION

.01 The following tables present separately for each line of business the discount factors under § 832 for the 1995 accident year. All the discount factors presented in this section were determined using the applicable interest rate under § 846(c) for 1995, which is 6.99 percent, and by assuming all estimated salvage is recovered in the middle of each calendar year. See Rev. Proc. 91-48, 1991-2 C.B. 760, for background regarding the tables.

.02 These tables must be used by taxpayers irrespective of whether they elected to discount unpaid losses using their own historical experience under § 846.

.03 Tables.

| Tables of Discount Factors
Salvage Recoverable
– 1995 –
Interest rate: 6.99 percent | | Workers' Compensation | Discount
Factor
(%) | Special Liability (Ocean Marine,
Aircraft (all Perils), Boiler and
Machinery) | Discount
Factor
(%) |
|--|----------|---------------------------|---------------------------|--|---------------------------|
| Homeowners/Farmowners | | Tax Year | | | |
| | | AY+ 0 | 82.0254 | | |
| | | AY+ 1 | 78.7426 | Tax Year | |
| | Discount | AY+ 2 | 75.4530 | AY+ 0 | 88.4358 |
| Tax Year | Factor | AY+ 3 | 73.4164 | AY+ 1 | 84.3485 |
| | (%) | AY+ 4 | 72.2836 | AY+ 2 | 82.1739 |
| AY+ 0 | 92.1201 | AY+ 5 | 70.6716 | AY+ 3 | 82.4582 |
| AY+ 1 | 86.4973 | AY+ 6 | 70.7786 | AY+ 4 | 82.4993 |
| AY+ 2 | 87.7173 | AY+ 7 | 70.1776 | AY+ 5 | 79.6222 |
| AY+ 3 | 88.6737 | AY+ 8 | 73.7542 | AY+ 6 | 82.7268 |
| AY+ 4 | 89.2550 | AY+ 9 | 76.5623 | AY+ 7 | 81.8317 |
| AY+ 5 | 88.4425 | AY+10 | 79.6363 | AY+ 8 | 73.7694 |
| AY+ 6 | 89.1570 | AY+11 | 83.0447 | AY+ 9 | 76.5759 |
| AY+ 7 | 88.5347 | AY+12 | 86.8913 | AY+10 | 79.6478 |
| AY+ 8 | 88.5749 | AY+13 | 91.3413 | AY+11 | 83.0538 |
| AY+ 9 | 91.4309 | AY+14 | 96.6782 | AY+12 | 86.8974 |
| AY+10 | 94.3114 | | | AY+13 | 91.3442 |
| AY+11 | 96.6782 | Commercial Multiple Peril | | AY+14 | 96.6782 |
| | | | | | |
| | | | Discount | | |
| | | | Factor | Other Liability | |
| | | | (%) | | |
| Private Passenger Auto Liability/
Medical | | Tax Year | | | Discount |
| | | AY+ 0 | 84.5977 | | Factor |
| | Discount | AY+ 1 | 82.3804 | | (%) |
| Tax Year | Factor | AY+ 2 | 84.2533 | Tax Year | |
| | (%) | AY+ 3 | 85.5645 | AY+ 0 | 74.9913 |
| AY+ 0 | 89.8297 | AY+ 4 | 85.5678 | AY+ 1 | 76.6962 |
| AY+ 1 | 89.2531 | AY+ 5 | 85.0322 | AY+ 2 | 78.6729 |
| AY+ 2 | 89.1837 | AY+ 6 | 83.7271 | AY+ 3 | 81.2450 |
| AY+ 3 | 88.6286 | AY+ 7 | 82.4739 | AY+ 4 | 81.2851 |
| AY+ 4 | 87.6363 | AY+ 8 | 81.6885 | AY+ 5 | 78.0602 |
| AY+ 5 | 86.2493 | AY+ 9 | 84.3008 | AY+ 6 | 77.7445 |
| AY+ 6 | 84.5846 | AY+10 | 87.0232 | AY+ 7 | 78.3647 |
| AY+ 7 | 85.1024 | AY+11 | 89.8548 | AY+ 8 | 79.8253 |
| AY+ 8 | 86.4661 | AY+12 | 92.7826 | AY+ 9 | 82.3624 |
| AY+ 9 | 89.2589 | AY+13 | 95.7275 | AY+10 | 85.0103 |
| AY+10 | 92.1356 | AY+14 | 96.6782 | AY+11 | 87.7729 |
| AY+11 | 95.0040 | | | AY+12 | 90.6521 |
| AY+12 | 96.6782 | Medical Malpractice | | AY+13 | 93.6413 |
| | | | | AY+14 | 96.6782 |
| | | | Discount | | |
| | | | Factor | Special Property (Fire, Allied Lines,
Inland Marine, Earthquake, Glass,
Burglary, and Theft) | |
| | | | (%) | | |
| Commercial Auto/Truck
Liability/Medical | | Tax Year | | | Discount |
| | | AY+ 0 | 71.1881 | | Factor |
| | Discount | AY+ 1 | 73.7433 | | (%) |
| Tax Year | Factor | AY+ 2 | 75.6368 | Tax Year | |
| | (%) | AY+ 3 | 77.2605 | AY+ 0 | 88.8940 |
| AY+ 0 | 86.5782 | AY+ 4 | 77.3058 | AY+ 1 | 90.7117 |
| AY+ 1 | 87.2011 | AY+ 5 | 75.1313 | AY+ 2 | 91.7529 |
| AY+ 2 | 87.8849 | AY+ 6 | 74.1443 | AY+ 3 | 93.2431 |
| AY+ 3 | 88.0109 | AY+ 7 | 77.2663 | AY+ 4 | 94.2815 |
| AY+ 4 | 88.6109 | AY+ 8 | 81.0022 | AY+ 5 | 96.0133 |
| AY+ 5 | 88.4532 | AY+ 9 | 83.5775 | AY+ 6 | 96.6782 |
| AY+ 6 | 88.4218 | AY+10 | 86.2580 | | |
| AY+ 7 | 88.9310 | AY+11 | 89.0403 | | |
| AY+ 8 | 91.3826 | AY+12 | 91.9061 | | |
| AY+ 9 | 94.2672 | AY+13 | 94.7684 | | |
| AY+10 | 96.6782 | AY+14 | 96.6782 | | |

Auto Physical Damage

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 94.9539 |
| AY+ 1 | 95.4470 |
| AY+ 2 | 96.6782 |

Fidelity, Surety, Financial Guaranty, Mortgage Guaranty Discount

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 83.3164 |
| AY+ 1 | 85.7886 |
| AY+ 2 | 87.2048 |
| AY+ 3 | 88.9064 |
| AY+ 4 | 90.6494 |
| AY+ 5 | 92.3574 |
| AY+ 6 | 93.6685 |
| AY+ 7 | 94.7558 |
| AY+ 8 | 96.6782 |

Other (including Credit, Accident and Health)

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 89.4810 |
| AY+ 1 | 91.3266 |
| AY+ 2 | 92.5551 |
| AY+ 3 | 94.2253 |
| AY+ 4 | 95.6255 |
| AY+ 5 | 96.6782 |

International (Composite)

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 84.0562 |
| AY+ 1 | 81.7424 |
| AY+ 2 | 81.4504 |
| AY+ 3 | 81.4777 |
| AY+ 4 | 80.4927 |
| AY+ 5 | 77.5781 |
| AY+ 6 | 76.5390 |
| AY+ 7 | 75.9567 |
| AY+ 8 | 77.5950 |
| AY+ 9 | 80.1440 |
| AY+10 | 82.8469 |
| AY+11 | 85.7374 |
| AY+12 | 88.8767 |
| AY+13 | 92.3982 |
| AY+14 | 96.6782 |

Reinsurance A

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 76.0273 |
| AY+ 1 | 79.4591 |
| AY+ 2 | 81.2292 |
| AY+ 3 | 83.1518 |
| AY+ 4 | 85.4059 |
| AY+ 5 | 87.8703 |
| AY+ 6 | 90.6323 |
| AY+ 7 | 93.5724 |
| AY+ 8 | 96.6782 |

Reinsurance B (Composite)

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 84.0562 |
| AY+ 1 | 81.7424 |
| AY+ 2 | 81.4504 |
| AY+ 3 | 81.4777 |
| AY+ 4 | 80.4927 |
| AY+ 5 | 77.5781 |
| AY+ 6 | 76.5390 |
| AY+ 7 | 75.9567 |
| AY+ 8 | 77.5950 |
| AY+ 9 | 80.1440 |
| AY+10 | 82.8469 |
| AY+11 | 85.7374 |
| AY+12 | 88.8767 |
| AY+13 | 92.3982 |
| AY+14 | 96.6782 |

Reinsurance C

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 76.0273 |
| AY+ 1 | 79.4591 |
| AY+ 2 | 81.2292 |
| AY+ 3 | 83.1518 |
| AY+ 4 | 85.4059 |
| AY+ 5 | 87.8703 |
| AY+ 6 | 90.6323 |
| AY+ 7 | 93.5724 |
| AY+ 8 | 96.6782 |

Miscellaneous Casualty (Composite)

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 84.3249 |
| AY+ 1 | 86.2938 |
| AY+ 2 | 87.2315 |
| AY+ 3 | 88.5161 |
| AY+ 4 | 89.7796 |
| AY+ 5 | 91.2642 |
| AY+ 6 | 92.6107 |
| AY+ 7 | 94.2823 |
| AY+ 8 | 96.6782 |

Long Lines (Composite)

| Tax Year | Discount Factor (%) |
|----------|---------------------|
| AY+ 0 | 84.0562 |
| AY+ 1 | 81.7424 |
| AY+ 2 | 81.4504 |
| AY+ 3 | 81.4777 |
| AY+ 4 | 80.4927 |
| AY+ 5 | 77.5781 |
| AY+ 6 | 76.5390 |
| AY+ 7 | 75.9567 |
| AY+ 8 | 77.5950 |
| AY+ 9 | 80.1440 |
| AY+10 | 82.8469 |
| AY+11 | 85.7374 |
| AY+12 | 88.8767 |
| AY+13 | 92.3982 |
| AY+14 | 96.6782 |

26 CFR 601.201: Rulings and determination letters

Rev. Proc. 95-42

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 89-13, 1989-1 C.B. 801, in order to simplify certain notice and registration requirements that apply to sponsors of regional prototype plans.

SECTION 2. BACKGROUND AND GENERAL INFORMATION

.01 Rev. Proc. 89-13 contains the procedures of the Internal Revenue Service for issuing notification letters relating to the qualification of regional prototype defined contribution and defined benefit plans.

.02 Section 14.05 of Rev. Proc. 89-13 contains certain notice and registra-

tion requirements, including the following.

(1) Section 14.05(1) requires the sponsor to notify the key district office on each anniversary of the date of its initial notification letter whether it has made any changes to the plan and whether it intends to continue to make the plan available for adoption.

(2) Section 14.05(2) requires the sponsor to give the key district office on each anniversary date cumulative lists of employers that have adopted the plan and a certification that the sponsor is in current compliance with requirements concerning certain notices that must be given to adopting employers.

SECTION 3. MODIFICATION OF REV. PROC. 89-13

.01 Section 14.05(1) of Rev. Proc. 89-13 is modified to require the annual notice to be given to the key district office at any time between January 1 and January 31 of each calendar year, beginning with the year after the year in which the initial favorable notification letter is issued, rather than on each anniversary of the date of issuance of the notification letter. This change is effective on August 28, 1995. Any annual notices that would otherwise have been due in 1995 need not be filed until January, 1996.

.02 Section 14.05(2) of Rev. Proc. 89-13 is modified to provide that the sponsor's annual notice to the key district office should no longer include the cumulative lists of employers that have adopted the plan. However, the sponsor must continue to maintain such lists and to furnish them to the key district office upon request. The sponsor need not retain information regarding an employer if more than three years have elapsed since the sponsor discontinued its sponsorship of the employer's prototype plan. The sponsor must also continue to include in its annual notice to the key district office a certification that it is in current compliance with the notification requirements in sections 14.05(3) and 14.05(4) of Rev. Proc. 89-13.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89-13 is modified.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective on August 28, 1995.

26 CFR 601.401: Employment taxes. (Also Part I, Sections 3121, 3231; 31.3121(a)(2)-1, 31.3231(e)-1.)

Rev. Proc. 95-43

The Internal Revenue Service is continuing its program of reviewing and identifying those revenue procedures that, although not specifically revoked or superseded, are no longer considered determinative. The revenue procedure listed below relating to the taxability of sick pay under the Federal Insurance Contributions Act (FICA) and the Railroad Retirement Tax Act (RRTA) is made obsolete by statutory changes invalidating Q&A-10 and regulations (§31.6051-3 of the Employment Tax Regulations and Part 32, Temporary employment tax regulations under the Act of December 29, 1981 (Pub. L. 97-123)) generally restating the guidance in Q&A-1 through Q&A-9.

Accordingly, the revenue procedure listed below is obsolete.

| <i>Rev. Proc. No.</i> | <i>C.B. Citation</i> |
|-----------------------|----------------------|
| 82-20 | 1982-1, 466 |

26 CFR 601.601: Rules and regulations.

Rev. Proc. 95-44

As part of the President's Regulatory Reinvention Initiative, the Treasury Department and the Internal Revenue Service have identified revenue procedures published in the Internal Revenue Bulletin that, although not specifically revoked or superseded, are obsolete because (1) the applicable statutory provisions or regulations have been changed or repealed; (2) the published guidance is specifically covered by statute, regulations, or subsequent published guidance; or (3) the facts set forth no longer exist or are not sufficiently described to permit clear application of the current statute and regulations.

This revenue procedure publishes a list of revenue procedures identified under the Regulatory Reinvention Initiative as being obsolete.

Accordingly, the revenue procedures listed below are hereby declared obsolete.

Rev. Proc. No. C.B. Citation

| | |
|-------|-----------------|
| 82-59 | 1982-2 C.B. 848 |
| 72-15 | 1972-1 C.B. 737 |
| 71-38 | 1971-2 C.B. 574 |

Treasury and the Service will continue to review other revenue procedures to ascertain those that, for the reasons stated above, are obsolete. Therefore, failure to include any particular revenue procedure in the above list should not be construed as necessarily indicating that the revenue procedure is not obsolete.

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. 95-45

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 1994.

.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. 94-31, 1994-1 C.B. 625, Rev. Proc. 94-15, 1994-1 C.B. 575, Rev. Proc. 92-63, 1992-2 C.B. 421, and Rev. Proc. 91-29, 1991-1 C.B. 562. This revenue procedure relists countries where the adverse conditions are still in effect, adds countries where periods of adverse conditions occurred after the compilation of the list in Rev. Proc. 94-31, and removes countries where the adverse conditions ended after compilation of the list in Rev. Proc. 94-31. Rev. Proc. 94-31, Rev. Proc. 94-15, Rev. Proc. 92-63, and Rev. Proc. 91-29 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:

| <i>Country</i> | <i>Date of Departure</i> | |
|--|--------------------------|---------------------|
| | <i>On or After</i> | <i>On or Before</i> |
| Afghanistan | April 23, 1979 | (still in effect) |
| Algeria | December 10, 1993 | March 10, 1994 |
| Bosnia and Herzegovina | April 7, 1992 | (still in effect) |
| Burundi | April 8, 1994 | October 4, 1994 |
| Croatia | April 7, 1992 | (still in effect) |
| Haiti | October 29, 1991 | January 18, 1994 |
| | June 10, 1994 | October 7, 1994 |
| Iran | September 1, 1978 | (still in effect) |
| Lebanon | August 31, 1979 | (still in effect) |
| The Former Yugoslav Republic
of Macedonia | June 13, 1992 | (still in effect) |
| Montenegro | June 13, 1992 | (still in effect) |
| Rwanda | April 8, 1994 | July 6, 1994 |
| Serbia | June 13, 1992 | (still in effect) |
| Somalia | December 21, 1990 | (still in effect) |
| Sudan | August 21, 1993 | February 16, 1994 |
| Yemen | May 5, 1994 | August 2, 1994 |
| Zaire | September 24, 1991 | January 18, 1994 |

1) The Former Yugoslav Republic of Macedonia, formerly part of the Socialist Federal Republic of Yugoslavia, has proclaimed independent statehood. On February 8, 1994, the United States formally recognized it as an independent state.

2) Montenegro and Serbia, formerly part of the Socialist Federal Republic of Yugoslavia, have asserted the formation of a joint independent state, but this entity has not been formally recognized as a state by the United States.

.05 Accordingly, for purposes of § 911 of the Code, an individual who left one of the foregoing countries during the specified period shall be treated as a qualified individual with respect to the period during which that individual was a bona fide resident of, or present in, that foreign country if the individual establishes a reasonable expectation of meeting the requirements of § 911(d) but for those conditions.

.06 To qualify for relief under § 911(d)(4), an individual must have established residency or have been physically present in the foreign coun-

try on or prior to the date that the Secretary of the Treasury determines that individuals were required to leave the foreign country. Individuals who establish residency or are first physically present in the foreign country after the date that the Secretary prescribes, but during the period for which the Secretary determines that individuals were required to leave the foreign country, shall not be treated as qualified individuals under § 911(d)(4) pursuant to § 911(d)(4)(C). For example, individuals who establish residency or are first

physically present in Iran after September 1, 1978, are not eligible to qualify for the exemption prescribed in § 911(d)(4). The same holds true with respect to individuals who move to Afghanistan after April 23, 1979, or Lebanon after August 31, 1979.

SEC. 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS office or, for a taxpayer residing or traveling outside

the United States, the nearest overseas IRS office.

SEC. 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 90-55, 1990-2 C.B. 638, is obsoleted.

26 CFR 601.602 Tax forms and instructions.

Rev. Proc. 95-46

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SECTION 1. PURPOSE

The purpose of this revenue procedure is to provide general requirements and conditions for the development, printing, and approval of substitute Form 1040A and related forms and schedules to be input through the Document Processing System (DPS). Approved forms may be filed in lieu of official IRS produced and distributed forms.

SECTION 2. SCOPE

This special revenue procedure contains instructions only for the approval of Form 1040A and related forms and schedules. All other IRS tax forms are covered by other revenue procedures. The Service accepts quality substitute tax forms that are consistent with the official forms they represent, and that do not have an adverse impact on our processing. The IRS Substitute Forms Program administers the formal acceptance and processing of these forms nationwide. This revenue procedure will be incorporated into Publication 1167, Substitute Printed, Computer-Prepared, and Computer-Generated Tax Forms and Schedules.

SECTION 3. HIGHLIGHTS OF THIS REVENUE PROCEDURE

There are several differences between this revenue procedure and Publication 1167. The most important differences are listed here.

.01 Submissions should be produced in full graphic detail including all horizontal and vertical lines (Section 5.03).

.02 The taxpayer name and SSN must appear on all pages (Section 5.05).

.03 Barcodes are required on certain forms (Section 6).

.04 The Service requires three or four original copies of each form, depending on the treatment of the entity area (Section 7.01(2)).

.05 Companies may request exemption from the barcoding requirement (Section 9).

SECTION 4. DEFINITIONS

.01 *Substitute Form*. A tax form (or related schedule) that differs in any way from the official version and is

intended to replace the entire form that is printed and distributed by the Service.

.02 *Computer-generated Substitute Form*. A tax return or form that is entirely designed and printed by the use of a computer printer, such as a laser printer, etc. on plain white paper. This return or form must conform to the physical layout of the corresponding Service form although the typeface may differ. The text should match the text on the officially printed form as closely as possible; condensed text and abbreviations will be considered on a case-by-case basis. Exception: All jurats (perjury statements) must be reproduced verbatim.

.03 *Computer-Prepared Substitute Form*. A preprinted form in which the taxpayer's tax entry information has been inserted by a computer, computer-printer or computer-type equipment, such as word-processing equipment.

.04 *Acceptable Reproduced Form*. A legible photocopy of an original form or of an unchanged reproduction proof supplied by the Service. (A reproduction proof is not a substitute form, but may subsequently be used as a computer-prepared substitute.)

SECTION 5. DOCUMENT PROCESSING SYSTEM

.01 The Service is modernizing its computer equipment to improve the efficiency of returns processing and provide improved customer service. This Tax Systems Modernization (TSM) includes the input of returns and attachments through DPS212.

.02 An integral part of DPS is the use of scanning equipment to capture return data. Templates will be designed for substitute forms, when these forms approximate the official form. This will allow the scanner to recognize forms developed by various sources.

.03 Substitute forms which duplicate published forms in graphic detail will be easier to develop templates for and will subsequently be processed more efficiently. Graphic detail includes all horizontal and vertical lines (or rules) as displayed on the officially-published form. Examples: the vertical line separating first and last name in the entity area or the horizontal lines where data is placed.

.04 If a submitted form varies significantly from the official form, so that a template cannot be easily devel-

oped, that form will not be approved. Examples of potential problems include the placement of data entry fields on the wrong page and extraneous graphics that interfere with data capture. Company logos are acceptable if they are not placed in close proximity to any data capture field.

.05 To aid the equipment in recognizing forms as they are fed into the scanner, the Service is adding barcodes to its documents.

.06 Documents will be phased into the system over a period of several years and barcodes will appear on the IRS-published forms as they are introduced to the system.

SECTION 6. BARCODES

.01 Barcodes for returns and attachments, other than Forms W-2 and the Form 1099 family, will be either seven in length using the 3 of 9 (or 39) format. The barcode must be positioned at least .5 inches from any edge of the paper. If possible, display the characters represented by the barcode. If these characters cannot be produced, display your three-character source code in the lower left corner on the first page of each document submitted for approval.

.02 A barcode is required on Forms 1040A and 8888 and Schedules 1, 2, 3, and EIC. The algorithm for the barcode is shown in Exhibit 1. A company that is not creating a substitute Form 1040A need not barcode Form 8888 or Schedule EIC for filing with Form 1040. Barcodes for Forms W-2 and the Form 1099 family are not required for tax year 1995 and will be covered in the appropriate revenue procedures.

.03 Barcodes will not appear for tax year 1995 on the official versions of other forms and schedules which may be associated with Form 1040A. However, we encourage creators of substitute forms to include barcodes on these forms as shown in Exhibit 1. Barcodes on these forms may be placed anywhere in the data capture area either horizontally or vertically. The Service prefers placement in the lower left corner as shown on Form 1040A.

.04 The barcode will be seven digits long as follows:

Digit 1 – version year and front or back of form

Digits 2 and 3 – form type

Digit 4 – version month or period

Digit 5 through 7 – source code

.05 The combination of digits 1 and 4 will indicate which version of a form is being used. If the form is reissued annually, *i.e.*, it has the tax year in the upper right corner, the first digit will indicate the tax year and the fourth digit will be “5”.

.06 If the form has a revision date under the form number, the first digit represents the year of revision and the fourth digit indicates the month. For example, the barcode for the front [page of a form revised in October 1995 will have a first digit of “5” and a fourth digit of “J”.

.07 Digits 5 through 7, the source code, replace the Forms Approval Number previously used by the Substitute Forms Program.

.08 An eighth digit, a page number code, will be used only for documents with more than two pages. This does not apply for tax year 1995 Forms 1040A as the forms scheduled for bar coding consist of no more than two pages.

SECTION 7. GENERAL REQUIREMENTS FOR APPROVAL

.01 Schedules are considered to be an integral part of a complete tax return when assigning consecutive page numbers and printed contiguously with page one of the return. However, Schedules 1, 2, and 3 of Form 1040A are examples of schedules that can be separately computer-generated. Although these schedules are published as part of the Form 1040A package, they are separate forms (*i.e.*, not part of the actual 1040A), and must be submitted as separate computer-generated substitute schedules.

.02 Things you cannot do to Internal Revenue Service Printed Tax Form 1040A to make it suitable for use as substitute tax form:

1 You cannot, without prior Service approval, change any Internal Revenue Service tax form or use your own (non-approved) versions, unless specifically permitted by this revenue procedure.

2 You cannot adjust any of the graphics on Form 1040A and subsequent forms/schedules without prior approval from the Service.

SECTION 8. APPROVAL

.01 Requests for Approval.

1 The Service cannot grant final approval of any substitute form until the official form has been published. However, the Service releases advance proof copies of selected major tax forms that are subject to further changes and OMB approval before their release in final format for printing and distribution to the public. We encourage submission of proposed substitutes of these advance proof forms, and will grant conditional approval based solely on these early proofs. These advance proofs are subject to significant change before forms are finalized. If these advance proofs are used as the basis for your substitute forms, you will be responsible for subsequently updating your final forms to agree with the final official version before use.

2 When specific approval of Form 1040A and related forms/schedules is desired, forward three original copies of the proposed substitutes to:

Internal Revenue Service
Attention: Substitute Forms Program Coordinator, T:FP:S 1111
Constitution Avenue N.W.
Room 2712 IR
Washington, DC 20224

This applies to all forms listed in Exhibit 1, whether or not the form is to include a barcode. If the entity area on your forms is not an exact graphical representation of the official form (*i.e.*, it is missing horizontal and vertical lines), submit a fourth copy of the form. On this copy of the forms, display non-sensitive data to aid in recognizing the data capture areas. To expedite this approval for DPS, please submit the proposed substitute Form 1040A and related forms separately from other substitute forms.

3 As no Service office except the one specifically mentioned above in Section 8.01.2, is authorized to approve substitute Form 1040A for DPS, unnecessary delay may result if forms are sent elsewhere for approval. All forms submitted to any other office must be forwarded to the appropriate office for formal control, review, and official approval. No IRS office is authorized to allow deviations from this revenue procedure.

4 The Service does not review or approve the logic of specific software programs, nor confirm the calculations entered on forms output from these programs that are submitted for approval. The accuracy of the program itself remains the responsibility of the

software package developer, distributor, and/or user. The Substitute Forms Program is concerned with the pre-filing quality review of the final forms output, produced by whatever means, that are expected to be processed by IRS submission centers.

SECTION 9. EXEMPTION FROM THE REQUIREMENTS FOR BARCODING

If the addition of barcodes to Form 1040A and related documents creates a

hardship on the creator of the substitute form, enclose a letter with the submission requesting exemption from this requirement. State the reason for the request. Requests for exemption will be handled on a case-by-case basis. If granted, an exemption is only in effect for one year.

SECTION 10. FILING FORM 1040A FOR DPS WITH THE SERVICE

Instruct the taxpayer to follow the

same instructions used for filing official forms. These instructions are in the taxpayer's tax package.

SECTION 11. EFFECT ON OTHER DOCUMENTS

This revenue procedure has no effect on any other document.

EXHIBIT 1

Algorithm for Seven Digit 3 of 9 Barcode for Form 1040A and Forms and Schedules Expected to Accompany Form 1040A

First Digit – Tax Year 1995 Forms ‘‘5’’ for front of form; ‘‘N’’ for back of form

Digits 2 and 3 – Form Type

Required for Approval

Optional Barcode

| <i>Form Type</i> | <i>Code</i> | <i>Form Type</i> | <i>Code</i> | <i>Form Type</i> | <i>Code</i> |
|------------------|-------------|------------------|-------------|------------------|-------------|
| 1040A | 1A | 911 | 01 | 8332 | 8F |
| 8888 | 8E | 1310 | 13 | 8379 | 83 |
| Sch. 1 | /1 | 2120 | 2B | 8606 | 86 |
| Sch. 2 | /2 | 2210 | 22 | 8615 | 8A |
| Sch. 3 | /3 | 2441 | 24 | 8815 | 88 |
| Sch. EIC | /E | 2688 | 26 | 8818 | 8B |
| | | 2848 | 28 | 8821 | 8C |
| | | 4868 | 48 | 8822 | 8D |
| | | 4852 | 4A | 9465 | 94 |
| | | 5498 | 54 | Sch. B | /B |
| | | 5754 | 57 | Sch. H | /H |
| | | 6251 | 62 | Sch. R | /R |

Form titles are shown in Exhibit 2.

Digit 4 – Version Code

Period or

Revision Date Code

Annual 5

All forms on this list are to be considered annual. Other version codes will be added as quarterly returns and infrequently revised forms and schedules are included for the DPS.

Digits 5 through 7 – Source Code

This is a three-character code which has been assigned or will be assigned to companies producing substitute forms.

Sample Barcode

Forms Referenced in Exhibit 1

| | |
|--------------|---|
| Form 1040A | U.S. Individual Income Tax Return |
| Form 8888 | Direct Deposit of Refund |
| Schedule 1 | Interest and Dividend Income for Form 1040A Filers |
| Schedule 2 | Child and Dependent Care Expenses for Form 1040A Filers |
| Schedule 3 | Credit for the Elderly of the Disabled for Form 1040A Filers |
| Schedule EIC | Earned Income Credit |
| Form 911 | Application for Taxpayer Assistance Order |
| Form 1310 | Statement of Person Claiming a Refund Due to Deceased Taxpayer |
| Form 2120 | Multiple Support Declaration |
| Form 2441 | Child and Dependent Care Expenses |
| Form 2688 | Application for Additional Extension of Time to File U.S. Individual Income Tax Return |
| Form 2848 | Power of Attorney and Declaration of Representative |
| Form 4868 | Application for Automatic Extension of Time to File U.S. Individual Income Tax Return |
| Form 4852 | Substitute for Form W-2, Wage and Tax Statement, or Form 1099-R, Distribution from Pensions |
| Form 5498 | Individual Retirement Arrangement Information |
| Form 5754 | Statement by Person(s) Receiving Gambling Wages |
| Form 6251 | Alternative Minimum Tax-Individuals |
| Form 8332 | Release of Claim to Exemption for Child of Divorced or Separated Parents |
| Form 8379 | Injured Spouse Claim and Allocation |
| Form 8606 | Nondeductible IRA Contributions, IRA Basis and Nontaxable IRA Distributions |
| Form 8615 | Tax for Children Under Age 14 Who Have Investment Income of more Than \$1,100 |
| Form 8815 | Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989 |
| Form 8818 | Optional Form to Record Redemption of Series EE U.S. Savings Bonds Issued After 1989 |
| Form 8821 | Tax Information Authorization |
| Form 8822 | Change of Address |
| Form 9465 | Installment Agreement Request |
| Schedule B | Interest and Dividend Deduction |
| Schedule H | Household Employment Taxes |
| Schedule R | Credit for the Elderly or Disabled |

Inclusion on this list of forms and schedules that are **not** supposed to be filed as attachments to Form 1040A does not imply that these forms are now acceptable as such. Filing of improper forms and schedules may delay processing of the return.

*26 CFR 601.601: Rules and regulations.
(Also Part I, §§ 103, 148.)*

Rev. Proc. 95-47

SECTION 1. PURPOSE

This revenue procedure sets forth the conditions under which an issuer of State or local bonds may make payments to the United States to reduce the yield on investments purchased with the proceeds of advance refunding bonds on a date when the issuer is unable to purchase United States Treasury securities—State and Local Government Series (“SLGS”) because the Department of the Treasury has suspended sales of SLGS.

SECTION 2. BACKGROUND

Section 103(a) of the Internal Revenue Code of 1986 provides that interest on a State or local bond is excludable from gross income. Section 103(b)(2) of the 1986 Code provides, however, that interest on an arbitrage bond is not excludable from gross income. Section 148(a) of the 1986 Code generally provides that a bond is an arbitrage bond if it is part of an issue any portion of the proceeds of which are reasonably expected (at the time of issuance of the bond) to be used directly or indirectly to acquire higher yielding investments. A bond is also an arbitrage bond if the issuer intentionally uses the proceeds for this purpose.

Section 1.148-5(b)(2) of the Income Tax Regulations provides that, for purposes of the yield restriction rules of § 148(a) of the 1986 Code, yield is computed separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individ-

ual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment. Yield restricted nonpurpose investments are treated as a separate class of investments.

Section 1.148-5(c) provides that certain payments may be made to the United States to reduce yield on an investment for purposes of § 148(a) of the 1986 Code. Section 1.148-5T(c)(3)-(ii) generally provides, however, that yield reduction payments may not be applied to investments allocable to gross proceeds of an advance refunding issue.

Section 1.148-10(g) provides that, notwithstanding any specific provision of §§ 1.148-1 through 1.148-11, the Commissioner may take any action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of § 148 of the 1986 Code.

SECTION 3. SCOPE

This revenue procedure applies to the determination of the amount of receipts from an investment that is purchased by an issuer on a date when the issuer is unable to purchase SLGS because the Department of the Treasury has suspended sales of SLGS. This revenue procedure applies only to proceeds allocable to an issue of State or local bonds that the issuer on the issue date reasonably expected to reinvest in SLGS having a zero percent yield and that arise from pre-existing yield-restricted investments. This revenue procedure applies for purposes of § 148(a) of the 1986 Code and § 103(c) of the Internal Revenue Code of 1954. References in this revenue procedure to § 148(a) of the 1986 Code include § 103(c) of the 1954 Code.

SECTION 4. PROCEDURE

.01 *Conditions to making special yield reduction payments.* For purposes of § 148(a), an issuer of State or local bonds may reduce the amount of receipts from an investment (an “alternative investment”) purchased with proceeds of the bonds by the amount of a payment made to the United States if the following requirements are satisfied:

(1) The alternative investment is purchased on a date when the issuer is unable to purchase SLGS in lieu of the alternative investment because the Department of the Treasury has suspended sales of SLGS.

(2) The issuer reasonably expected on the issue date of the bonds that it would use bond proceeds to purchase SLGS on a date described in section 4.01(1) of this revenue procedure.

(3) The maturity date of the alternative investment is not more than 90 days from the date of purchase of the alternative investment.

(4) The issuer exercises reasonable diligence to use the proceeds of the maturing alternative investment to purchase SLGS, if available, for the remainder of the term that was reasonably expected on the issue date.

(5) The payment to the United States is made not later than 180 days after the date of purchase of the alternative investment.

(6) The purchase price of the alternative investment does not exceed the fair market value of the alternative

investment, and the issuer maintains books and records relating to the establishment of the purchase price.

(7) The payment to the United States is equal to the difference between the purchase price of the alternative investment on the date of purchase and the amount of all receipts from the alternative investment.

.02 *Manner of making special yield reduction payments.* Except as otherwise provided in section 4.01 of this revenue procedure, payments made under this revenue procedure must be made in the same manner as yield reduction payments under § 1.148-5T(c)(2)(i). The following statement should be noted in the top margin of Form 8038-T: “Special Yield Reduction Payment Made Pursuant to Revenue Procedure 95-47.”

SECTION 5. EFFECTIVE DATE

This revenue procedure applies to a purchase of an investment that occurs on or after October 17, 1995.

26 CFR 601.602: Forms and instructions
(Also Part I, Sections 501, 6033.)

Rev. Proc. 95-48

SECTION 1. PURPOSE

This revenue procedure specifies two additional classes of organizations that are not required to file annual information returns on Form 990, Return of Organization Exempt From Income Tax. As described in section 4, these two classes of organizations are: (1) governmental units, and (2) affiliates of governmental units that are exempt from federal income tax under section 501(a) of the Internal Revenue Code. This revenue procedure supplements Rev. Proc. 83-23, 1983-1 C.B. 687.

SECTION 2. BACKGROUND

.01 Section 6033(a)(1) of the Code generally requires the filing of annual information returns by exempt organizations.

.02 Section 6033(a)(2)(A) of the Code provides certain mandatory exceptions to this filing requirement.

.03 Section 6033(a)(2)(B) of the Code provides discretionary exceptions from filing such returns where the Secretary “determines that such filing

is not necessary to the efficient administration of the internal revenue laws.”

.04 Section 1.6033-2(g)(6) of the Income Tax Regulations delegates authority to the Commissioner to excuse organizations from the filing requirement. It provides that “[t]he Commissioner may relieve any organization or class of organizations from filing, in whole or in part, the annual return required by [section 6033] where [the Commissioner] determines that such returns are not necessary for the efficient administration of the internal revenue laws.”

.05 Section 1.6033-2(g)(1) of the regulations provides a partial list of organizations that are not required to file annual returns either because they are excepted by statute or because the Commissioner has exercised the authority referred to in section 2.03. Rev. Proc. 83-23 provides a more complete list.

SECTION 3. ORGANIZATIONS EXCEPTED FROM FILING

.01 Pursuant to the authority of section 1.6033-2(g)(6) of the Income Tax Regulations, an organization that is either a “governmental unit” or an “affiliate of a governmental unit,” within the meaning of section 4, is not required to file Form 990.

.02 The exception from filing provided in section 3.01 applies to all tax years beginning after December 31, 1969, for which no Form 990 has been filed by the date of publication of this revenue procedure.

.03 This revenue procedure does not affect an organization’s obligation to file Form 990-T, Exempt Organization Business Income Tax Return. Thus, if an organization is required to file Form 990-T, it must continue to file that form, even though it is not required to file Form 990.

SECTION 4. “GOVERNMENTAL UNIT” AND “AFFILIATE OF A GOVERNMENTAL UNIT”

.01 For purposes of this revenue procedure, an organization is treated as a “governmental unit” if:

(a) It is a state or local governmental unit as defined in section 1.103-1(b) of the regulations;

(b) It is entitled to receive deductible charitable contributions as an organization described in section 170(c)(1) of the Code; or

(c) It is an Indian tribal government, or a political subdivision thereof, under sections 7701(a)(40) and 7871 of the Code.

.02 For purposes of this revenue procedure, an organization is treated as an "affiliate of a governmental unit" if it is described in section 501(c) of the Code and it meets the requirements of either section 4.02(a) or (b):

(a) It has a ruling or determination from the Service that:

(i) Its income, derived from activities constituting the basis for its exemption under section 501(c) of the Code, is excluded from gross income under section 115;

(ii) It is entitled to receive deductible charitable contributions under section 170(c)(1) of the Code, on the basis that contributions to it are "for the use of" governmental units; or

(iii) It is a wholly owned instrumentality of a state or a political subdivision thereof, for employment tax purposes (*see* sections 3121(b)(7) and 3306(c)(7) of the Code); or

(b) The organization does not have a ruling or determination described in section 4.02(a) but:

(i) It is either "operated, supervised, or controlled by" governmental units, or by organizations that are affiliates of governmental units, within the meaning of section 1.509(a)-4(g)(1)(i) of the regulations, or the members of the organization's governing body are elected by the public at large, pursuant to local statute or ordinance;

(ii) It possesses two or more of the affiliation factors listed in section 4.03; and

(iii) Its filing of Form 990 is not otherwise necessary to the efficient administration of the internal revenue laws.

.03 The following affiliation factors will be considered under paragraph (b)(ii) of section 4.02:

(a) The organization was created by one or more governmental units, organizations that are affiliates of governmental units, or public officials acting in their official capacity.

(b) The organization's support is received principally from taxes, tolls, fines, government appropriations, or fees collected pursuant to statutory authority. Amounts received as government grants or other contract payments are not qualifying support under this paragraph.

(c) The organization is financially accountable to one or more governmental units. This factor is present if the organization is (i) required to report to governmental unit(s), at least annually, information comparable to that required by Form 990; and (ii) is subject to financial audit by the governmental unit(s) to which it reports. A report submitted voluntarily by the organization does not satisfy clause (i). Also, reports and audits pursuant to government grants or other contracts do not alone satisfy this paragraph (c).

(d) One or more governmental units, or organizations that are affiliates of governmental units, exercise control over, or oversee, some or all of the organization's expenditures (although it is not financially accountable to governmental units as described in paragraph (c) of this section).

(e) If the organization is dissolved, its assets will (by reason of a provision in its articles of organization or by operation of law) be distributed to one or more governmental units, or organizations that are affiliates of governmental units within the meaning of section 4 of this revenue procedure.

.04 In making a ruling or determination whether the organization's filing of Form 990 is otherwise necessary to the efficient administration of the internal revenue laws under section 4.02(b)(iii), all relevant facts and circumstances shall be considered. Relevant facts and circumstances suggesting that filing is necessary for efficient tax administration include the extent to which the organization has taxable subsidiaries or participates in joint ventures with non-exempt entities; whether it engages in substantial public fund-raising efforts; and whether its activities provide significant benefits to private interests.

SECTION 5. RULINGS AND DETERMINATION LETTERS

.01 An organization may request a ruling described in section 4.02(a) pursuant to Rev. Proc. 95-1, 1995-1 C.B. 313. The appropriate user fee must be paid (currently, \$3,575, pursuant to Rev. Proc. 95-1, Appendix A, 53).

.02 An organization that has been recognized as exempt under section 501 of the Code may (but is not required to) request a ruling or determination that it meets the requirements to be excepted from filing Form 990 as

a "governmental unit" or an "affiliate of a governmental unit." The request for a ruling or determination must be submitted under the procedures in Rev. Proc. 95-4, 1995-1 C.B. 397. The appropriate user fee must be paid (currently, \$100 for a ruling, pursuant to Rev. Proc. 95-8, § 6.11(4), 1995-1 C.B. 485).

.03 An organization seeking recognition of exempt status under section 501 of the Code may request a determination that it meets the requirements to be excepted from filing Form 990 as a "governmental unit" or an "affiliate of a governmental unit," by submitting information required by line 9 of Part I of Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code or submitting a separate written request with its application for recognition of exemption. See Rev. Proc. 90-27, 1990-1 C.B. 514, for additional procedures with regard to applications for recognition of exemption.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 83-23 is hereby supplemented.

26 CFR 601.602: Tax forms and instructions. (Also Part I, Sections 6012, 6061; 1.6012-5, 1.6061-1.)

Rev. Proc. 95-49

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SECTION 1. PURPOSE

This revenue procedure informs those who participate in the 1996 Electronic Filing Program for Form 1040 and Form 1040A, U.S. Individual Income Tax Return, and Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents, of their obligations to the Internal Revenue Service, taxpayers, and other participants. This revenue procedure updates Rev. Proc. 94-63, 1994-2 C.B. 785.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 1.6012-5 of the Income Tax Regulations provides that the Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in 26 CFR Part 1 (Income Tax), subject to the conditions, limitations, and special rules governing

the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.02 For purposes of this revenue procedure, an electronically filed Form 1040, Form 1040A, or Form 1040EZ is a composite return consisting of electronically transmitted data and certain paper documents. The nonelectronic portion of the return consists of Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing, and other paper documents that cannot be electronically transmitted. Form 8453 must be received by the Service before any electronically filed return is complete. An electronically filed return must contain the same information that a return filed completely on paper contains. See section 7 for procedures for completing Form 8453.

.03 The Service will periodically issue a publication that lists the forms and schedules associated with a Form 1040 that can be electronically transmitted.

.04 A Form 1040, a Form 1040A, or a Form 1040EZ cannot be electronically filed after October 15, 1996, notwithstanding the fact that the taxpayer has been granted an extension to file a return beyond that date.

.05 An amended tax return cannot be electronically filed. A taxpayer must file an amended tax return on paper in accordance with the instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

.06 A tax return that has a foreign address for the taxpayer cannot be electronically filed. Army/Air Force (APO) and Fleet (FPO) post offices are not considered foreign addresses.

.07 A tax return for a decedent cannot be electronically filed. The decedent's spouse or personal representative must file a paper tax return for the decedent.

.08 This revenue procedure updates Rev. Proc. 94-63, which applied to the Electronic Filing Program for the 1995 filing season. The updates include changes in the Electronic Filing Program for the 1996 filing season, clarifications of prior Electronic Filing Program statements, and additional guidance derived from other Service documents that relate to the Electronic Filing Program. Some of the updates are:

(1) an ERO must not have a foreign address (section 4.02);

(2) additions to the reasons to submit a revised Form 8633 (section 4.04);

(3) certain officers of publicly held corporations and bank officials may not need to submit fingerprints with their applications (section 4.10);

(4) an ERO or a Service Bureau must input each taxpayer address that appears on wage and tax documentation if the address differs from the taxpayer's address on Form 1040 (section 5.04);

(5) an Electronic Filer must tell the Service when it stops electronic filing (section 5.07);

(6) modifications to the procedures for completing Form 8453 when a paid preparer prepared the return (section 5.11);

(7) an ERO must ensure against the unauthorized use of its CPIN(s) (section 5.12);

(8) additions to the list of wage and tax documentation that are required before February 15, 1996 (section 5.13);

(9) within 24 hours of receiving an acknowledgement that a return has been rejected, an ERO must notify the taxpayer that the Service has rejected the return (section 5.14);

(10) a Service Bureau must ensure against the unauthorized use of its SBIN(s) (section 5.16(10));

(11) additional restrictions on addresses that may be used on Form 8453 and in the electronic portion of the return (section 7.01(3));

(12) an ERO's obligation to provide a taxpayer with a copy of the taxpayer's return is clarified (section 8.01);

(13) taxpayer inquiries regarding the status of returns should be referred to the local district office Tele-Tax number (section 8.05);

(14) Electronic Filers must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting (section 12.02);

(15) the effect of suspending a "Principal" or "Responsible Official" on entities that listed the "Principal" or "Responsible Official" on their Forms 8633 (section 13.02);

(16) clarification of the two-year period for denial or suspension (section 13.10);

(17) modifications to the administrative review processes for denials and suspensions (sections 14 and 15); and

(18) modifications to the VITA and TCE programs (section 16).

SECTION 3. ELECTRONIC FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the Electronic Filing Program, as described in section 4, a participant is referred to as an “Electronic Filer.”

.02 An Electronic Filer is categorized as follows:

(1) **ELECTRONIC RETURN ORIGINATOR.** An “Electronic Return Originator” (ERO) is either: (a) an “Electronic Return Preparer” who prepares tax returns, including Forms 8453, for taxpayers who intend to have their returns electronically filed; or (b) an “Electronic Return Collector” who accepts completed tax returns, including Forms 8453, from taxpayers who intend to have their returns electronically filed.

(2) **SERVICE BUREAU.** A “Service Bureau” receives tax return information on any media from an ERO, formats the return information, and either forwards the return information to a Transmitter or sends back the return information to the ERO. A Service Bureau may or may not process Forms 8453 and send them to the appropriate service center. A Service Bureau does not transmit returns directly to the Service.

(3) **SOFTWARE DEVELOPER.** A “Software Developer” develops software for the purposes of (a) formatting returns according to the Service’s electronic return specifications; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

(4) **TRANSMITTER.** A “Transmitter” transmits the electronic portion of a return directly to the IRS Data Communications Subsystem. An entity that provides a “bump-up” service is a Transmitter. A “bump-up” service provider increases the transmission rate or line speed of formatted or reformatted information that is being sent to the Service via a public switched telephone network. For example, a bump-up service provider may increase the transmission rate or line speed of information from 4800 bits per second (BPS) to 9600 BPS. Service specifications for electronic filing require an asynchronous speed of 300 BPS to 19,200 BPS or a bisynchronous speed of 4800 BPS to 19,200 BPS.

.03 The Electronic Filer categories are not mutually exclusive. For example, an ERO can, at the same time, be

considered a Transmitter, Software Developer, or Service Bureau depending on the function(s) performed.

.04 An electronic filing controlled office: (1) is an office in which an Electronic Filer has an ownership interest; (2) uses hardware, software, and transmission services supplied by an Electronic Filer; (3) receives income tax returns for electronic filing; and (4) has direct contact with taxpayers. At a minimum, direct contact includes verifying dollar amounts, routing transit numbers, and depositor account numbers on Forms 8453. A controlled office may or may not be open all year.

.05 An Electronic Filer may have a drop-off collection point(s). The activity at a drop-off collection point is limited solely to receiving a return that a taxpayer wants to have electronically filed and collecting a fee for electronically filing that return. Although the Electronic Filer may not have an ownership interest in the drop-off collection point, the Electronic Filer may have a written or oral agreement with an entity on that site that relates to electronic filing.

SECTION 4. ACCEPTANCE IN THE ELECTRONIC FILING PROGRAM

.01 For applicants described in section 4.03 of this revenue procedure, the application period begins on August 1, 1995, and ends on December 1, 1995. Revised applications described in section 4.04 of this revenue procedure must be submitted within 14 days of the change(s) reflected on the revised Form 8633, Application to Participate in the Electronic Filing Program.

.02 If an Electronic Filer has a foreign location, that location must list an APO or FPO address on Form 8633, line 1r.

.03 Applicants must file a new Form 8633 with fingerprint cards for the appropriate individuals if:

(1) the applicant has never actively participated in the electronic filing program;

(2) the applicant has previously been denied participation in the Electronic Filing Program; or

(3) the applicant has been suspended from the Electronic Filing Program.

.04 Participants in the 1995 Electronic Filing Program must submit a revised Form 8633 to participate in the 1996 Electronic Filing Program if:

(1) the participant functioned solely as a Software Developer during the 1995 Electronic Filing Program and intends to function as an ERO, Service Bureau, or Transmitter during the 1996 Electronic Filing Program;

(2) there is an additional principal, such as a partner or a corporate officer, that must be listed on Form 8633, line 1k(1), “Principals of Your Firm or Organization”;

(3) there is a “Principal” listed on Form 8633, line 1k(1), that should be deleted;

(4) the “Responsible Official” on Form 8633, line 1k(2), changes; or

(5) there is any change to:

(a) the Firm name or Doing Business As (DBA) name;

(b) the business or mailing address;

(c) the contact representative or the alternate contact representative’s name or telephone number;

(d) the Electronic Filer’s form of organization, as described on Form 8633, line 1k;

(e) the electronic functions performed by an Electronic Filer, other than an Electronic Filer who functions solely as a Software Developer; or

(f) the number or location(s) of drop-off collection points.

.05 A Form 8633 submitted pursuant to section 4.04 (l) through (4) of this revenue procedure must have completed fingerprint cards attached for the appropriate individual(s). All “Principals” and the “Responsible Official” must sign the Form 8633.

.06 A Form 8633 submitted pursuant to section 4.04(5) of this revenue procedure needs to include only entries on lines 1a through 1i and the information being revised. A “Principal” or “Responsible Official” must sign the Form 8633.

.07 To be accepted into the 1996 Electronic Filing Program, an applicant or a 1995 Electronic Filing Program participant who is described in section 4.04(1) through (4) of this revenue procedure must:

(1) file a properly completed Form 8633 with the service center that accepts electronically filed returns from the applicant’s state; and

(2) successfully complete the necessary testing at the appropriate service center(s) if the applicant intends to function as a Transmitter or Software Developer.

.08 Each individual listed as a principal or a responsible official must:

(1) be a United States citizen or an alien admitted for lawful permanent residence as described in 8 U.S.C. § 1101(a)(20) (1988);

(2) have attained the age of 21 as of the date of application;

(3) submit with Form 8633 one standard fingerprint card with a full set of fingerprints taken by a law enforcement agency, except as provided in section 4.10 of this revenue procedure;

(4) pass a suitability check that includes a credit check and a fingerprint check; and

(5) if applying to be an ERO, meet state and local licensing and/or bonding requirements in connection with the preparation of tax returns and the collection of prepared returns that taxpayers intend to have electronically filed. However, if the state and local licensing and/or bonding requirements apply to a business entity, the individual(s) must demonstrate that the business entity meets the requirements.

.09 The same "responsible official" may be listed on a maximum of ten applications. The "responsible official" is the person who oversees the daily operations of the office. The "responsible official" must be able to physically visit on a daily basis each office for which he or she is listed as the "responsible official."

.10 An individual may choose to submit evidence of the individual's professional status in lieu of one standard fingerprint card if the individual is:

(1) an attorney in good standing of the bar of the highest court of any State, possession, territory, Commonwealth, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service;

(2) a certified public accountant who is duly qualified to practice as a certified public accountant in any State, possession, territory, Commonwealth, or the District of Columbia and is not currently under suspension or disbarment from practice before the Service;

(3) an enrolled agent pursuant to part 10 of 31 CFR Subtitle A;

(4) an officer of a publicly held corporation; or

(5) a banking official who is bonded and has been fingerprinted within the last two years.

.11 The Service will issue to eligible applicants for the 1996 Electronic Filing Program, as well as participants in the 1995 Electronic Filing Program who do not have to reapply pursuant to section 4.04 of this revenue procedure:

(1) a letter of acceptance into the Electronic Filing Program for the 1996 filing season;

(2) an Electronic Filing Identification Number (EFIN); (3) if appropriate, an Electronic Transmitter Identification Number (ETIN);

(4) if appropriate, a Service Bureau Identification Number (SBIN); and

(5) if appropriate, a Collection Point Identification Number (CPIN). No one without these credentials may participate in the Electronic Filing Program for the 1996 filing season.

.12 If an Electronic Filer is a Software Developer who performs no other function in the Electronic Filing Program but software development, no principal or responsible official needs to pass a suitability check.

.13 If an Electronic Filer will have a drop-off collection point(s), as defined in section 3.05, for the 1996 filing season, an Electronic Filer must submit a Form 8633 that lists each drop-off collection point. By listing a drop-off collection site on Form 8633, an Electronic Filer becomes a "parent" in relation to a listed drop-off collection point.

.14 The following reasons may result in the rejection of an application to participate in the 1996 Electronic Filing Program (this list is not all-inclusive):

(1) conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust;

(2) failure to file timely and accurate business or personal tax returns;

(3) failure to timely pay personal or business tax liabilities;

(4) assessment of penalties;

(5) suspension/disbarment from practice before the Service;

(6) other facts or conduct of a disreputable nature that would reflect adversely on the Electronic Filing Program;

(7) misrepresentation on an application;

(8) suspension or rejection from the program in a prior year;

(9) unethical practices in return preparation;

(10) stockpiling returns prior to official acceptance into the Electronic Filing Program (see section 5.15);

(11) knowingly and directly or indirectly employing or accepting assistance from any person who has been denied acceptance into the Electronic Filing Program or is suspended from the Electronic Filing Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program; or

(12) knowingly and directly or indirectly accepting employment as an associate, correspondent, or as a sub-agent from, or sharing fees with, any person who has been denied acceptance into the Electronic Filing Program or is suspended from the Electronic Filing Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Electronic Filing Program.

SECTION 5. RESPONSIBILITIES OF AN ELECTRONIC FILER

.01 To ensure that complete returns are accurately and efficiently filed, an Electronic Filer must comply with all the publications and notices of the Service. Currently, these publications and notices include:

(1) Handbook for Electronic Filers of Individual Income Tax Returns, Publication 1345;

(2) Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns, Publication 1346;

(3) Test Package for Electronic Filing of Individual Income Tax Returns, Publication 1436; and

(4) Electronic Filing System Bulletin Board (EFS Bulletin Board).

.02 An Electronic Filer must maintain a high degree of integrity, compliance, and accuracy.

.03 An Electronic Filer may only accept returns for electronic filing directly from taxpayers, from drop-off collection sites accurately identified on Form 8633, or from another Electronic Filer.

.04 If the taxpayer's address on a Form W-2, Wage and Tax Statement, Form W-2G, Statement for Recipients of Certain Gambling Winnings, Form 1099-R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing

Plans, IRAs, Insurance Contracts, etc., Form 1040, Schedule C, Profit or Loss From Business (Sole Proprietorship), or Form 1040, Schedule C-EZ, Profit or Loss From Business—Short Version, or any other tax form is different than the taxpayer's address in the entity section of the electronic portion of the taxpayer's Form 1040, the ERO or the Service Bureau must input for transmission to the Service those addresses that differ from the taxpayer's address on the electronic portion of the taxpayer's Form 1040.

.05 If an Electronic Filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or on the amount of taxes saved. An Electronic Filer may not charge a separate fee for Direct Deposit. See section 9 of this revenue procedure.

.06 An Electronic Filer who has been accepted into the 1996 Electronic Filing Program must submit a revised Form 8633 to the appropriate service center when any of the conditions or changes described in section 4.04 of this revenue procedure occur.

.07 An Electronic Filer must notify the service center where the Electronic Filer filed its Form 8633 within 14 days of discontinuing its participation in the Electronic Filing Program.

.08 An Electronic Filer must ensure that an electronic return is filed on or before the due date of the return. A tax return is not considered filed until the electronic portion of the tax return has been acknowledged as accepted for processing and a completed and signed Form 8453 has been received by the Service. However, if the electronic portion of a return is successfully transmitted on or shortly before the due date and the Electronic Filer complies with section 7.01 of this revenue procedure, the return will be deemed timely filed. If the electronic portion of a return is initially transmitted on or shortly before the due date and is ultimately rejected, but the Electronic Filer complies with section 5.14 of this revenue procedure, the return will be deemed timely filed. In the case of a balance due return, see section 11 of this revenue procedure for instructions on how to make a timely payment of tax.

.09 An Electronic Filer who functions as an ERO must:

(1) comply with the procedures for completing and securing Forms 8453

described in section 7 of this revenue procedure;

(2) comply with the procedures described in section 11 of this revenue procedure for handling a balance due return;

(3) while returns are being filed, retain and, if requested, make available to the Service the following material at the business address from which a return was accepted for electronic filing:

(a) a copy of the signed Form 8453 and Forms W-2, W-2G, and 1099-R;

(b) a complete copy of the electronic portion of the return (may be retained on magnetic media) that can be readily and accurately converted into an electronic transmission that the Service can process; and

(c) the acknowledgement file received from the Service or from a third party Transmitter; and

(4) retain until the end of the calendar year in which a return was filed, and, if requested, make available to the Service the materials described in section 5.09(3) of this revenue procedure at either the business address from which a return was electronically filed or from the contact person named on Form 8633.

.10 An ERO who is the paid preparer of an electronic tax return must also retain for the prescribed amount of time the materials described in § 1.6107-1(b) that are required to be kept by an income tax return preparer.

.11 An ERO must identify the paid preparer (if any) in the appropriate field of the electronic return, in addition to ensuring that the paid preparer signed Form 8453. If Form 8453 is not signed by the paid preparer, the ERO must attach a copy of the Form 1040EZ signed by the paid preparer below the taxpayer's signature or pages one and two of Form 1040A or Form 1040 that includes the paid preparer's signature. These copies must be marked "COPY-DO NOT PROCESS" to prevent duplicate filings.

.12 An ERO must ensure against the unauthorized use of its EFIN and, if applicable, the CPIN(s) issued to its drop-off collection point(s). An ERO must not transfer its EFIN or the CPIN(s) of its drop-off collection point(s) by sale, merger, loan, gift, or otherwise to another entity.

.13 An ERO must not electronically file or otherwise transfer to a Service Bureau or a Transmitter, a return

before February 15, 1996, without a Form W-2, Form W-2G, or Form 1099 R. A paycheck stub, a substitute Form W-2, or any other form of substitute wage and tax documentation is unacceptable before February 15.

.14 If the electronic portion of a taxpayer's return is acknowledged as rejected by the Service, and the reason for the rejection cannot be rectified by the actions described in section 6.02(3), the ERO, within 24 hours of receiving the rejection, must take all reasonable steps to tell the taxpayer that the taxpayer's return has not been filed. When the ERO advises the taxpayer that the taxpayer's return has not been filed, the ERO must provide the taxpayer with the reject code(s), an explanation of the reject code(s), and the sequence number of each reject code(s). If the taxpayer chooses not to have the previously rejected return retransmitted or if the return cannot be accepted for processing, the taxpayer must file a paper return by the later of:

(1) the due date of the return; or

(2) within ten calendar days of the Service's acknowledgement that the return is rejected or the notice that the return cannot be retransmitted with an explanation of why the return is being filed after the due date.

.15 An ERO is responsible for ensuring that stockpiling does not occur at its office(s) or drop-off collection point(s). Stockpiling means collecting returns from taxpayers or from another Electronic Filer prior to official acceptance into the Electronic Filing Program, or, after official acceptance into the Electronic Filing Program, waiting more than three calendar days to transmit a return to the Service after receiving the information necessary for an electronic transmission of a tax return.

.16 An Electronic Filer who functions as a Service Bureau must:

(1) deliver all electronic returns to a Transmitter or to the ERO who gave the electronic returns to the Service Bureau within three calendar days of receipt;

(2) retrieve the acknowledgement file from the Transmitter within one calendar day of receipt by the Transmitter;

(3) initiate the communication of the acknowledgement file to the ERO (whether related or not) within one work day of retrieving the acknowledgement file;

(4) if the Service Bureau processes Forms 8453, send back to the ERO any return and Form 8453 that needs correction, unless the correction is described in section 6.02(3);

(5) accept tax return information only from an ERO who is in good standing in the Electronic Filing Program;

(6) include its SBIN and the ERO's EFIN with all return information the Service Bureau forwards to a Transmitter or sends back to an ERO;

(7) retain each acknowledgement file received from a Transmitter until the end of the calendar year in which the electronic return was filed;

(8) if requested, serve as a contact point between its client EROs and the Service;

(9) if requested, provide the Service with a list of each client ERO; and

(10) ensure against the unauthorized use of its SBIN. A Service Bureau must not transfer its SBIN by sale, merger, loan, gift, or otherwise to another entity.

.17 An Electronic Filer who functions as a Transmitter must:

(1) transmit all electronic returns within three calendar days of receipt, retrieve the acknowledgement file within two work days of transmission, and initiate the communication of the acknowledgement file to the ERO or the Service Bureau (whether or not the ERO or the Service Bureau are related to the Transmitter) within two work days of retrieving the acknowledgement file;

(2) match the acknowledgement file to the original transmission file and resubmit those returns that are not acknowledged as accepted for processing after corrections are made;

(3) if an acknowledgement of acceptance for processing has not been received by the Transmitter within two work days of transmission or if a Transmitter receives an acknowledgement for a return that was not transmitted on the designated transmission, the Transmitter must immediately contact the Electronic Filing Unit at the appropriate service center for further instructions;

(4) if a return has been rejected after three transmission attempts, the Transmitter must contact the appropriate service center Electronic Filing Unit for assistance;

(5) ensure the security of all transmitted data;

(6) promptly correct any transmission error that causes an electronic return to be rejected;

(7) retain an acknowledgement file received from the Service until the end of the calendar year in which the electronic return was filed;

(8) ensure against the unauthorized use of its EFIN or ETIN. A Transmitter must not transfer its EFIN or ETIN by sale, merger, loan, gift, or otherwise to another entity; and

(9) not use software that has a Service assigned production password built into the software.

.18 A Transmitter who provides transmission services to other unrelated Electronic Filers must only accept electronic returns for transmission to the IRS Data Communications Subsystem from accepted Electronic Filers. A Transmitter must include the ERO's EFIN and if applicable, the CPIN on each return that the Transmitter accepts from an ERO. In addition, a Transmitter must also include a Service Bureau's SBIN if a Service Bureau formats the return information.

.19 An Electronic Filer who functions as a Software Developer must:

(1) promptly correct any software error which causes an electronic return to be rejected;

(2) promptly distribute any software correction;

(3) ensure that any software package that will be used to transmit any returns from multiple Electronic Filers has the capability of combining returns from these Electronic Filers into one Service transmission file taking into account the sorting requirements of the Declaration Control Number (DCN);

(4) ensure that no other entity uses the Software Developer's EFIN or ETIN. A Software Developer must not transfer by sale, merger, loan, gift, or otherwise its EFIN or ETIN to another entity; and

(5) not incorporate into its software a Service assigned production password.

.20 An Electronic Filer with a drop-off collection point is the ERO for that drop-off collection point. The ERO must clearly display its name at each drop-off collection point. The Service will hold the ERO responsible for any violation of the advertising standards described in section 12 or any other violation of this revenue procedure that occurs at a drop-off collection point

listed on the ERO's Form 8633. The ERO must also serve as the contact point between the Service and the drop-off collection point for all correspondence including problem resolution and report evaluation.

.21 In addition to the specific responsibilities described in this section, an Electronic Filer must meet all the requirements of this revenue procedure to keep the privilege of participating in the Electronic Filing Program.

SECTION 6. PENALTIES

.01 Penalties for Disclosure or Use of Information.

(1) An Electronic Filer, except a Software Developer, is a tax return preparer (Preparer) under the definition of § 301.7216-1(b) of the Regulations on Procedure and Administration. A Preparer is subject to a criminal penalty for disclosure or use of tax return information, as described in § 301.7216-1(a). In general, that regulation provides that any preparer who discloses or uses any tax return information for a purpose other than preparing, assisting in preparing, or obtaining or providing services in connection with the preparation of a tax return is guilty of a misdemeanor. In addition, § 6713 of the Internal Revenue Code provides for civil penalties that may be assessed against a preparer who makes an unauthorized disclosure or use of tax return information.

(2) Under § 301.7216-2(h), disclosure of tax return information among accepted Electronic Filers for the purpose of preparing a return is permissible. For example, it is permissible for an ERO to pass on tax return information to a Service Bureau and/or a Transmitter for the purpose of having an electronic return formatted and transmitted to the Service. However, if the tax return information is disclosed or used in any other way, a Service Bureau and/or a Transmitter may be guilty of a misdemeanor as described in section 6.01(1) of this revenue procedure.

.02 Other Preparer Penalties.

(1) Preparer penalties may be asserted against an individual or firm who meets the definition of an income tax return preparer under § 7701(a)(36) and § 301.7701-15. Examples of preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in §§ 6694, 6695, and 6713.

(2) Under § 301.7701-15(d), Electronic Return Collectors, Service Bureaus, Transmitters, and Software Developers are not income tax return preparers for the purpose of assessing most preparer penalties as long as their services are limited to “typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund.”

(3) If an Electronic Return Collector, Service Bureau, Transmitter, or Software Developer alters the return information in a nonsubstantive way, this alteration will be considered to come under the “mechanical assistance” exception described in § 301.7701-15(d)-(1). A nonsubstantive change is a correction or change limited to a transposition error, misplaced entry, spelling error, or arithmetic correction that falls within the following tolerances:

(a) the Total Tax amount, Withholding amount, Refund amount, or Amount Owed shown on Form 8453 differs from the corresponding amount on the electronic portion of the tax return by no more than \$7;

(b) the Total Income amount shown on Form 8453 differs from the corresponding amount on the electronic portion of the tax return by no more than \$25; or

(c) dropping cents and rounding to whole dollars.

(4) If an Electronic Return Collector, Service Bureau, or Transmitter alters the return information in a substantive way, rather than having the taxpayer alter the return, the Electronic Return Collector, Service Bureau, or Transmitter will be considered to be an income tax return preparer for purposes of § 7701(a)(36).

(5) If an Electronic Return Collector, Service Bureau, or Transmitter, or the product of a Software Developer, goes beyond mechanical assistance, any of these parties may be held liable for income tax return preparer penalties. Rev. Rul. 85-189, 1985-2 C.B. 341, describes a situation where a Software Developer was determined to be an income tax return preparer and subject to certain preparer penalties.

.03 In addition to the above specified provisions, the Service reserves the right to assert all appropriate preparer, nonpreparer, and disclosure penalties against an Electronic Filer as warranted under the circumstances.

SECTION 7. FORM 8453, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ELECTRONIC FILING

.01 Procedures for Completing Form 8453.

(1) Form 8453 must be completed in accordance with the instructions for Form 8453.

(2) The taxpayer(s)'s name, address, social security number(s), tax return information, and direct deposit of refund information in the electronic transmission must be identical to the information on the Form 8453 that the taxpayer(s) signed and provided for submission to the Service.

(3) An Electronic Filer, a financial institution, or any other entity associated with the electronic filing of a taxpayer's return must not put its address in the section reserved for the taxpayer's address on Form 8453 or anywhere in the electronic portion of a return.

(4) After the return has been prepared and before the return is electronically transmitted, the taxpayer must verify the information on the electronic portion of the return and on Form 8453, and must sign Form 8453. The taxpayer may verify the information on the electronic portion of the return by viewing this information on a computer display terminal. Both spouses' signatures are required on a joint return prior to the electronic transmission of the tax return. An easily readable paper copy of the prepared return must be provided to the taxpayer at the time of signature.

(5) An Electronic Filer must submit the taxpayer's Form 8453 to the appropriate service center within one work day after the Electronic Filer receives acknowledgment that the electronic portion of the taxpayer's return has been accepted for processing.

(6) If an Electronic Filer functions as an ERO, the Electronic Filer must sign the ERO's Declaration on Form 8453.

(7) If the ERO is also the paid preparer, the ERO must check the “Paid Preparer” box and sign the ERO Declaration on Form 8453.

.02 Corrections to Form 8453.

(1) A new Form 8453 is not required for a nonsubstantive change. A nonsubstantive change is limited to a correction that does not exceed the tolerances, described in section 7.02(2) of this revenue procedure for arithmetic errors, a transposition error, a mis-

placed entry, or a spelling error. The incorrect nonsubstantive information must be neatly lined through on the Form 8453 and the correct data entered next to the lined-through entry. Also, the person making the correction must initial the correction.

(2) The tolerances for section 7.02(1) of this revenue procedure are:

(a) the “Total Income” does not differ from the amount on the electronic tax return by more than \$25; or

(b) the “Total Tax”, the “Federal income tax withheld”, the “Refund”, or the “Amount you owe” does not differ from the amount on the electronic portion of the tax return by more than \$7.

(3) If the ERO makes a substantive change to the electronic portion of the return after Form 8453 has been signed by the taxpayer, but before it is transmitted, the ERO must have all the necessary parties described above sign a new Form 8453 that reflects the corrections before the return is transmitted.

(4) Dropping cents or rounding to whole dollars does not constitute a substantive change or alteration to the return unless the amount differs by more than the above tolerances. All rounding should be accomplished in accordance with the instructions in the Form 1040 tax package.

.03 If the Service determines that a Form 8453 is missing, the ERO must provide the Service with a replacement. The ERO must also provide a copy of the Form(s) W-2, W-2G, 1099R, and all other attachments to Form 8453.

.04 If a substitute Form 8453 is used, it must be approved by the Service prior to use. See Rev. Proc. 95-16, 1995-1 C.B. 525.

SECTION 8. INFORMATION AN ELECTRONIC FILER MUST PROVIDE TO THE TAXPAYER

.01 The ERO must furnish the taxpayer with a complete paper copy of the taxpayer's return. A complete copy of a taxpayer's return includes a copy of the taxpayer's completed Form 8453, the nonelectronic portion of a return, and a print out of the electronic portion of the return. This information can be contained on a replica of an official form or on an unofficial form. However, on an unofficial form, data entries must be referenced to the line numbers on an official form.

.02 The ERO must advise the taxpayer to retain a complete copy of the return and any supporting material.

.03 The ERO must advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center that would handle the taxpayer's paper return.

.04 The ERO must, upon request, provide the taxpayer with the Document Control Number and the date the electronic portion of the taxpayer's return was acknowledged as accepted for processing by the Service.

.05 If a taxpayer inquires about the status of a tax return, the ERO must advise the taxpayer to call the local IRS district office Tele-Tax number. The ERO should also advise the taxpayer to wait at least three weeks from the acceptance date of the electronic return before calling the local IRS district office Tele-Tax number.

.06 If a taxpayer chooses to use an address other than his or her home address on the return, the Electronic Filer must inform the taxpayer that the address on the return will become the taxpayer's "last known address" for all purposes of the Internal Revenue Code. This means that all future written communications from the Service to the taxpayer will be sent to the address on the return rather than the taxpayer's home address. In particular, the Service is required to send the following notices to a taxpayer's "last known address":

(1) formal document request for the production of foreign-based documentation (§ 982(c)(1));

(2) notification of disclosure proceedings (§ 6110(f)(3)(B));

(3) notice of deficiency (§ 6212(b));

(4) notice and demand for tax (§ 6303(a));

(5) notice of revocation of certification of release or nonattachment of a lien (§ 6325(f)(2)(A));

(6) notice of intention to levy (§ 6331(d)(2)(C));

(7) copy of notice of levy with respect to a life insurance or endowment contract (§ 6332(b)(1));

(8) notice of seizure and sale (§ 6335(a) and (b));

(9) notice of liability in transferee cases (§ 6901(g)); and

(10) notice of third-party summons (§ 7609(a)(2)).

See Rev. Proc. 90-18, 1990-1 C.B. 491, for additional information about "last known address."

SECTION 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service will ordinarily process a request for Direct Deposit but reserves the right to issue a paper refund check.

.02 The Service does not guarantee a specific date by which a refund will be directly deposited into the taxpayer's financial institution account.

.03 Neither the Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error, negligence, or malfeasance on the part of the taxpayer, Electronic Filer, financial institution, or any of their agents.

.04 An ERO must:

(1) ensure that the taxpayer is aware of all the general information regarding a Direct Deposit;

(2) not charge a separate fee for a Direct Deposit;

(3) accept any Direct Deposit election to any eligible financial institution designated by the taxpayer;

(4) ensure that the taxpayer is eligible to choose Direct Deposit;

(5) verify that the taxpayer has entered the Direct Deposit information requested on Part II of Form 8453 correctly and that the information entered is the information transmitted with the electronic portion of the return;

(6) caution the taxpayer that once an electronic return has been accepted for processing by the Service:

(a) the Direct Deposit election cannot be rescinded;

(b) the Routing Transit Number (RTN) of the financial institution cannot be changed; and

(c) the taxpayer's account number cannot be changed; and

(7) advise the taxpayer of the procedures to be followed if there is a need to contact the Service about a Direct Deposit request.

SECTION 10. REFUND ANTICIPATION LOANS

.01 A Refund Anticipation Loan (RAL) is money borrowed by a taxpayer that is based on a taxpayer's anticipated income tax refund. The Service has no involvement in RALs. A RAL is a contract between the taxpayer and the lender.

.02 Any entity that is involved in the Electronic Filing Program, including a financial institution that accepts direct deposits of income tax refunds, has an obligation to every taxpayer who applies for a RAL to clearly explain to the taxpayer that a RAL is in fact a loan, and not a substitute for or a quicker way of receiving an income tax refund. An Electronic Filer must advise the taxpayer that if a Direct Deposit is not timely, the taxpayer may be liable to the lender for additional interest on the RAL.

.03 An Electronic Filer may assist a taxpayer in applying for a RAL.

.04 An Electronic Filer may charge a flat fee to assist a taxpayer in applying for a RAL. The fee must be identical for all of the Electronic Filer's customers and must not be related to the amount of the refund or a RAL. The Electronic Filer must not accept a fee from a financial institution for any service connected with a RAL that is contingent upon the amount of the refund or a RAL.

.05 The Service has no responsibility for the payment of any fees associated with the preparation of a return, the electronic transmission of a return, or a RAL.

.06 An Electronic Filer may disclose tax information to the lending financial institution in connection with an application for a RAL only with the taxpayer's written consent as specified in § 301.7216-3(b).

.07 An Electronic Filer that is also the return preparer, and the financial institution or other lender that makes an RAL, may not be related taxpayers within the meaning of § 267 or § 707.

.08 Section 6695(f) imposes a \$500 penalty on a return preparer who endorses or negotiates a refund check issued to any taxpayer other than the return preparer. However, a bank, as defined in § 581, may accept the full amount of a refund check as a deposit in the taxpayer's account for the benefit of the taxpayer. Section 1.6695-1(f) clarifies § 6695 of the Code by explaining that the prohibition on a return preparer negotiating a refund check is limited to a refund check for a return that the return preparer prepared. A preparer that is also a financial institution, but has not made a loan to the taxpayer on the basis of the taxpayer's anticipated refund, may (1) cash a refund check and remit all of the cash to the

taxpayer or accept a refund check for deposit in full to a taxpayer's account, provided the bank does not initially endorse or negotiate the check; or (2) endorse a refund check for deposit in full to a taxpayer's account pursuant to a written authorization of the taxpayer. A preparer bank may also subsequently endorse or negotiate a refund check as part of the check-clearing process through the financial system after initial endorsement. Any income tax return preparer that violates this provision may be suspended from the Electronic Filing Program.

SECTION 11. BALANCE DUE RETURNS

.01 All service centers that accept electronically filed returns will accept electronically filed balance due returns.

.02 The Electronic Filer must furnish Form 1040-V, Electronic Payment Voucher, to a taxpayer who electronically files a balance due return.

.03 To expedite the crediting of a tax payment, a taxpayer who electronically files a balance due return should mail his or her tax payment with either Form 1040-V, Payment Voucher, or the scannable payment voucher that is included in some tax packages. Each of these options has specific mailing instructions.

.04 A taxpayer who electronically files a balance due return must make a full and timely payment of any tax that is due. Failure to make full payment of any tax that is due on or before April 15, 1996, will result in the imposition of interest and may result in the imposition of penalties.

SECTION 12. ADVERTISING STANDARDS FOR ELECTRONIC FILERS AND FINANCIAL INSTITUTIONS

.01 An Electronic Filer shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, FMS, or the Treasury Department. Any claims concerning faster refunds by virtue of

electronic filing must be consistent with the language in official Service publications.

.02 An Electronic Filer must adhere to all relevant federal, state, and local consumer protection laws.

.03 An Electronic Filer must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An Electronic Filer must not use improper or misleading advertising in relation to the Electronic Filing Program (including the time frames for refunds and RALs).

.05 Use of Direct Deposit name and logo.

(1) The name "Direct Deposit" will be used with initial capital letters or all capital letters.

(2) The logo/graphic for Direct Deposit will be used whenever feasible in advertising copy.

(3) The color or size of the Direct Deposit logo/graphic may be changed when used in advertising pieces.

.06 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.07 Advertising for a cooperative electronic return project (public/private sector) must clearly state the names of all cooperating parties.

.08 In advertising the availability of a RAL, an Electronic Filer and a financial institution must clearly (and, if applicable, in easily readable print) refer to or describe the funds being advanced as a loan, not a refund; that is, it must be made clear in the advertising that the taxpayer is borrowing against the anticipated refund and not obtaining the refund itself from the financial institution.

.09 If an Electronic Filer uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The Electronic Filer must keep a copy of the pre-recorded advertisement for a period of at least 36 months from the date of the last transmission or use.

.10 If an Electronic Filer uses direct mail or fax communications to advertise, the Electronic Filer must retain a copy of the actual mailing or fax, along with a list or other description of persons to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.11 Acceptance to participate in the Electronic Filing Program does not

imply endorsement by the Service or FMS of the software or quality of services provided.

SECTION 13. MONITORING AND SUSPENSION OF AN ELECTRONIC FILER

.01 The Service will monitor an Electronic Filer for conformity with this revenue procedure. The Service can immediately suspend, without notice, an Electronic Filer from the Electronic Filing Program. However, in most circumstances, a suspension from participation in the Electronic Filing Program is effective as of the date of the letter informing the Electronic Filer of the suspension. Before suspending an Electronic Filer, the Service may issue a warning letter that describes specific corrective action for deviations from this revenue procedure.

.02 If a "Principal" or "Responsible Official" is suspended from the Electronic Filing Program, every entity that listed the suspended "Principal" or "Responsible Official" on its Form 8633 will also be suspended.

.03 The Service will monitor the timely receipt of Forms 8453, as well as their overall legibility (especially the recording of the DCN).

.04 The Service will monitor the quality of an Electronic Filer's transmissions throughout the filing season. The Service will also monitor electronic returns and tabulate rejections, errors, and other defects. If quality deteriorates, the Electronic Filer will receive a warning from the Service.

.05 The Service will monitor drop-off collection points and advise a parent of any Electronic Filing Program violations the Service has encountered with a parent's drop-off collection point. If a parent fails to correct a drop-off collection point problem, the parent will be required to eliminate that drop-off collection point. Failure to take corrective action or eliminate a drop-off collection point will cause the Service to suspend the parent. If the Service initiates suspension action, it will apply to all returns filed by the parent.

.06 The Service will monitor complaints about an Electronic Filer and issue a warning or suspension letter as appropriate.

.07 The Service reserves the right to suspend the electronic filing privilege of any Electronic Filer who violates

any provision of this revenue procedure. Generally, the Service will advise a suspended Electronic Filer concerning the requirements for reacceptance into the Electronic Filing Program. The following reasons may lead to a warning letter and/or suspension of an Electronic Filer from the Electronic Filing Program (this list is not all-inclusive):

(1) the reasons listed in section 4.14 of this revenue procedure;

(2) deterioration in the format of individual transmissions;

(3) unacceptable cumulative error or rejection rate;

(4) untimely received, illegible, incomplete, missing, or unapproved substitute Forms 8453;

(5) stockpiling returns at any time while participating in the Electronic Filing Program;

(6) failure on the part of a Transmitter to retrieve acknowledgement files within two work days of transmission by the Service;

(7) failure on the part of a Transmitter to initiate the communication of acknowledgement files to clients within two work days of receipt of the acknowledgement files from the Service;

(8) significant complaints about an Electronic Filer's performance in the Electronic Filing Program;

(9) failure on the part of an Electronic Filer to ensure that no other entity uses the Electronic Filer's EFIN and/or ETIN;

(10) having more than one EFIN for the same business entity at the same location (the business entity is generally the entity that reports on its return the income derived from electronic filing), unless the Service has issued more than one EFIN to a business entity. For example, the Service may issue more than one EFIN to accommodate high volumes of returns, or the filing of a Federal/State return;

(11) failure on the part of a Transmitter to include a Service Bureau's SBIN in the transmission of a return submitted by a Service Bureau;

(12) failure on the part of an ERO to include a drop-off collection point's CPIN as part of a return collected from a drop-off collection point;

(13) failure on the part of an Electronic Filer to cooperate with the Service's efforts to monitor Electronic Filers and investigate electronic filing abuse;

(14) failure on the part of an Electronic Filer to properly use the standard/non-standard W-2 indicator;

(15) failure on the part of an Electronic Filer to properly use the refund anticipation loan (RAL) indicator;

(16) failure on the part of a Service Bureau or a Transmitter to include the ERO's EFIN as part of a return that the ERO submits to the Service Bureau or the Transmitter;

(17) violation of the advertising standards described in section 12;

(18) failure to maintain and make available records as described in section 5.09(4) of this revenue procedure;

(19) accepting a tax return for electronic filing either directly or indirectly from a person (other than the taxpayer who is submitting his or her return) who is not in the Electronic Filing Program;

(20) submitting the electronic portion of a return with information that is not identical to the information on Form 8453;

(21) failure to timely pay any applicable fees, as implemented by subsequent guidance;

(22) filing returns before February 15, 1996, with any form of substitute W-2 or wage and tax documentation; or

(23) failure to timely submit a revised Form 8633 notifying the Service of changes described in section 4.04 of this revenue procedure.

.08 The Service will list in the Internal Revenue Bulletin, district office listings, district office newsletters, and on the EFS Bulletin Board the name and owner(s) of any entity suspended from the Electronic Filing Program and the effective date of the suspension.

.09 A district director may warn Electronic Filers who are using the services of a rejected or a suspended Electronic Filer that sections 4.14(11) and (12) of this revenue procedure prohibit a business relationship with a rejected or a suspended Electronic Filer. However, in appropriate circumstances, the Service may immediately suspend the Electronic Filer.

.10 Denials of applications and suspensions of participation in the Electronic Filing Program will result in:

(1) a rejected applicant not being reconsidered for participation in the Electronic Filing Program for at least two years; and

(2) a suspended Electronic Filer not being reconsidered for participation in the Electronic Filing Program for at least two years.

For the purposes of this section 13.10, two years means the remaining months in the calendar year of denial of participation or suspension and the following two calendar years.

SECTION 14. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE ELECTRONIC FILING PROGRAM

.01 An applicant who has been denied participation in the Electronic Filing Program has the right to an administrative review. During the administrative review process, the denial of participation remains in effect.

.02 In response to the submission of a Form 8633, the appropriate district office will either (1) accept an applicant into the Electronic Filing Program, or (2) issue a proposed letter of denial that explains to the applicant why the district office proposes to reject the application to participate in the Electronic Filing Program.

.03 An applicant who receives a proposed letter of denial may respond, in writing, to the district office that issued the proposed letter of denial. The applicant's response must address the district office's explanation for proposing the denial to participate. The district office must receive the applicant's response within 30 calendar days of the date of the proposed letter of denial.

.04 Upon receipt of an applicant's written response, the district office will reconsider its proposed letter of denial. The district office may (1) withdraw its proposed letter of denial and admit the applicant into the Electronic Filing Program, or (2) finalize its proposed letter of denial and issue it to the applicant.

.05 If an applicant receives a final letter from the district office that denies the applicant participation in the Electronic Filing Program, the applicant is entitled to an appeal, in writing, to the Director of Practice.

.06 The appeal must be filed with the district office that issued the denial letter within 30 calendar days of the date of the denial letter. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be

reversed. In addition, the applicant must include a copy of the applicant's Form 8633 and a copy of the denial letter.

.07 The district office whose denial is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the applicant and the material described in section 14.06 of this revenue procedure that the applicant has submitted to the district office. The district office will forward to the Director of Practice these materials within 15 calendar days of receipt of the applicant's appeal to the Director of Practice.

.08 Failure to respond within the 30-day periods described in sections 14.03 and 14.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

SECTION 15. ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE ELECTRONIC FILING PROGRAM

.01 An Electronic Filer who has been suspended from participation in the Electronic Filing Program has the right to an administrative review. During the administrative review process, the suspension remains in effect.

.02 If an Electronic Filer receives a proposed suspension letter from a district office or service center, the Electronic Filer may submit a detailed written explanation, with supporting documentation, of why the proposed suspension letter should be withdrawn. The Electronic Filer must ensure that the district office or service center that issued the proposed suspension letter receives the Electronic Filer's written response within 30 calendar days of the date of the proposed suspension letter.

.03 Upon receipt of the Electronic Filer's written response, the district office or service center will reconsider its proposed suspension of the Electronic Filer. The district office or service center will either withdraw its proposed suspension letter and reinstate the Electronic Filer or finalize the suspension letter and issue it to the Electronic Filer.

.04 If an Electronic Filer receives a suspension letter from a district office or a service center, the Electronic Filer is entitled to an appeal, in writing, to the Director of Practice.

.05 The Electronic Filer must ensure that the district office or service center that issued the suspension letter receives the Electronic Filers's written appeal for review by the Director of Practice within 30 calendar days of the date of the suspension letter. The Electronic Filer's written appeal for review must contain detailed reasons, with supporting documentation, for reversal of the suspension. In addition, the Electronic Filer must include a copy of its Form 8633 and a copy of the suspension letter.

.06 The district office or service center whose decision to suspend is being appealed will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the Electronic Filer and the material described in section 15.05 of this revenue procedure that the Electronic Filer has submitted to the district office or the service center. The district office or the service center will forward to the Director of Practice these materials within 15 calendar days of the receipt of an Electronic Filer's written request for appeal.

.07 Failure to appeal within the 30-day period described in section 15.05 of this revenue procedure irrevocably terminates an Electronic Filer's right to an appeal.

SECTION 16. VITA AND TCE SPONSORED ELECTRONIC FILING

.01 This revenue procedure applies to VITA (Volunteer Income Tax Assistance) and TCE (Tax Counselling for the Elderly) sponsors subject to the exceptions and restrictions described in this section.

.02 For purposes of this section, the District Director may be represented by a person designated by the District Director such as a District Office Electronic Filing Coordinator (DOEFC) or a Taxpayer Education Coordinator.

.03 To be accepted in, or to continue participation in, the Electronic Filing Program, a VITA or TCE sponsor must:

(1) have obtained the District Director's permission (and, in the case of a TCE sponsor, the permission of the Service office that is funding the TCE program) to provide electronic filing; and

(2) have a manual or electronic quality review system for each return to be electronically filed.

.04 The District Director will advise the VITA and TCE sponsor how to submit or transmit returns. Some of the options available to the District Director are:

(1) having the VITA or TCE sponsor submit returns on paper, magnetic disk, or in an electronic transmission to the DOEFC or other locally designated office;

(2) having the VITA or TCE sponsor directly transmit returns to the appropriate service center; or

(3) having the VITA or TCE sponsor use a third party Transmitter.

.05 A VITA or TCE sponsor is not required to manually sign Form 8453 as ERO. However, if the VITA or TCE sponsor chooses not to manually sign Form 8453, the VITA or TCE sponsor must otherwise furnish on Form 8453 its VITA or TCE acronym and, if operating from multiple sites, a site designation number.

.06 A VITA or TCE sponsor can only accept a return for electronic filing that is (1) prepared at the VITA or TCE site by a VITA or TCE volunteer, (2) prepared by a taxpayer that meets the criteria for VITA or TCE assistance, or (3) prepared by a paid preparer that meets the criteria for VITA or TCE assistance.

.07 Only returns and accompanying forms and schedules included in a district, VITA, or TCE training course may be accepted for electronic filing by a VITA or TCE sponsor.

.08 A VITA or TCE sponsor and a District Director may enter into an agreement that provides for the retention of copies of tax returns and Forms 8453 by a District Director. This information must be retained by either the VITA or TCE sponsor or a District Director. This information must not be given to a third party, including a third party Transmitter.

.09 A District Director is responsible for ensuring that Form 8453 is sent to the appropriate Service office or service center. However, a District Director may delegate to the VITA or TCE sponsor the responsibility for mailing Form 8453 to the appropriate office or service center. The VITA or TCE sponsor is responsible for furnishing the DCN to the taxpayer with instructions for including the DCN on Form 8453.

.10 A VITA or TCE sponsor may collect a fee only if it is directly related to defraying the actual cost of elec-

tronically transmitting a tax return. A VITA or TCE sponsor may also collect this fee on behalf of a third party Transmitter who electronically transmitted a VITA or TCE return.

.11 Before a VITA or TCE sponsor may collect a fee for electronically filing a tax return, the VITA or TCE sponsor must ensure that the taxpayer understands that:

(1) the fee is not for the preparation of the return; and

(2) the VITA or TCE service is offered without regard to either the electronic filing of a return or the collection of a fee.

SECTION 17. EMPLOYER SPONSORED ELECTRONIC FILING

.01 This revenue procedure applies to an employer who chooses to offer electronic filing as an employee benefit to (1) business owners and spouses, (2) employees and spouses, and/or (3) dependents of business owners and employees, subject to the exceptions and restrictions described in this section.

.02 For purposes of this section, the District Director may be represented by a person designated by the District Director such as a DOEFC or a Taxpayer Education Coordinator.

.03 An employer may choose to electronically transmit returns or may arrange to have tax returns electronically transmitted through a third party. If an employer chooses to transmit returns from more than one location, the employer must submit a properly completed Form 8633 for each location.

.04 An employer may offer electronic filing as an employee benefit whether the employer chooses to transmit tax returns or contracts with a third party to transmit the tax returns.

.05 If an employer contracts with a third party to transmit tax returns, the employer may collect from participating employees a fee that is directly

related to defraying the actual cost of electronically transmitting a tax return.

.06 An employer is not required to manually sign Form 8453 as ERO. However, if the employer chooses not to manually sign Form 8453, the employer must otherwise furnish on Form 8453 its name, address, and the designation "Employee Benefit," and if operating from multiple sites, a site designation number.

.07 An employer and a District Director may enter into an agreement that provides for the retention of copies of tax returns including Forms 8453. In the absence of such an agreement, this information must be retained by the employer. This information is not to be given to a third party, including a third party Transmitter.

.08 An employer and a District Director may enter into an agreement that would shift the responsibility for collecting and sending Forms 8453 to the appropriate service center from the employer to the taxpayer. However, the employer will have to furnish the DCN to the taxpayer with instructions for including the DCN on Form 8453.

SECTION 18. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94-63, 1994-2 C.B. 785, is superseded.

SECTION 19. EFFECTIVE DATE

This revenue procedure is effective November 22, 1995.

SECTION 20. INTERNAL REVENUE SERVICE OFFICE CONTACT

All questions regarding this revenue procedure should be directed to the Internal Revenue Service. The telephone number for this purpose is (202) 283-1010 (not a toll-free number). Questions regarding acquiring an additional EFIN in order to file a Federal/

State return should be addressed to the service center where the entity filed its Form 8633.

26 CFR 601.201: Rulings and determination letters.
(Also Part I, § 2601; 26.2601-1.)

Rev. Proc. 95-50

SECTION 1. BACKGROUND

Rev. Proc. 95-3, 1995-1 C.B. 385, sets forth areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Domestic) in which the Internal Revenue Service will not issue advance rulings or determination letters. Section 5 of Rev. Proc. 95-3 lists areas under extensive study in which rulings or determination letters will not be issued.

SEC. 2. PROCEDURE

Rev. Proc. 95-3 is amplified by adding to section 5 the following: Section 2601.—Generation-Skipping Transfer Tax Imposed.—Whether a trust that is excepted from the application of the generation-skipping transfer tax because it was irrevocable on September 25, 1985, will lose its excepted status if the situs of the trust is changed from the United States to a situs outside of the United States.

SEC. 3. EFFECTIVE DATE

This revenue procedure applies to all ruling requests pending in the National Office as of December 11, 1995, and ruling requests received after that date.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 95-3 is amplified.

Rev. Proc. 95-51

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SECTION 1. PURPOSE AND SCOPE as further described below. The approval under this revenue procedure is granted in accordance with § 412(c)(5) of the Internal Revenue Code and § 302(c)(5) of the Employee Retirement Income Security Act of 1974 (ERISA). Section 3 provides approval to change the funding method of the plan to one of fourteen methods, including a change in the asset valuation method to one of three asset valuation methods, a change in the valuation date to the first

.01 This revenue procedure provides approval to change the funding method used to determine the minimum funding standard for defined benefit plans

day of the plan year, and a change in the method for valuing ancillary benefits to the method used to value retirement benefits. Section 4 provides approvals for certain changes that become necessary or expedient under special circumstances.

.02 Any changes in funding method under this revenue procedure must satisfy the rules of Section 5 concerning the continued maintenance of certain amortization bases, the creation of an amortization base resulting from the change in method (method change base), and the amortization period for the method change base. Taxpayers, plan administrators, and enrolled actuaries are cautioned to consider the overall restrictions for use of this procedure (see section 6.01), the additional restrictions for approval of any of the changes listed in section 3 (see section 6.02), and specific restrictions described under each of the approvals. Approval for changes not provided by this revenue procedure may be requested from the Internal Revenue Service.

.03 The funding method changes approved in this revenue procedure also apply for purposes of § 404. However, calculations under the funding method for purposes of § 404 may require certain modifications to elements in the calculations. For example, for purposes of § 412, the value of assets used in the determination of the normal cost under an aggregate funding method is adjusted for any credit balance or funding deficiency in the funding standard account. The value of assets is not adjusted in that manner for purposes of § 404 but is, instead, adjusted for any undeducted contributions (see § 1.404(a)-14(d)(2) of the Income Tax Regulations).

.04 The application of a funding method must conform to all of the requirements of the regulations under § 412. Thus, for example, in a method which allocates liabilities among different elements of past and future service, the allocation of liabilities must be reasonable as required under § 1.412(c)(3)-1(c)(5).

SECTION 2. BACKGROUND

.01 Section 412(c)(5)(A), as amended, and § 302(c)(5)(A) of ERISA, Pub. L. 93-406, 1974-3 C.B. 1, 40, as amended, state that if the funding method of a plan is changed, the new funding method shall become effective

only if the change is approved by the Secretary.

.02 Section 1.412(c)(1)-1 of the regulations provides that the term “funding method”, when used in § 412, has the same meaning as the term “actuarial cost method” in § 3(31) of ERISA. Section 1.412(c)(1)-1 further provides that the funding method of a plan includes not only the overall funding method used by the plan but also each specific method of computation used in applying the overall method. Therefore, for example, the funding method of a plan includes the date on which assets and liabilities are valued (the valuation date). The funding method also includes the definition of compensation which is used to determine the normal cost or accrued liability. Furthermore, a change in a particular aspect of a funding method does not change any other aspects of that method. For example, a change in funding method from the unit credit to the level dollar individual entry age normal method does not change the current valuation date or asset valuation method used for the plan.

.03 Section 1.412(c)(2)-1 generally provides that a change in the actuarial valuation method used to value the assets of a plan is a change in funding method that requires approval under § 412(c)(5).

.04 Rev. Proc. 78-17, 1978-2 C.B. 490, Rev. Proc. 79-50, 1979-2 C.B. 532, Rev. Proc. 80-50, 1980-2 C.B. 816, and Rev. Proc. 81-29, 1981-2 C.B. 550 granted approval for certain changes of funding method. Rev. Proc. 85-29, 1985-1 C.B. 581, as extended by Notice 90-63, 1990-2 C.B. 347, and by Rev. Proc. 92-48, 1992-1 C.B. 987, gave broad approval for changes to any acceptable funding method for plan years beginning on or after January 1, 1984 but not after December 31, 1993, and superseded Rev. Procs. 78-17, 79-50, 80-50, and 81-29. Rev. Proc. 78-37, 1978-2 C.B. 540, provides the procedure by which a plan administrator or plan sponsor may obtain approval of the Secretary of the Treasury for a change in funding method.

.05 Section 412(c)(12), which was added by the Retirement Protection Act of 1994, requires that any increases in plan benefits that are scheduled to take effect during the term of a collective bargaining agreement currently applicable to a plan that is described in § 413(a) (other than a multiemployer plan), must be anticipated. If the

funding method of a plan does not currently anticipate such benefit increases, the funding method must be changed to do so. Section 4.01 provides approval for this change.

SECTION 3. APPROVAL FOR SPECIFIED CHANGES

Subject to the applicability restrictions of section 6 and to the individual conditions under each method below, approval is granted for a change to one of the following funding methods. The development of the normal cost is described for each of the funding methods provided in subsections .01, through .09. For funding methods that directly calculate an accrued liability, within the meaning of Rev. Rul. 81-13, 1981-1 C.B. 229, the development of the accrued liability is also described.

.01 *Approval 1.* Approval is granted for a change in funding method to the unit credit funding method described below.

(1) This approval does not apply if the plan is a cash balance plan. For this purpose, a cash balance plan is a defined benefit plan that defines any portion of an employee's benefits by reference to the employee's hypothetical account, where such hypothetical account is determined by reference to hypothetical allocations and hypothetical earnings that are designed to mimic the actual allocations of contributions and earnings to an employee's account that would occur under a defined contribution plan.

(2) Under this method, the normal cost is the sum of the individual normal costs for all active participants. An individual normal cost is the sum of the normal costs for the various benefits valued using the method. The normal cost for each benefit is the present value of the portion of the projected benefit at each expected separation date that is allocated to the current plan year as set forth in paragraphs (5) and (6) below. For purposes of this approval, separation date includes any date of benefit commencement, if earlier.

(3) The accrued liability under the method is the sum of the individual accrued liabilities for each participant. An individual's accrued liability is the sum of the accrued liabilities for the various benefits valued using the method. The accrued liability for each benefit is the present value of the

portion of the projected benefit at each expected separation date that is allocated to prior plan years as set forth in paragraphs (4), (5), and (6) below.

(4) For a participant other than an active participant, or for a beneficiary, the projected benefit is the accrued retirement benefit, or other plan benefit, under the terms of the plan and the projected benefit is allocated to prior plan years.

(5) For an active participant, when valuing all benefits other than ancillary benefits that are not directly related to the accrued retirement benefit, the projected benefit related to a particular separation date is the benefit determined for the participant under the plan's benefit formula(s) calculated using the projected compensation and the projection, under respective assumptions, of any other components that would be used in the calculation of the benefit on the expected separation date. The projected benefit at each expected separation date is allocated to the years of credited service as follows.

(a) The portion of the projected benefit allocated to the current plan year is determined as

(i) the benefit that would be determined for the participant under the plan's benefit formula(s) calculated using the projected compensation, if applicable, and the projection, under respective assumptions, of any other components that would be used in the calculation of the benefit on the expected separation date, except taking into account only credited service through the end of the current plan year, minus

(ii) the benefit that would be determined for the participant under the plan's benefit formula(s) calculated using the projected compensation, if applicable, and the projection, under respective assumptions, of any other components that would be used in the

calculation of the benefit on the expected separation date, except taking into account only credited service through the beginning of the current plan year.

(b) The portion of the projected benefit allocated to prior plan years is the benefit determined for the participant under the plan's benefit formulas calculated using the projected compensation, if applicable, and the projection, under respective assumptions, of any other components that would be used in the calculation of the benefit on the expected separation date, except taking into account only credited service through the beginning of the current plan year (*i.e.*, the amount in subparagraph (a)(ii) above).

(c) Notwithstanding that the allocations in subparagraphs (a) and (b) only take into account credited service as of the beginning and end of the plan year, if a participant is expected to satisfy an eligibility requirement for a particular benefit that is being valued (e.g., subsidized early retirement benefit) as of an expected separation date, the amounts in subparagraphs (a) and (b), and in paragraph (6) below, must be determined as if the employee has satisfied the eligibility requirement.

(d) The portion of the projected benefit allocated to prior plan years may not be less than the participant's actual accrued benefit as of the beginning of the current plan year. In addition, the benefit determined as of the end of the current plan year in subparagraph (a)(i) above may not be less than the participant's estimated accrued benefit as of the end of the current plan year.

(6) For active participants, when valuing ancillary benefits that are not directly related to the accrued retirement benefit, the projected benefit related to a particular separation date is the benefit determined for the partici-

pant under the plan's benefit formula(s) calculated using the projected compensation and the projection, under respective assumptions, of any other components that would be used in the calculation of the benefit on the expected separation date. The portion of the projected benefit allocated to the current plan year is the projected benefit at the expected separation date divided by the number of years of service the participant will have at such date. The portion of such projected benefit allocated to prior years of service is the projected benefit multiplied by a fraction, the numerator of which is the number of years of service at the beginning of the plan year, and the denominator of which is the number of years of service the participant will have at the expected separation date.

(7) The unfunded liability equals the total accrued liability less the actuarial value of plan assets. All present values are determined as of the valuation date.

(8) The following examples illustrate the application of the method.

(a) *Example 1.* The retirement benefit under the terms of a plan is equal to 1.3% of high 1-year compensation per year of service, but not less than the top-heavy minimum of 2% of high 5-year average compensation for each year the plan is top-heavy (not exceeding 20%), as required under § 416(c). Compensation under the plan is limited to \$100,000. The plan has been top-heavy only for the last 7 years. Employee E has 10 years of service at the beginning of the current plan year. E's compensation for that year is \$30,000. The compensation is assumed to increase at the rate of 5% compounded yearly. The particular benefit being valued is the early retirement benefit anticipated to commence at the expected separation date 7 years in the future (*i.e.*, after completion of 17 years of service). At this separation date, the employee will be eligible for early retirement, and will have projected compensation of \$40,202, and projected high 5-year average compensation of \$36,552. The allocated benefits determined for Employee E at the beginning and end of the plan year, and on the separation date, are shown in the table below.

| Allocated Benefit Determined Under | Determined as of the | | |
|--|------------------------|----------------------|----------------------|
| | Beginning of Plan Year | End of Plan Year | Separation Date |
| (1) 1.3% Benefit Formula | \$5,226 ¹ | \$5,749 ¹ | \$8,885 ³ |
| (2) Top-Heavy Formula | \$5,117 ² | \$5,848 ² | \$7,310 ³ |
| (3) Allocated Benefit (greater of (1) and (2)) | \$5,226 | \$5,848 | \$8,885 |

¹\$5,226 = \$40,202 × 1.3% × 10; \$5,749 = \$40,202 × 1.3% × 11

²\$5,117 = \$36,552 × 2.0% × 7; \$5,848 = \$36,552 × 2.0% × 8

³\$8,885 = \$40,202 × 1.3% × 17; \$7,310 = \$36,552 × 2.0% × 10

The benefit allocated to the current year is \$622 (\$5,848–\$5,226), and the benefit allocated to prior years is \$5,226. In this case, the projected benefit at the separation date is based on the 1.3% benefit formula, and the current year's benefit allocation of the projected benefit results in an amount which is based on the 1.3% benefit formula at the beginning of the year and on the top-heavy formula at the end of the year.

(b) *Example 2:* Plan B is an accumulation plan within the meaning of § 1.401(a)(4)–12 of the regulations. The benefit formula under Plan B for each plan year is 1% of compensation for such year. The sum of the amounts for each of the years constitutes an employee's benefit. The accrued benefit at any date under Plan B is the benefit payable at normal retirement age for the years of service to date. Employee F has 3 years of service at the beginning of the year. The benefit being valued is the normal retirement benefit payable at the normal retirement date (the date Employee F reaches normal retirement age). At normal retirement age, Employee F will have 20 years of service. Compensation is assumed to increase at a rate of 5% per year. Employee F's compensation was \$28,665, \$27,170, and \$26,000 for the prior year, the second prior year, and the third prior year, respectively. For valuation purposes, Employee F's compensation for the current year is assumed to be \$30,098. During the preceding plan year, Plan B was amended effective on the first day of the current plan year to provide that with respect to all prior plan years, the normal retirement benefit is updated to the greater of the benefit actually accumulated as of the beginning of the current plan year or 1% of the preceding year's compensation multiplied by the number of years of service prior to the beginning of the current plan year.

The benefit determined for Employee F, taking into account only credited service through the beginning of the current plan year under the plan's benefit formula is \$860 (the greater of (a) \$818 ((1% × \$26,000) + (1% × \$27,170) + (1% × \$28,665)), or (b) \$860 (1% × \$28,665 × 3)). Taking the amendment into account, the projected benefit payable at normal retirement age is \$8,637 (\$860 + (1% × \$30,098 × 25.84), where 25.84 is the accumulation of \$1 payable at the end of the year for 17 years determined at 5% interest). For purposes of allocating the projected benefit, changes in compensation assumed for later plan years are not taken into account in accordance with the plan's benefit formula. The benefit allocated to the current plan year is \$301 ((860 + (1% × \$30,098)) – 860).

.02 *Approval 2.* Approval is granted for a change in funding method to the level percent of compensation aggregate funding method described below.

(1) This approval applies only for plans which provide for compensation-related benefits.

(2) Under this method, the normal cost is calculated in the aggregate as the normal cost accrual rate multiplied

by the total compensation of all active participants.

(a) The normal cost accrual rate is (i) the total present value of future benefits of all participants and beneficiaries less adjusted assets, divided by

(ii) the total, for all active participants, of the present value of the compensation expected to be paid to each participant for each year of the participant's anticipated future service, determined as of the participant's attained age.

(b) For this purpose, the adjusted assets are equal to

(i) the actuarial value of the assets, plus

(ii) the sum of the outstanding balances of the amortization bases established on account of the current liability full funding limitation, if any, funding waivers under § 412(b)(2)(C), switchback to the regular funding standard under § 412(b)(2)(D), use of the shortfall method under § 1.412(c)-(1)–2 of the regulations, and the transition under § 1.412(c)(3)–2(d), minus

(iii) the credit balance (or plus the funding deficiency), if any, in the funding standard account.

.03 *Approval 3.* Approval is granted for a change in funding method to the level dollar aggregate funding method described below.

(1) Under this method, the normal cost is calculated in the aggregate as the normal cost per active participant multiplied by the number of active participants.

(a) The normal cost per active participant is

(i) the total present value of future benefits of all participants and beneficiaries, less adjusted assets, divided by

(ii) the total, for all active participants, of the present value of an annuity of \$1 per year for every year of a participant's anticipated future service, determined as of the participant's attained age.

(b) For this purpose, the adjusted assets are equal to

(i) the actuarial value of the assets, plus

(ii) the sum of the outstanding balances of the amortization bases established on account of the current liability full funding limitation, if any, funding waivers under § 412(b)(2)(C), switchback to the regular funding standard under § 412(b)(2)(D), use of

the shortfall method under § 1.412(c)-(1)–2 of the regulations, and the transition under § 1.412(c)(3)–2(d), minus

(iii) the credit balance (or plus the funding deficiency), if any, in the funding standard account.

.04 *Approval 4.* Approval is granted for a change in funding method to the level percent of compensation individual aggregate funding method described below.

(1) This approval applies only for plans which provide for compensation-related benefits.

(2) This approval does not apply if the actuarial value of assets is less than the present value of benefits for inactive participants and beneficiaries, or if the amount in paragraph (3)(b)(i) is less than zero.

(3) Under this method, the normal cost is the sum of the individual normal costs for each active participant.

(a) The normal cost for an active participant is

(i) the present value of future benefits for the participant, less allocated adjusted assets, divided by

(ii) the ratio of (A) the present value of the compensation expected to be paid to the participant for each year of the participant's anticipated future service, determined as of the participant's attained age, to (B) the participant's current compensation.

(b) For this purpose, allocated adjusted assets are calculated as follows:

(i) First, the adjusted value of the assets is equal to:

(A) the actuarial value of the assets, plus

(B) the sum of the outstanding balances of the amortization bases established on account of the current liability full funding limitation, if any, funding waivers under § 412(b)(2)(C), switchback to the regular funding standard under § 412(b)(2)(D), use of the shortfall method under § 1.412-(c)(1)–2 of the regulations, and the transition under § 1.412(c)(3)–2(d), minus

(C) the credit balance (or plus the funding deficiency), if any, in the funding standard account, minus

(D) any liabilities retained by the plan for any inactive participant or beneficiary.

(ii) In the first year the method is used, the allocated adjusted value of

the assets for an active participant is calculated by allocating the adjusted value of the assets in proportion to the present value of accrued benefits, or in proportion to the accrued liability determined under one of the immediate gain funding methods described in subsection .01 or .08.

(iii) For years subsequent to the first year in which the method is used, the adjusted value of the assets is allocated to an active participant in the proportion that

(A) the sum of the allocated adjusted assets and calculated normal cost as of the valuation date for the prior year for that active participant bears to

(B) the total of the amounts in (A) for all active participants.

.05 *Approval 5.* Approval is granted for a change in funding method to the level dollar individual aggregate funding method described below.

(1) This approval does not apply if the actuarial value of assets is less than the present value of benefits of inactive participants and beneficiaries, or if the amount in paragraph (2)(b)(i) is less than zero.

(2) Under this method, the normal cost is the sum of the individual normal costs for each active participant.

(a) The normal cost for an active participant is

(i) the present value of future benefits for the participant less allocated adjusted assets, divided by

(ii) the present value of an annuity of \$1 per year for every year of the participant's anticipated future service, determined as of the participant's attained age.

(b) For this purpose, allocated adjusted assets are calculated as follows:

(i) First, the adjusted value of the assets is equal to:

(A) the actuarial value of the assets, plus

(B) the sum of the outstanding balances of the amortization bases established on account of the current liability full funding limitation, if any, funding waivers under § 412(b)(2)(C), switchback to the regular funding standard under § 412(b)(2)(D), use of the shortfall method under § 1.412(c)(1)-2 of the regulations, and the transition under § 1.412(c)(3)-2(d), minus

(C) the credit balance (or plus the funding deficiency), if any, in the funding standard account, minus

(D) any liabilities retained by the plan for any inactive participant or beneficiary.

(ii) In the first year the method is used, allocated adjusted assets for an active participant is calculated by allocating the adjusted value of the assets in proportion to the present value of accrued benefits, or in proportion to the accrued liability determined under one of the immediate gain funding methods described in subsection .01 or .09.

(iii) For years subsequent to the first year in which the method is used, the adjusted value of the assets is allocated to an active participant in the proportion that

(A) the sum of the allocated adjusted assets and calculated normal cost as of the valuation date for the prior year for that active participant bears to

(B) the total of the amounts in (A) for all active participants.

.06 *Approval 6.* Approval is granted for a change in funding method to the level percent of compensation frozen initial liability funding method described below.

(1) This approval applies only for plans which provide for compensation-related benefits.

(2) Under this method, the normal cost is calculated in the aggregate, for every year the method is used including the first, as the normal cost accrual rate multiplied by the total compensation of all active participants.

(a) The normal cost accrual rate is

(i) the total present value of future benefits of all participants and beneficiaries less the sum of the actuarial value of assets and the unfunded liability, divided by

(ii) the total, for all active participants, of the present value of the compensation expected to be paid to each participant for each year of the participant's anticipated future service, determined as of the participant's attained age.

(b) As of the date of change, the unfunded liability is set equal to the unfunded accrued liability determined under the level percentage of compensation individual entry age normal funding method described in subsection .08.

(c) For years subsequent to the plan year of the change in method, the unfunded liability equals

(i) the unfunded liability for the prior plan year, plus the normal cost

for the prior plan year (the result adjusted with appropriate interest to the valuation date), minus the actual contribution(s) for the prior plan year (adjusted with appropriate interest to the valuation date), and

(ii) the unfunded liability is further increased (or decreased) by the amount of any base established on the valuation date which results from a plan amendment or a change in assumptions. Such bases are amortized over the period(s) described in § 412(b)(2)(B) or § 412(b)(3)(B), as applicable.

.07 *Approval 7.* Approval is granted for a change in funding method to the level dollar frozen initial liability funding method described below.

(1) Under this method, the normal cost is calculated in the aggregate, for every year the method is used including the first, as the normal cost per active participant multiplied by the number of active participants.

(a) The normal cost per active participant is

(i) the total present value of future benefits of all participants and beneficiaries less the sum of the actuarial value of assets and the unfunded liability, divided by

(ii) the total, for all active participants, of the present value of an annuity of \$1 per year for every year of a participant's anticipated future service, determined as of the participant's attained age.

(b) As of the date of change, the unfunded liability is set equal to the unfunded accrued liability determined under the level dollar individual entry age normal funding method described in subsection .09.

(c) For years subsequent to the plan year of the change in method, the unfunded liability equals

(i) the unfunded liability for the prior plan year, plus the normal cost for the prior plan year (the result adjusted with appropriate interest to the valuation date), minus the actual contribution(s) for the prior plan year (adjusted with appropriate interest to the valuation date), and

(ii) the unfunded liability is further increased (or decreased) by the amount of any base established on the valuation date which results from a plan amendment or a change in assumptions. Such bases are amortized over the period(s) described in § 412(b)(2)(B) or § 412(b)(3)(B), as applicable.

.08 *Approval 8.* Approval is granted for a change in funding method to the level percent of compensation individual entry age normal funding method described below.

(1) This approval does not apply if the alternative minimum funding standard account is used at any time within the 5-year period commencing with the first day of the plan year for which the change is made.

(2) This approval applies only for plans which provide for compensation-related benefits.

(3) Under this method, the normal cost is the sum of the individual normal costs for all active participants. For an active participant, the normal cost is the participant's normal cost accrual rate, multiplied by the participant's current compensation.

(a) The normal cost accrual rate equals

(i) the present value of future benefits for the participant, determined as of the participant's entry age, divided by

(ii) the present value of the compensation expected to be paid to the participant for each year of the participant's anticipated future service, determined as of the participant's entry age.

(b) In calculating the present value of future compensation, the salary scale must be applied both retrospectively and prospectively to estimate compensation in years prior to and subsequent to the valuation year based on the compensation used for the valuation.

(c) The accrued liability is the sum of the individual accrued liabilities for all participants and beneficiaries. A participant's accrued liability equals the present value, at the participant's attained age, of future benefits less, the present value at the participant's attained age of the individual normal costs payable in the future. A beneficiary's accrued liability equals the present value, at the beneficiary's attained age, of future benefits. The unfunded accrued liability equals the total accrued liability less the actuarial value of assets.

(d) Under this method, the entry age used for each active participant is the participant's age at the time he or she would have commenced participation if the plan had always been in existence under current terms, or the age as of which he or she began to earn service credits for purposes of benefit accrual under the current terms of the plan.

.09 *Approval 9.* Approval is granted for a change in funding method to the level dollar individual entry age normal funding method described below.

(1) This approval does not apply if the alternative minimum funding standard account is used at any time within the 5-year period commencing with the first day of the plan year for which the change is made.

(2) Under this method, the normal cost is the sum of the individual normal costs for all active participants.

(a) For an active participant, the individual normal cost equals

(i) the present value of future benefits for the participant, determined as of the participant's entry age, divided by

(ii) the present value of an annuity of \$1 per year for every year of the participant's anticipated future service, determined as of the participant's entry age.

(b) The accrued liability is the sum of the individual accrued liabilities for all participants and beneficiaries. A participant's accrued liability equals the present value, at the participant's attained age, of future benefits, less the present value at the participant's attained age of the individual normal costs payable in the future. A beneficiary's accrued liability equals the present value, at the beneficiary's attained age, of future benefits. The unfunded accrued liability equals the total accrued liability less the actuarial value of the plan assets.

(c) Under this method, entry age used for each active participant is the participant's age at the time he or she would have commenced participation if the plan had always been in existence under current terms, or the age as of which he or she began to earn service credits for purposes of benefit accrual under the current terms of the plan.

.10 *Approval 10.* Approval is granted for a change in asset valuation method to fair market value as defined in § 1.412(c)(2)-1(c) of the regulations.

.11 *Approval 11.* Approval is granted for a change in asset valuation method to the average fair market value (without phase-in) as defined in § 1.412(c)(2)-1(b)(7) of the regulations, or to any alternative formulation that is algebraically equivalent to this average fair market value. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market

value defined in § 1.412(c)(2)-1(c). The stated averaging period may not exceed five (5) plan years.

For example, under § 1.412(c)(2)-1(b)(7), if the averaging period is five years, in the first year the average value is based on the fair market value of assets in the current year and the adjusted values of assets for the prior four years as provided in § 1.412(c)(2)-1(b)(8). An alternative formulation which is algebraically equivalent to this method is one in which the average value of assets is equal to the fair market value on the valuation date, minus decreasing fractions ($\frac{4}{5}$, $\frac{3}{5}$, $\frac{2}{5}$, and $\frac{1}{5}$, in this example) of the appreciation and depreciation in each of the four preceding years.

.12 *Approval 12.* Approval is granted for a change in asset valuation method to the average fair market value (with phase-in) as defined in § 1.412(c)(2)-1(b)(7) of the regulations, or to any alternative formulation that is algebraically equivalent to this average fair market value. The asset value determined under the method will be adjusted to be no greater than 120% and no less than 80% of the fair market value defined in § 1.412(c)(2)-1(c). The stated averaging period may not exceed five (5) plan years.

In the first year this method is used, the average is calculated as in subsection .11, except that the adjusted values for all but the most recent prior year are replaced by the adjusted value for the most recent prior year. In the second year, the average is calculated as in subsection .11, except that the values for all but the most recent two prior years are replaced by the adjusted value for the second most recent prior year. This process is continued until values for all prior years in the averaging period are phased in.

.13 *Approval 13.* Approval is granted for a change in the valuation date to the first day of the plan year.

.14 *Approval 14.* Approval is granted to change the funding method used for valuing ancillary benefits to the funding method used to value retirement benefits, if the prior method for valuing ancillary benefits had been the one-year term method. For this purpose, ancillary benefits are defined in § 1.412(c)(3)-1(f)(2) of the regulations and include pre-retirement death and disability benefits.

SECTION 4. SPECIAL APPROVALS

.01 *Approval to Anticipate Scheduled Benefit Increases.* Approval is granted to change the funding method currently used for a collectively bargained plan described in § 413(a) to a method which is the same as the old method except that the new method will anticipate benefit increases scheduled to take effect during the term of the collective-bargaining agreement currently applicable to the plan.

.02 *Approvals to Remedy Unreasonable Allocation of Costs.*

(1) If a plan uses an individual aggregate funding method and an individual normal cost becomes negative for a participant, approval is granted to re-allocate excess assets in proportion to the present value of accrued benefits, or in proportion to the accrued liability determined under the immediate gain funding method described in section 3.01, section 3.08 (only if the normal cost for a participant is determined as a level percent of compensation under plan's method), or section 3.09 (only if the normal cost for a participant is determined as a level dollar amount under the plan's method). For this purpose, excess assets are defined as the excess of the assets currently allocated for the participant over the present value of the participant's future benefits.

(2) If a plan uses a spread gain funding method which establishes an initial unfunded liability using an immediate gain funding method (e.g., frozen initial liability or attained age normal), and the normal cost and/or unfunded liability become(s) negative, then, in the case where the normal cost under the plan's method is determined as a level percentage of compensation, approval is granted to reestablish the unfunded liability under the funding method described in section 3.01 if the unfunded liability was originally established under the unit credit method, or under the funding method described in section 3.08 if the unfunded liability was originally established under the entry age normal method. See Rev. Rul. 81-213, 1981-2 C.B. 101, regarding whether a funding method is a spread gain funding method or an immediate gain funding method. In the case where the normal cost under the plan's method is determined as a level dollar amount, approval is granted to reestablish the

unfunded liability under the funding method described in section 3.01 if the unfunded liability was originally established under the unit credit method, or under the funding method described in section 3.09 if the unfunded liability was originally established under the entry age normal method. If the reestablished unfunded liability is less than zero, approval is granted to change to the aggregate funding method described in section 3.02 (if the normal cost under the plan's method is determined as a level percent of compensation), or section 3.03 (if the normal cost under the plan's method is determined as a level dollar amount).

(3) If a plan that uses a spread gain funding method which establishes an initial unfunded liability using an immediate gain funding method (e.g., frozen initial liability or attained age normal), becomes fully funded within the meaning of § 412(c)(6) (without taking into account § 412(c)(7)(A)-(i)(I)), approval is granted to change to the aggregate funding method described in section 3.02 (if the normal cost under the plan's method is determined as a level percent of compensation), or section 3.03 (if the normal cost under the plan's method is determined as a level dollar amount).

(4) If a plan uses an individual aggregate funding method and the actuarial value of plan assets is less than the present value of benefits for inactive participants and beneficiaries, or if the actuarial value of the assets, plus the sum of the outstanding balances of the amortization bases established on account of the current liability full funding limitation, if any, funding waivers under § 412(b)(2)(C), switchback to the regular funding standard under § 412(b)(2)(D), use of the shortfall method under § 1.412(c)(1)-2 of the regulations, and the transition under § 1.412(c)(3)-2(d), minus the credit balance (or plus the funding deficiency), if any, in the funding standard account, minus any liabilities retained by the plan for any inactive participant or beneficiary is less than zero, approval is granted to change to the aggregate funding method described in section 3.02 (if the normal cost under the plan's method is determined as a level percent of compensation), or section 3.03 (if the normal cost under the plan's method is determined as a level dollar amount).

(5) If a plan provides that no participant may accrue a benefit as of a date that is no later than the first day of the plan year, approval is granted to change to the unit credit method described in section 3.01.

.03 *Approval for Change in Funding Method for Fully Funded Terminated Plans.*

(1) For a plan year during which a plan is terminated, the funding method may be changed to a method described in paragraph (2) provided that the conditions set forth in paragraph (3) are satisfied. As part of the change in method, the valuation date may be changed to the date of termination or the first day of the plan year, and the asset valuation method may be changed to value plan assets at fair market value.

(2) A method is described in this subsection if the normal cost for the plan year is the present value of the benefits accruing in the plan year, and the accrued liability is the present value of the benefits accrued as of the first day of the plan year.

(3) The conditions in this subsection are satisfied if:

(a) As of the date of termination, the fair market value of the assets of the plan (exclusive of contributions receivable) is not less than the present value of all benefit liabilities (whether or not vested), and

(b) if applicable, a timely notice of intention to terminate was filed with the PBGC.

.04 *Approval for Takeover Plans.*

(1) Approval is granted by this paragraph for a change in funding method where all the conditions set forth in paragraphs (2) through (4) are satisfied.

(2) There has been both a change in the enrolled actuary for the plan and a change in the business organization providing actuarial services to the plan.

(3) The method used by the new actuary is substantially the same as the method used by the prior actuary, and is consistent with the information contained in the prior actuarial valuation reports or prior Schedules B of Form 5500. Also, the method used by the new actuary must be applied to the prior year (using the assumptions of the prior actuary) and the net charge in the funding standard account produced must not differ by more than five percent (5%) from the net charge calculated by the prior actuary for that year.

(4) The change in costs due to the change in method is treated in the same manner as an experience gain or loss, unless the actuarial assumptions are being changed, in which case the change in method is treated as part of the change in assumptions.

SECTION 5. GENERAL RULES RELATING TO FUNDING METHODS

Approval for a change to any method in this revenue procedure does not apply unless the provisions of sections .01 through .03 are satisfied.

.01 *Amortization Bases.*

(1) *Continued Maintenance of Waiver, Shortfall, Five-Year Alternative Switchback, Transition, and Current Liability Bases.* In the case of a plan which, prior to a change in funding method, has a funding waiver base described in § 412(b)(2)(C), a base due to a switchback to the regular funding standard account described in § 412(b)(2)(D), a shortfall base described in § 1.412(c)(1)–2(g) of the regulations, a transition base described in § 1.412(c)(3)–2(d), or a base that was established to amortize a credit in the funding standard account due to the 150 percent of current liability full funding limitation, the current funding method, regardless of any other characteristics, must maintain such base(s) as if the funding method had not changed and must charge, or credit, the funding standard account with the amortization charge(s), or credit(s), for such base(s) after the change in funding method.

(2) *Creation of a Funding Method Change Base.* Except in the case of a change to a funding method described in section 3.02, 3.03, 3.04, or 3.05, all existing bases shall be maintained and an amortization base shall be established equal to the difference between the unfunded accrued liability under the new method and an amount equal to (A) the net sum of the outstanding balances of all amortization bases (including, when the preceding method was an immediate gain method, the gain or loss base for the immediately preceding period), treating credit bases as negative bases, less (B) the credit balance (or plus the funding deficiency), if any, in the funding standard account, all adjusted for interest at the valuation rate to the valuation date in the plan year for which the change is made. If this difference is a

positive or negative number, the resulting base will be a charge base or a credit base, respectively. In the case of a change to a funding method described in section 3.02, 3.03, 3.04, or 3.05, (a) the bases described in paragraph (1) must be maintained, and (b) all amortization bases other than those described in paragraph (1) shall be considered fully amortized.

(3) *Amortization Period.* For any charge or credit base established pursuant to the requirements of paragraph (2), the amortization period is 10 years.

(4) No base is established due solely to a change in valuation date.

.02 Although compensation must be limited in accordance with § 401(a)(17) in determining benefits to be valued, it may or may not be so limited in determining the present value of future compensation expected to be paid to the participant for each year of the participant's anticipated future service. However, the alternative used is part of the method and any change in such practice is a change in funding method.

.03 Whenever, under the funding method, the normal cost is calculated as a level percentage of compensation, then an individual's compensation is included in the amount of current year's compensation to which the normal cost percentage is applied if and only if the compensation for that individual is included in the present value of future compensation over which normal costs are spread. Similarly, whenever the normal cost is calculated as a level dollar amount, then an individual is included in the determination of the number of individuals by which the normal cost per participant is multiplied if and only if that individual is included for purposes of determining the present value of an annuity of \$1 for years of anticipated service over which normal costs are spread.

SECTION 6. RESTRICTIONS UNDER REVENUE PROCEDURE

.01 *General Restrictions.*

(1) This revenue procedure does not apply to a change in funding method for a plan year if either (a) a Schedule B of Form 5500 has been filed for such plan year using some other funding method or (b) the due date (including extensions) for such Schedule B has passed.

(2) This revenue procedure does not apply unless the plan administrator

(within the meaning of § 414(g)) or an authorized representative of the plan sponsor indicates as part of the series Form 5500 for the plan year for which the change is effective that the plan administrator or plan sponsor agrees to the change in funding method.

(3) This revenue procedure does not apply if, for the plan year of the change, a minimum funding waiver under § 412(d) has been requested for the plan or is being amortized, or if an extension of an amortization period under § 412(e) has been requested or is currently applicable for computing minimum funding requirements, for the plan.

(4) This revenue procedure does not apply if the plan is under an Employee Plans examination for any plan year, or if the plan sponsor, or a representative, has received verbal or written notification from the EP/EO Division of an impending Employee Plans examination, or of an impending referral from another part of the Service for an Employee Plans examination, or if the plan has been under such an examination and is in Appeals or in litigation for issues raised in an Employee Plans examination.

(5) Except as provided in section 4.03, this revenue procedure does not apply to a change which is made for a plan year in which the plan is terminated.

(6) *Non-Applicability if Shortfall Method is Discontinued.* If the current method makes use of the shortfall method, approval to change to another funding method under this revenue procedure will apply only if the new funding method continues to make use of the shortfall method. For example, approval is not granted to change from the entry age normal method (which uses the shortfall method) to the unit credit method under section 3.01 unless the unit credit method makes use of the shortfall method.

.02 *Additional Restrictions For Approvals in Section 3.*

(1) *Non-Applicability for Reversion Cases.* This revenue procedure does not apply to changes in funding method required by Treasury Release R-2697 dated May 24, 1984, concerning the reversion of assets from a terminated plan. Furthermore, approval under section 3 does not apply if, in the 15 years preceding the date of change, such plan was involved in a transaction described in such Treasury Release subsequent to May 24, 1984.

(2) *Non-Applicability for Plans Using Universal Life Insurance Products.* Approval to change to a method described in section 3 does not apply in the case of a plan for which some of the assets are provided through universal life insurance policies unless, under the funding method adopted, (a) all plan benefits including those provided by the universal life insurance policies are considered liabilities in calculating costs and are funded using the same method as used for retirement costs, and (b) the cash value as of the valuation date of such contracts is treated the same as all other assets of the plan in calculating costs. However, the requirements of (a) above will not fail to be satisfied merely because ancillary benefits, within the meaning of § 1.412(c)(3)-1(f)(2) of the regulations, are funded on a reasonable one-year term funding method.

(3) *Four-Year Limitation on Changes.* Approval to change to a method described in section 3 does not apply to any of the following changes:

(a) the asset valuation method is being changed and the asset valuation method was changed in any of the four (4) preceding plan years,

(b) the valuation date is being changed and the valuation date was changed in any of the four (4) preceding plan years, or

(c) the funding method is being changed in a way not described in (a) or (b) and a funding method change not described in (a) or (b) was made in any of the four (4) preceding plan years.

(4) *Non-Applicability when Liabilities are Adjusted for Assets.* Approval to change to a method described in section 3 does not apply to a change in funding method under which the liabilities are adjusted to reflect the performance or expected performance of the assets.

(5) *Non-Applicability if Benefit Accruals are Frozen Under the Plan.* Approval to change to any method described in sections 3.02 through 3.09, does not apply if a plan provides that no participant may accrue a benefit as of a date that is no later than the first day of the plan year. In such a case, approval to change to the method described in section 3.01 applies only as described in section 4.02(5).

(6) *Non-Applicability if Negative Normal Cost or Negative Unfunded Liability Results From the Change.* Approval to change to a method

described in section 3 does not apply if, as a result of the change in method, a negative normal cost or a negative unfunded liability is produced.

(7) *Non-Applicability if Change in Method is Being Made Pursuant to a Spin-off or Merger.* Approval to change to a method described in section 3 does not apply if the funding method for a plan year is being changed in connection with a plan spin-off or merger.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for plan years commencing on or after January 1, 1995.

SECTION 8. COMMENTS REQUESTED FOR ADDITIONAL METHODS SUBJECT TO APPROVAL

Taxpayers, plan administrators, and enrolled actuaries may wish to use other funding methods for which approval is not provided in this revenue procedure, but which satisfy the requirements of the regulations under § 412. The Service requests written comments concerning additional funding methods that may be considered for approval in future guidance. Comments and information should be sent to: Commissioner of the Internal Revenue Service, Attention: CP:E:EP, Washington, DC 20224.

26 CFR 601.202: Closing agreements.
(Also Part I, §§ 401, 404, 415, 514, 4972, 4975, 4980, 7872; 1.401-1, 1.415-6, 1.514(a)-1.)

Rev. Proc. 95-52

SECTION 1. PURPOSE

The purpose of this revenue procedure is to extend indefinitely a closing agreement program to settle certain tax liabilities that arise out of transactions between an employer and an otherwise qualified defined contribution plan. The authority to enter closing agreements pursuant to this revenue procedure applies only in the instance of transactions in which the employer makes conditional payments to an otherwise qualified defined contribution plan on account of plan assets that are invested in a guaranteed contract issued by a life insurance company that has been

placed in state insurer delinquency proceedings.

This revenue procedure also restates the clarification that for purposes of Rev. Proc. 92-10, 1992-1 C.B. 661, such conditional payments constitute assets that are available for purposes of making required minimum distributions.

SECTION 2. BACKGROUND

.01 In the recent past, several life insurance companies, within the meaning of § 816(a) of the Internal Revenue Code of 1986, have experienced financial difficulties and have been placed in state insurer delinquency proceedings (e.g., rehabilitation and conservatorship).

These life insurance companies have issued a number of guaranteed investment contracts and group annuity contracts (“guaranteed contracts”) under which distributions or payments have been reduced or suspended by reason of the state insurer delinquency proceedings. Assets of certain defined contribution plans, within the meaning of § 401(a), have been invested in these guaranteed contracts, and these plans are therefore “affected plans.” Typically, the guaranteed contract is one of several investment options offered under an affected plan that permits participants to direct the investment of their accounts. Thus, to the extent that a participant’s account balance is invested in a guaranteed contract, distributions, loans, or investment transfers from that portion of the participant’s account balance may be affected during the period that payments from the guaranteed contract are reduced or suspended. Pursuant to the state insurer delinquency proceedings, the affected plan may receive additional proceeds in the future on account of the guaranteed contract. It is possible, however, that the proceeds ultimately received by the affected plan on account of the guaranteed contract may be less than the amount that otherwise would have been received had the insurance company met the terms and conditions of the guaranteed contract.

.02 An employer maintaining an affected plan may request an exemption from the Department of Labor (“DOL”) under § 408(a) of the Employee Retirement Income Security Act of 1974 and § 4975(c)(2) of the

Code in order to make certain payments to the affected plan. These payments would be conditioned upon their return to the employer to the extent that the affected plan receives future payments on account of a guaranteed contract. Typically, an employer wishes to make such conditional payments in order to facilitate distributions, loans, or investment transfers from the portions of participants' account balances that are allocable to a guaranteed contract. An employer need not request an individual exemption, however, if the conditional payments are made in a manner that satisfies a DOL class exemption, e.g., PTE 80-26, 1980-2 C.B. 323.

.03 If an employer chooses to make conditional payments to an affected plan, as described in section 2.02, the application of the following sections of the Code may adversely affect the plan's qualified status and result in certain income and excise taxes:

(1) Section 401(a)(2) provides generally that a qualified plan and its related trust must be operated for the exclusive benefit of employees and their beneficiaries. A trust shall not constitute a qualified trust unless under the trust instrument it is impossible to divert trust assets prior to the satisfaction of all of the trust's liabilities.

(2) Section 401(a)(4) provides generally that a qualified plan may not discriminate in favor of highly compensated employees (within the meaning of § 414(q)).

(3) Section 404(a) provides for the deduction from income of contributions to a plan of deferred compensation.

(4) Section 415 limits the contributions and other additions under a qualified defined contribution plan with respect to a participant for any year.

(5) Section 514 provides generally that unrelated business taxable income includes income from property with respect to which there is acquisition indebtedness.

(6) Section 4972 imposes an excise tax on an employer that makes non-deductible contributions to a qualified plan and sets forth an ordering rule for determining the amount of nondeductible contributions.

(7) Section 4975 imposes an excise tax on a disqualified person where there is a prohibited transaction involving a plan and the disqualified person.

(8) Section 4980 imposes an excise tax on the employer maintaining a

qualified plan where there is a direct or indirect reversion of plan assets.

(9) Section 7872 provides rules for the treatment of certain below-market loans.

.04 Section 7121 of the Code permits the Service to enter into a written agreement ("closing agreement") with a person relating to the tax liabilities of such person.

SECTION 3. CLOSING AGREEMENT PROGRAM FOR RESTORATIVE PAYMENTS

.01 Under this revenue procedure, the Service will enter into a closing agreement with an employer that maintains an affected plan and the trustee of the plan's trust that provides that restorative payments (including amounts subsequently returned to the employer) do not cause the affected plan to violate §§ 401(a)(2), 401(a)(4), or 415. In general, restorative payments are conditional payments to an affected plan on account of plan assets that are invested in a guaranteed contract under which payments have been reduced or suspended by reason of state insurer delinquency proceedings.

.02 Under this revenue procedure, the closing agreement will provide for the timing of deductions under § 404 for any restorative payments ultimately retained by the trust of an affected plan. The closing agreement will also provide that the restorative payments will not trigger the application of any excise taxes described in §§ 4972 and 4980. In addition, the closing agreement will provide that the restorative payments will not be treated as giving rise to acquisition indebtedness under § 514 or as a below-market loan under § 7872.

.03 The Service will not enter into the closing agreement described in this revenue procedure unless an employer that maintains an affected plan either has received a prohibited transaction exemption from DOL to make restorative payments or supplies an opinion of counsel that the restorative payments are exempt under a DOL class exemption. Where § 4975 does not apply to an affected plan (*i.e.*, no exemption is required from DOL) the Service will consider entering into a closing agreement with an employer under the terms and conditions set forth in the sample closing agreement, excluding those conditions that relate to § 4975 and any

other income tax or excise taxes that would otherwise not apply to the employer.

.04 The specific terms and conditions applicable to the closing agreement (including certain variable factors) are set forth in the sample closing agreement attached as an exhibit to this revenue procedure. This is the case even if an employer has already selected a method of payment in lieu of the original schedule of payments of principal and interest from the guaranteed contract or if the employer wishes to limit restorative payments solely to loans or transfers or distributions.

.05 A request for a closing agreement under this revenue procedure is subject to the provisions of Rev. Proc. 95-4, 1995-1 C.B. 397, without regard to any user fee described in Rev. Proc. 95-8, 1995-1 C.B. 485. Any such request must contain the relevant items listed in section 9 of Rev. Proc. 95-4, and must also include (1) a copy of the guaranteed contract, (2) a copy of the agreement under which the employer will make (or is making) restorative payments to the affected plan, (3) a completed closing agreement (to the extent that the information is available at the time of the request), (4) a copy of the most recent series Form 5500 filed for the affected plan to which the closing agreement would apply, (5) if applicable, a copy of either the application submitted to DOL for the prohibited transaction exemption or an opinion of counsel that a class exemption applies, and (6) if a rate of interest is to be used after the maturity date of the guaranteed contract, a statement of the reasons that such interest rate is reasonable under the facts and circumstances. Any such request must be clearly labeled as a request for a closing agreement under this revenue procedure. Five copies of the applicable closing agreement must be enclosed and sent to the following address:

Internal Revenue Service
1111 Constitution Avenue, N.W.
Employee Plans Technical Branch,
Rm. 6052
Washington, D.C. 20224

SECTION 4. CLARIFICATION OF REV. PROC. 92-10

.01 Rev. Proc. 92-10 provides guidance regarding the required minimum distribution under § 401(a)(9) for a

plan or arrangement that has invested assets in an annuity contract or guaranteed investment contract under which payments have been reduced or suspended by reason of state insurer delinquency proceedings.

.02 Where an employer makes restorative payments to an affected plan, as described in this revenue procedure, the affected plan's assets attributable to restorative payments are assets that must be used to make required minimum distributions to participants. Thus, with regard to a participant to whom an affected plan must

make a required minimum distribution, the unavailable portion of an affected investment (as those terms are used in section 5.01 of Rev. Proc. 92-10) is reduced by the amount of assets attributable to restorative payments that is held in the trust on account of the portion of the participant's account balance that is allocable to the guaranteed contract.

SECTION 5. EFFECT ON OTHER REVENUE PROCEDURES

Rev. Proc. 92-10 is clarified.

Rev. Proc. 92-16, 1992-1 C.B. 673, is modified and superseded.

Rev. Proc. 94-19 is superseded.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective February 2, 1995, and will continue in effect until a contrary publication in the Internal Revenue Bulletin. This revenue procedure pertains to requests for closing agreements on or after that date and (as stated in Rev. Proc. 92-16) required minimum distributions that relate to the 1991 and later calendar years.

EXHIBIT

CLOSING AGREEMENT ON FINAL DETERMINATION
COVERING SPECIFIC MATTERS

Under § 7121 of the Internal Revenue Code (the “Code”), the X Corporation (the “Employer”), _____ [address and EIN], the X Corporation Retirement Plan Trust (the “Trust”), _____ [address and EIN], and the Commissioner of Internal Revenue make the following closing agreement:

WHEREAS, the X Corporation Retirement Plan (the “Plan”) was established on _____; and
WHEREAS, the Employer represents that the Plan and Trust are qualified under § 401(a) of the Code; and
WHEREAS, the Plan is a defined contribution plan; and

[The closing agreement must contain either Alternative A or Alternative B.]

Alternative A

WHEREAS, the Trust holds a guaranteed investment contract [insert group annuity contract, if applicable] (the “GC”) issued by _____ (the “Insurer”), a life insurance company (within the meaning of § 816(a) of the Code) that is in state insurer delinquency proceedings; and

Alternative B

WHEREAS, the Trust holds an interest in a guaranteed investment contract [insert group annuity contract, if applicable] (the “GC”) issued by _____ (the “Insurer”), a life insurance company within the meaning of § 816(a) of the Code that is in state insurer delinquency proceedings; and

WHEREAS, the Insurer is prohibited under the state insurer delinquency proceedings from making full payment in accordance with the terms of the GC; and

WHEREAS, the Employer represents that it has made or will make payments to the Trust (“Restorative Payments”) meeting the following criteria:

1. The total of the Restorative Payments made on any date plus the amount of Restorative Payments made before that date (less the amount of Restorative Payments that have previously been returned pursuant to paragraph 2 below) do not exceed the “current value” of the GC as of that date. The “current value” of the GC is defined as [if *Alternative A* above is used insert “the issue price of the GC” and if *Alternative B* above is used insert “the sum of the Trust’s investments in the GC”], adjusted as follows: (A) interest is credited to the current date calculated at the guaranteed interest rate under the terms of the GC during any period for which the terms of the GC provide for interest at a guaranteed rate; [(B) no interest is credited for periods for which no rate of interest is guaranteed under the terms of the GC or (B) interest is credited for periods for which no interest is guaranteed under the terms of the GC at _____]; and (C) any actual proceeds received by the Trust on or before the current date with respect to the GC are subtracted when received. For purposes of this agreement, all references to various terms and conditions of the GC refer to the terms and conditions of the GC in force immediately prior to the beginning of the state insurer delinquency proceedings.

2. Pursuant to a written agreement between the Employer and the Trustee, whenever the total amount of the Restorative Payments (less the amount of Restorative Payments that have previously been returned pursuant to this paragraph) exceeds the current value of the GC, the “excess amount” will be promptly returned to the Employer. The “excess amount” is defined as the excess of Restorative Payments (less the amount of Restorative Payments that have previously been returned pursuant to this paragraph) over the current value of the GC, plus any actual or deemed earnings on Restorative Payments permitted to be returned to the Employer under a prohibited transaction exemption issued by the Department of Labor.

3. The Employer notifies the Trustee at the time any Restorative Payment is paid to the Trust that the payment is a Restorative Payment under the written agreement described in paragraph 2 above; and

[The closing agreement should include either Alternative C or Alternative D.]

Alternative C

WHEREAS, the Department of Labor issued a prohibited transaction exemption to the Employer on _____ [date of issuance], in accordance with § 408(a) of the Employee Retirement Income Security Act of 1974, covering the payment of Restorative Payments to the Trust and the return of Restorative Payments to the Employer as described above; and

Alternative D

WHEREAS, the Employer has supplied an opinion of counsel to the Service stating that a class exemption issued by the Department of Labor in accordance with § 408(a) of the Employee Retirement Income Security Act of 1974 covers the payment of Restorative Payments to the Trust and the return of Restorative Payments to the Employer as described above; and

WHEREAS, the Employer and the Trustee have determined that the agreement set forth herein is in the best interests of the Employer and the Trust; and

WHEREAS, the Service, through its authorized representative, has determined that said agreement is also in its best interests;

NOW IT IS HEREBY DETERMINED AND AGREED for federal income and excise tax purposes that the above representations are material to this closing agreement and that:

1. The Service will treat the Plan as not failing to satisfy the requirements of § 401(a) of the Code on account of the following:

(A) The payment of Restorative Payments to the Trust.

(B) The return of Restorative Payments (and earnings as permitted to be returned) to the Employer (including any amount deemed returned to the Employer as provided in subparagraph 6(D) below) as required under the representations made in this agreement.

(C) The use of Restorative Payments and earnings thereon to make distributions or loans to any participant or to make any transfer to another investment option from the participant's account.

(D) The allocation of earnings attributable to Restorative Payments to any participant's account, where earnings attributable to Restorative Payments are used in lieu of current employer contributions to make current allocations to a participant's account as provided in subparagraph 6(F) below.

2. The Service will not apply the § 4972 excise tax on nondeductible contributions to Restorative Payments that are treated as contributions (as provided in subparagraph 6(C) below) and that exceed the deduction limits under § 404. If otherwise applicable, the § 4972 excise tax will apply only to the amount of nondeductible contributions remaining, if any, after subtracting the "amount attributable to Restorative Payments." In each year, the "amount attributable to Restorative Payments" is the sum of (1) the amount of Restorative Payments treated as contributions for the taxable year under subparagraph 6(C) below; plus (2) the amount of nondeductible contributions for the preceding year for which the § 4972 excise tax was not applied because of this paragraph.

3. The Service will not apply the § 4980 excise tax on employer reversions to the return of Restorative Payments or earnings thereon, or to the deemed return of Restorative Payments or earnings thereon as provided under subparagraph 6(D) below.

4. The Service will not treat the Trust as having incurred acquisition indebtedness under § 514 of the Code on account of the receipt of Restorative Payments.

5. The Service will not treat the payment of Restorative Payments to the Trust as a below-market loan under § 7872 of the Code.

6. As a condition to the treatment described in paragraphs 1 through 5 above, the Employer and the Trustee agree to the following:

(A) The use of Restorative Payments and earnings thereon to make distributions or loans to any participant or to make any transfer to another investment option from the participant's account will not increase the amount of the participant's account balance over the amount that would have been the participant's account balance, in the absence of Restorative Payments, had the Insurer satisfied the terms and conditions of the GC. This subparagraph does not apply to allocations made as provided in subparagraph (F)(3) of this paragraph 6.

(B) The use of Restorative Payments and earnings thereon to make distributions or loans to any participant or to make any transfer to another investment option from the participant's account will be carried out on the same basis with respect to all similarly situated participants. This subparagraph does not apply to allocations made as provided in subparagraph (F)(3) of this paragraph 6.

(C) Any Restorative Payments will be treated as contributions paid to the Trust in a particular taxable year to the extent that the Employer has reasonably determined that the Restorative Payments will not be returned pursuant to the state insurer delinquency proceedings. The Restorative Payments that are not returned to the Employer and that are treated as contributions under this paragraph will be subject to the limits of § 404 of the Code.

(D) Where any Restorative Payments or earnings thereon are required to be returned to the Employer, as represented in this agreement, any amount that is not promptly returned to the Employer will be treated as returned to the Employer and recontributed to the Trust in the taxable year in which the Trustee is obligated to return that amount to the Employer. Because the deemed recontribution to the Trust is not a Restorative Payment, it is subject to the rules governing plan contributions and allocations without regard to this agreement.

(E) Amounts that are returned to the Employer, as described under the representations in this agreement, are treated as follows:

(1) Except as provided in subparagraph (2) below, an amount returned to the Employer is includible in the gross income of the Employer only if the amount returned causes the total of the amounts returned to date to exceed the total Restorative Payments made to date.

(2) An amount returned to the Employer that does not cause the total of amounts returned to the Employer to exceed the total Restorative Payments is includible in gross income, subject to § 111 of the Code, if the amount returned causes the total of amounts returned to the Employer to exceed the total Restorative Payments made to date less Restorative Payments deducted by the Employer to date.

(F) The Trustee will maintain an unallocated suspense account to determine the amount of any increase in the value of Plan assets over what the value would have been, in the absence of Restorative Payments, had the Insurer satisfied the terms and conditions of the GC. This account will be maintained as described in subparagraphs (1) and (2) below. Any balance ultimately remaining in this account will be allocated to participants' accounts as described in subparagraph (3) below.

(1) The account will be established as of the date the Employer commences to make Restorative Payments to the Plan. The amount in the account, until subparagraph (2) below applies, will be equal to the amount of Restorative Payments plus the proceeds received by the Plan on account of the GC, less distributions, loans and transfers to other investment options of account balances invested in the GC, and repayments of Restorative Payments to the Employer (including amounts deemed repaid under subparagraph (D) of this paragraph 6). The account will be adjusted to reflect the investment experience (positive or negative) attributable to any balance in the account.

(2) When the Trust is not entitled to receive any further proceeds on account of the GC, the value of all participants' account balances remaining that are attributable to investment in the GC will be subtracted from the amount in the account.

(3) Any positive balance remaining in the account, after the application of subparagraph (2) above, must be allocated to participants' accounts as contributions under the Plan before any additional employer contributions are made to the Plan. The Employer will not treat this allocation as a contribution paid to the Trust under § 404 of the Code. The Employer will make this allocation in accordance with the normal plan qualification rules, including §§ 401(a)(4) and 415.

7. This agreement constitutes a resolution under the Code solely of the specific matters discussed herein. No inference shall be made as to the application of the Code under any facts and circumstances outside this agreement. No inference shall be made with respect to whether this resolution satisfies other federal law, including Title I of the Employee Retirement Income Security Act of 1974.

This agreement is final and conclusive except:

- (a) the matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of material fact;
- (b) it is subject to the Code sections that expressly provide that effect be given to their provisions (including any stated exception for § 7122) notwithstanding any other law or rule of law; and
- (c) if it relates to a tax period ending after the date of this agreement, it is subject to any law, enacted after the agreement date, that applies to that tax period.

By signing, the above parties certify that they have read and agreed to the terms of this document.

X CORPORATION

By: _____

Title: _____ Date Signed: _____

X CORPORATION RETIREMENT PLAN TRUST

By: _____

Title: _____ Date Signed: _____

COMMISSIONER OF INTERNAL REVENUE

By: _____

Title: _____ Date Signed: _____

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SECTION 1. PURPOSE

This revenue procedure sets forth inflation adjusted items for 1996.

SECTION 2. CHANGE MADE FROM PRECEDING YEAR

An amount used to provide an exception to reporting requirements under § 6033(e)(3) of the Internal Revenue Code for certain exempt organizations with nondeductible lobbying expenditures is adjusted for inflation for tax years beginning in 1996. See section 3.11 of this revenue procedure.

SECTION 3. 1996 ADJUSTED ITEMS

.01 *Tax Rate Tables.*

The following adjusted tax rate tables are prescribed in lieu of the tables in subsections (a), (b), (c), (d), and (e) of § 1 of the Code with respect to tax years beginning in 1996.

TABLE 1—Section 1(a).—MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

| If Taxable Income Is: | The Tax Is: |
|---------------------------------------|--|
| Not Over \$40,100 | 15% of the taxable income |
| Over \$40,100 but not over \$96,900 | \$6,015 plus 28% of the excess over \$40,100 |
| Over \$96,900 but not over \$147,700 | \$21,919 plus 31% of the excess over \$96,900 |
| Over \$147,700 but not over \$236,750 | \$37,667 plus 36% of the excess over \$147,700 |
| Over \$263,750 | \$79,445 plus 39.6% of the excess over \$263,750 |

TABLE 2—Section 1(b).—HEADS OF HOUSEHOLDS

| If Taxable Income Is: | The Tax Is: |
|---------------------------------------|--|
| Not Over \$32,150 | 15% of the taxable income |
| Over \$32,150 but not over \$83,050 | \$4,822.50 plus 28% of the excess over \$32,150 |
| Over \$83,050 but not over \$134,500 | \$19,074.50 plus 31% of the excess over \$83,050 |
| Over \$134,500 but not over \$263,750 | \$35,024 plus 36% of the excess over \$134,500 |
| Over \$263,750 | \$81,554 plus 39.6% of the excess over \$263,750 |

TABLE 3—Section 1(c).—UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

| If Taxable Income Is: | The Tax Is: |
|---------------------------------------|---|
| Not Over \$24,000 | 15% of the taxable income |
| Over \$24,000 but not over \$58,150 | \$3,600 plus 28% of the excess over \$24,000 |
| Over \$58,150 but not over \$121,300 | \$13,162 plus 31% of the excess over \$58,150 |
| Over \$121,300 but not over \$263,750 | \$32,738.50 plus 36% of the excess over \$121,300 |
| Over \$263,750 | \$84,020.50 plus 39.6% of the excess over \$263,750 |

TABLE 4—Section 1(d).—MARRIED INDIVIDUALS FILING SEPARATE RETURNS

| If Taxable Income Is: | The Tax Is: |
|--------------------------------------|---|
| Not Over \$20,050 | 15% of the taxable income |
| Over \$20,050 but not over \$48,450 | \$3,007.50 plus 28% of the excess over \$20,050 |
| Over \$48,450 but not over \$73,850 | \$10,959.50 plus 31% of the excess over \$48,450 |
| Over \$73,850 but not over \$131,875 | \$18,833.50 plus 36% of the excess over \$73,850 |
| Over \$131,875 | \$39,722.50 plus 39.6% of the excess over \$131,875 |

TABLE 5—Section 1(e).—ESTATES AND TRUSTS

| If Taxable Income Is: | The Tax Is: |
|-----------------------------------|---|
| Not Over \$1,600 | 15% of the taxable income |
| Over \$1,600 but not over \$3,800 | \$240 plus 28% of the excess over \$1,600 |
| Over \$3,800 but not over \$5,800 | \$856 plus 31% of the excess over \$3,800 |
| Over \$5,800 but not over \$7,900 | \$1,476 plus 36% of the excess over \$5,800 |
| Over \$7,900 | \$2,232 plus 39.6% of the excess over \$7,900 |

.02 *Unearned Income of Minor Children Taxed as if Parent's Income (the "Kiddie Tax").*

(1) Section 1(g) provides that the tax on the net unearned income of a child under the age of 14 is computed at the marginal rate of the child's parent. Under § 1(g)(4)(A)(ii), net unearned income generally equals unearned income less the sum of (I) the amount in effect for the tax year under

§ 63(c)(5)(A), plus (II) the greater of the amount described in (I) or certain itemized deductions.

(2) The amount in effect for tax years beginning in 1996 under § 63(c)(5)(A) is \$650. See section 3.04(2) below. Accordingly, for tax years beginning in 1996 net unearned income will generally equal unearned income less the greater of \$1,300 or \$650 plus certain itemized deductions.

.03 *Earned Income Tax Credit.*

(1) Section 32(a)(1) provides an earned income tax credit amount for certain taxpayers with one child, two or more children, or no children. For tax years beginning in 1996, the "maximum amount of the credit" is calculated by multiplying the "earned income amount" by the "credit percentage" as follows:

| <i>Type of Taxpayer</i> | <i>Credit Percentage</i> | <i>Earned Income Amount</i> | <i>Maximum Amount of the Credit</i> |
|-------------------------|--------------------------|-----------------------------|-------------------------------------|
| 1 child | 34 | \$6,330 | \$2,152 |
| 2 or more children | 40 | \$8,890 | \$3,556 |
| no children | 7.65 | \$4,220 | \$ 323 |

(2) Section 32(a)(2) provides for the phaseout of the earned income tax credit. The amount of the reduction in the maximum amount of the credit caused by the phaseout is calculated by multiplying the "phaseout percentage" by the amount by which the taxpayer's adjusted gross income (or, if greater, earned income) exceeds the "threshold phaseout amount." For tax years beginning in 1996, the "phaseout percentages," the "threshold phaseout amounts," and the "completed phaseout amounts" are as follows:

| <i>Type of Taxpayer</i> | <i>Phaseout Percentage</i> | <i>Threshold Phaseout Amount</i> | <i>Completed Phaseout Amount</i> |
|-------------------------|----------------------------|----------------------------------|----------------------------------|
| 1 child | 15.98 | \$11,610 | \$25,078 |
| 2 or more children | 21.06 | \$11,610 | \$28,495 |
| no children | 7.65 | \$ 5,280 | \$ 9,500 |

(3) The Internal Revenue Service will prescribe tables showing the amount of the earned income tax credit for each type of taxpayer.

.04 Standard Deduction.

(1) The following adjusted standard deduction amounts are prescribed in lieu of the amounts set forth in § 63(c)(2) with respect to tax years beginning in 1996.

| <i>Filing Status</i> | <i>Standard Deduction</i> |
|--|---------------------------|
| MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES | \$6,700 |
| HEADS OF HOUSEHOLDS | \$5,900 |
| UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS) | \$4,000 |
| MARRIED INDIVIDUALS FILING A SEPARATE RETURN | \$3,350 |

(2) Under § 63(c)(5) for tax years beginning in 1996, the standard deduction for an individual who may be claimed as a dependent by another taxpayer for a tax year beginning in the calendar year in which the individual's tax year begins, cannot exceed the greater of (A) \$650 or (B) the amount of the individual's earned income.

(3) Under § 63(f) for tax years beginning in 1996, the additional standard deduction amounts for the aged and for the blind are \$800 for each. These amounts are each increased to \$1,000 if the individual is also unmarried and not a surviving spouse.

.05 Overall Limitation on Itemized Deductions.

(1) Section 68 provides that the amount of itemized deductions other wise allowable for the tax year shall be reduced by the lesser of (1) 3 percent of the excess of adjusted gross income over the "applicable amount," or (2) 80 percent of the amount of certain itemized deductions otherwise allowable for the tax year.

(2) The “applicable amount” for tax years beginning in 1996 is \$117,950 (\$58,975 in the case of a separate return by a married individual within the meaning of § 7703).

.06 Qualified Transportation Fringe.

(1) Section 132(f) provides an exclusion from gross income for certain employer-provided transportation referred to as a “qualified transportation fringe.” A “qualified transportation fringe” means any of the following: transportation in a commuter highway vehicle between the employee’s residence and place of employment, any transit pass, and qualified parking. Section 132(f)(2)(A) limits the exclusion for the aggregate of the transportation in a commuter highway vehicle

and the transit pass to \$60 per month (the “\$60 vehicle/transit” limitation). Section 132(f)(2)(B) limits the exclusion for qualified parking to \$155 per month (the “\$155 parking” limitation).

(2) For tax years beginning in 1996, the “\$60 vehicle/transit” limitation is \$65 and the “\$155 parking” limitation is \$165.

.07 Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.

(1) Section 135 provides an exclusion of income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses. Section 135(b)(2) provides for the phaseout of the exclusion. The amount of the reduction in the

exclusion caused by the phaseout is calculated by multiplying the amount otherwise excludable by a fraction. The numerator of the fraction is the excess of the taxpayer’s modified adjusted gross income over the threshold amount (\$60,000 for joint returns or \$40,000 for others) and the denominator is \$30,000 for joint returns or \$15,000 for others.

(2) For tax years beginning in 1996, the amounts of modified adjusted gross income above which the phaseout of the exclusion begins (“threshold phaseout amounts”) and the amounts at which the benefit is completely phased out (“completed phaseout amounts”) are as follows:

| <i>Type of Taxpayer</i> | <i>Threshold Phaseout Amount</i> | <i>Completed Phaseout Amount</i> |
|-------------------------|----------------------------------|----------------------------------|
| Code § 1(a) | \$65,250 | \$95,250 |
| Others | \$43,500 | \$58,500 |

.08 Personal Exemption.

(1) Section 151(b) generally allows a taxpayer an exemption for himself or herself. Section 151(c) generally allows a taxpayer additional exemptions for dependents as defined in § 152. The personal exemption for tax years beginning in 1996 is \$2,550.

(2) Section 151(d)(3) provides for the phaseout of the tax benefit of the personal exemptions allowed by § 151. The reduction in the amount of personal exemptions caused by the phaseout is calculated by reducing the total amount of the personal exemptions by 2 percent for each \$2,500 increment (or portion thereof) of adjusted gross income in excess of a threshold phaseout amount. For tax years beginning in 1996, the “threshold phaseout amounts” and the “completed phaseout amounts” are as follows:

| <i>Type of Taxpayer</i> | <i>Threshold Phaseout Amount</i> | <i>Completed Phaseout Amount After</i> |
|-------------------------|----------------------------------|--|
| Code § 1(a) | \$176,950 | \$299,450 |
| Code § 1(b) | \$147,450 | \$269,950 |
| Code § 1(c) | \$117,950 | \$240,450 |
| Code § 1(d) | \$ 88,475 | \$149,725 |

.09 Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.

(1) Section 513(h)(1)(A) provides that, in the case of certain exempt organizations, the term “unrelated business income” does not include activities relating to the distribution of “low cost articles” (as defined in § 513(h)(2)) if the distribution of such articles is incidental to the solicitation of charitable contributions.

(2) Section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471, as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987, and as modified by Rev. Proc. 92-102, 1992-2

C.B. 579, provides guidelines for determining the deductible amount of contributions under § 170 when the contributors receive something in return for their contributions. The guidelines provide that insubstantial benefits received by the contributor (in the context of a charitable fund-raising campaign) are disregarded, which makes the contribution fully deductible under § 170. The guidelines further provide the following three alternative limitations on what are insubstantial benefits:

(a) The fair market value of all the benefits received is not more than

2-percent of the contribution, or \$50 (the “\$50 benefit” limitation), whichever is less;

(b) The contribution is \$25 (the “\$25 payment” limitation) or more, and the only benefits received by the donor in return during the calendar year have a cost, in the aggregate, of not more than a “low cost article” under § 513(h)(2); or

(c) In connection with a request for a charitable contribution, the charity mails or otherwise distributes free, unordered items to patrons, and the cost of such items (in the aggregate) distributed to any single patron in a

calendar year is not more than a “low cost article” under § 513(h)(2).

(3) For tax years beginning in 1996, the “\$50 benefit” limitation is \$67, the “\$25 payment” limitation is \$33.50, and the “low cost article” limitation is \$6.70.

.10 *Luxury Automobile Excise Tax.*

(1) Section 4001(a) imposes an excise tax on the first retail sale of any passenger vehicle to the extent the price exceeds \$30,000 (the “\$30,000 amount”). Section 4003(a) imposes an excise tax on the installation of parts or accessories on a passenger vehicle within six months of the date after the vehicle was first placed in service, to the extent the price of all parts and accessories, including installation, and the price of the vehicle exceed the “\$30,000 amount.”

(2) The “\$30,000 amount” for calendar year 1996 is \$34,000.

.11 *Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures.*

(1) Section 6033(e)(1)(A) provides that certain exempt organizations that pay or incur nondeductible lobbying expenditures must include the total of those expenditures on their annual returns and must notify their members with a reasonable estimate of the portion of dues allocated to those expenditures. Section 6033(e)(3) provides that § 6033(e)(1)(A) shall not apply to an organization that establishes to the satisfaction of the Secretary that substantially all of its dues are nondeductible without regard to the lobbying expenditure restrictions. Section 4.02 of Rev. Proc. 95-35, 1995-32 I.R.B. 51, provides that § 501(c)(4) social welfare organizations and § 501(c)(5) agricultural and horticultural organizations are treated as satisfying § 6033(e)(3) if either (1) more than 90 percent of all annual dues are received from persons, families, or entities who each pay less than \$50 (the “\$50 exception” amount), or (2) more than 90 percent of all annual dues are received from certain exempt entities.

(2) For tax years beginning in 1996, the “\$50 exception” amount is \$52.

SECTION 4. COMPUTATION OF INFLATION ADJUSTMENTS

.01 *Tax Rate Tables.*

(1) Section 1(f)(1) provides that not later than December 15 of each calen-

dar year, the Secretary shall prescribe inflation-adjusted tax rate tables that apply in lieu of the tax rate tables in § 1 with respect to tax years beginning in the succeeding calendar year.

(2) Under § 1(f)(3), the inflation adjustment for a calendar year is the percentage (if any) by which the Consumer Price Index (CPI) for the preceding calendar year exceeds the CPI for the calendar year 1992. However, § 1(f)(7)(A) provides that in prescribing the inflation adjustments for the 36 percent and 39.6 percent tax rate brackets, the preceding calendar year’s CPI is compared with the CPI for the calendar year 1993. For purposes of computing the inflation adjustment, § 1(f)(4) defines the CPI as the average of the 12 monthly CPIs for the 12-month period ending on August 31 of such calendar year. Under § 1(f)(5), the CPI is that for all-urban consumers published by the Department of Labor.

(3) Section 1(f)(2)(A) provides that the inflation adjustment is reflected in the tax rate tables by increasing the minimum and maximum dollar amounts for each rate bracket. Under § 1(f)(6), an adjusted bracket amount is “rounded down” to the nearest multiple of \$50 (\$25 in the case of married individuals filing separately).

.02 *Kiddie Tax.* Section 1(g)(4) uses the limitation on the standard deduction for certain dependents under § 63(c)-(5)(A) in computing the “kiddie tax.” That limitation is adjusted for inflation under § 63(c)(4). The inflation adjustment computation under § 63(c)(4) is described below in section 4.04.

.03 *Earned Income Tax Credit.* Section 32(i) provides that the “earned income amounts” and “phaseout amounts,” which limit the earned income tax credit, are adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year’s CPI is compared with the CPI for the calendar year 1993. Under § 32(i)(2), an adjusted amount is rounded to the nearest multiple of \$10 (or, if the adjusted amount is a multiple of \$5, it is increased to the next highest multiple of \$10).

.04 *Standard Deduction.* Under § 63(c)(4), the standard deduction amounts (including the limitation for certain dependents and the additional standard deduction amounts for the aged and for the blind) are adjusted for inflation under the method described in § 1(f)(3), except that the preceding

calendar year’s CPI is compared with the CPI for the calendar year 1987. Under § 1(f)(6), an adjusted amount is “rounded down” to the nearest multiple of \$50 (\$25 in the case of the basic standard deduction for married individuals filing separately).

.05 *Overall Limitation on Itemized Deductions.* Section 68(b)(2) provides that the “applicable amount” for the overall limitation on itemized deductions is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year’s CPI is compared with the CPI for the calendar year 1990. Under § 1(f)(6), the adjusted “applicable amount” is “rounded down” to the nearest multiple of \$50 (\$25 in the case of married individuals filing separately).

.06 *Qualified Transportation Fringe.* Section 132(f) provides that the limitation on the amount of the exclusion from gross income for a qualified transportation fringe is adjusted for inflation under the method described in § 1(f)(3). See section 4.01 above. Under § 132(f)(6)(B), an increased amount that is not a multiple of \$5 is “rounded down” to the next lowest multiple of \$5.

.07 *Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.* Section 135(b)(2)(B) provides that the dollar amount at which the phaseout of the exclusion (of income from the redemption of United States savings bonds for taxpayers who pay qualified higher education expenses) begins is adjusted for inflation under the method described in § 1(f)(3). The preceding calendar year’s CPI is compared with the CPI for the calendar year 1992. The adjusted dollar amount is rounded to the nearest multiple of \$50 (if the adjusted figure is a multiple of \$25, it is increased to the next highest multiple of \$50) under § 135(b)(2)(C).

.08 *Personal Exemption.*

(1) Section 151(d)(4)(A) provides that the personal exemption amount is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year’s CPI is compared with the CPI for the calendar year 1988. The adjusted exemption is “rounded down” to the nearest multiple of \$50 under § 1(f)(6).

(2) Section 151(d)(4)(B) provides that the “threshold amounts” at which the phaseout of the tax benefit of the personal exemptions begins are ad-

justed for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1990. Under § 1(f)(6), an adjusted "threshold amount" is "rounded down" to the nearest multiple of \$50 (\$25 in the case of married individuals filing separately).

.09 *Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.*

(1) Section 513(h)(2)(C) provides that the maximum cost of a "low cost article" is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1987.

(2) Rev. Proc. 90-12 provides for the adjustment of the "low cost article" and the "\$25 payment" limitations in that revenue procedure as provided under § 513(h)(2)(C). The "\$50 benefit" limitation in that revenue procedure is adjusted in the same manner.

.10 *Luxury Automobile Excise Tax.*

(1) Section 4001(e) provides that the "\$30,000 amount" threshold for the excise tax on a luxury automobile in §§ 4001(a) and 4003(a) is adjusted for inflation. The adjustment, before rounding, is the excess of (A) the "\$30,000 amount" increased by the method described in § 1(f)(3), except that the preceding calendar year's CPI is compared with the CPI for the calendar year 1990, over (B) the dollar amount in effect under § 4001(a) for the calendar year. Under § 4001(e)(1)(B), the adjusted "\$30,000 amount" is "rounded down" to the nearest multiple of \$2,000.

(2) Section 4001(e)(1) further provides that the adjusted and rounded amount shall apply to the calendar year subsequent to the year on which the cost of living calculations are based. This means that the inflation adjustment factor for the \$30,000 amount for tax years beginning in 1996 is computed by comparing the CPI for calendar year 1994 with the CPI for the calendar year 1990.

.11 *Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures.* Section 5.05 of Rev. Proc. 95-35 provides that the "\$50 exception" amount is adjusted for inflation under the method described in § 1(f)(3), except that the preceding calendar year's CPI is com-

pared with the CPI for the calendar year 1994. The adjusted "\$50 exception" amount is rounded up to the next highest dollar.

SECTION 5. 1996 INFLATION ADJUSTMENT FACTORS

.01 *1994 Base Year Adjustments.* The CPI for 1995 is 151.0750000000 and the CPI for 1994 is 146.9000000000. This results in an inflation adjustment factor of 1.0284206943. This factor applies to the reporting exception for certain exempt organizations with nondeductible lobbying expenditures for tax years beginning in 1996.

.02 *1993 Base Year Adjustments.* The CPI for 1995 is 151.0750000000 and the CPI for 1993 is 143.1750000000. This results in an inflation adjustment factor of 1.0551772307. This factor applies to the 36 percent and 39.6 percent brackets of the tax rate tables, and to the earned income tax credit for tax years beginning in 1996.

.03 *1992 Base Year Adjustments.* The CPI for 1995 is 151.0750000000 and the CPI for 1992 is 138.9250000000. This results in an inflation adjustment factor of 1.0874572611. This factor applies to the 15 percent, 28 percent, and 31 percent brackets of the tax rate tables, to the qualified higher education expense exclusion, and to the qualified transportation fringe limitations for tax years beginning in 1996.

.04 *1990 Base Year Adjustments.*

(1) The CPI for 1995 is 151.0750000000 and the CPI for 1990 is 128.0583333333. This results in an inflation adjustment factor of 1.1797357975. This factor applies to the phaseout of personal exemptions and to the limitation on itemized deductions for tax years beginning in 1996.

(2) The CPI for 1994 is 146.9000000000 and the CPI for 1990 is 128.0583333333. This results in an inflation adjustment factor of 1.1471334678. This factor applies to the luxury automobile excise tax threshold for tax years beginning in 1996.

.05 *1988 Base Year Adjustments.* The CPI for 1995 is 151.0750000000 and the CPI for 1988 is 116.6166666667. This results in an inflation adjustment factor of 1.2954837788. This factor applies to the personal exemption for tax years beginning in 1996.

.06 *1987 Base Year Adjustments.* The CPI for 1995 is 151.0750000000 and the CPI for 1987 is 111.9833333333.

This results in an inflation adjustment factor of 1.3490846852. This factor applies to the "kiddie tax," the standard deduction amounts, and the insubstantial benefit limitations for charitable contributions for tax years beginning in 1996.

SECTION 6. EFFECTIVE DATE

For income tax purposes, this revenue procedure applies to tax years beginning in 1996. For excise tax purposes, this revenue procedure applies to transactions occurring in calendar year 1996. Congress is currently considering legislation that may affect this revenue procedure. If that legislation is enacted, this revenue procedure will be updated accordingly.

26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability. (Also Part I, Sections 62, 162, 274, 1016; 1.62-2, 1.162-17, 1.274-5T, 1.274(d)-1, 1.1016-3.)

Rev. Proc. 95-54

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 94-73, 1994-2 C.B. 816, by providing optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred on or after January 1, 1996, of operating a passenger automobile for business, charitable, medical, or moving expense purposes. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under § 1.274-5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

SEC. 2. SUMMARY OF STANDARD MILEAGE RATES

| | |
|-----------------------------------|---------------------|
| Business (Sec. 5 below) | 31 cents per mile |
| Rural Mail Carrier (Sec. 6 below) | 46.5 cents per mile |
| Charitable (Sec. 7 below) | 12 cents per mile |
| Medical and Moving (Sec. 7 below) | 10 cents per mile |

SEC. 3. BACKGROUND

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating a passenger automobile to the extent that it is used in a trade or business. However, under § 262, no portion of the cost of operating a passenger automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4)) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.03 Section 1.274(d)-1 in part, grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of local travel and transportation away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel and transportation expenses for purposes of § 1.274-5T(c), and (2) satisfying the requirements of an adequate accounting to the employer of the amount of such expenses for purposes of § 1.274-5T(f).

.04 Section 62(a)(2)(A) allows an employee, in determining adjusted

gross income, a deduction for the expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.05 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.06 Under § 1.62-2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62-2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)-1 will be treated as substantiation of the amount of such expenses for purposes of § 1.62-2. Under § 1.62-2(f)(2), the Commissioner may prescribe rules under which an arrangement providing mileage allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to miles of travel not substantiated.

.07 Section 1.62-2(h)(2)(i)(B) provides that if a payor pays a mileage

allowance under an arrangement that meets the requirements of § 1.62-2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with § 1.62-2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under §§ 274(d) and 1.274(d)-1, and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)-3, 31.3231(e)-3, 31.3306(b)-2, and 31.3401(a)-4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62-2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.08 Under § 1.62-2(h)(2)(i)(B)(4), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

SEC. 4. DEFINITIONS

.01 *Standard mileage rate.* The term "standard mileage rate" means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating passenger automobiles owned by them (including vans, pickups, or panel trucks) for business purposes, or by taxpayers in computing the deductible costs of operating passenger automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses.* The term "transportation expenses" means the expenses of operating a passenger automobile for local travel or transportation away from home.

.03 *Mileage allowance.* The term "mileage allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62-2(c)(1) and that is

(1) paid with respect to the ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable standard mileage rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.04 *Flat rate or stated schedule.* A mileage allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03. Such allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation, insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for such purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

SEC. 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general.* The standard mileage rate for transportation expenses paid or incurred on or after January 1, 1996, is 31 cents per mile for all miles of use for business purposes. This business standard mileage rate will be adjusted annually (to the extent warranted) by the Service, and any such adjustment will be applied prospectively.

.02 *Use of the business standard mileage rate.* A taxpayer may, on a yearly basis, deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both operating and fixed) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of operating and fixed costs.* A deduction computed using the standard mileage rate for business miles is in

lieu of operating and fixed costs of the automobile allocable to business purposes. Such items as depreciation, maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and registration fees are included in operating and fixed costs.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local taxes (other than those included in the cost of gasoline) may be deducted as separate items, but only to the extent that the interest or taxes are allowable deductions under § 163 or 164 respectively. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable. However, § 162(h)(2)(A) expressly provides that interest is nondeductible personal interest when it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 also expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property will be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of such property.

.05 *Depreciation.*

For automobiles placed in service for business purposes after December 31, 1979, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 7 cents a mile for 1980 and 1981; 7.5 cents a mile for 1982; 8 cents a mile for 1983, 1984, and 1985; 9 cents a mile for 1986; 10 cents a mile for 1987; 10.5 cents a mile for 1988; 11 cents a mile for 1989, 1990, and 1991; 11.5 cents a mile for 1992 and 1993; and 12 cents a mile for 1994, 1995, and 1996, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, the rates above will not apply to any year in which such costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 *Limitations.*

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) vehicles used for hire, such as taxicabs, (b) two or more automobiles used simultaneously (such as in fleet operations), or (c) any vehicle that is leased, rather than owned, by the taxpayer.

(2) The business standard mileage rate may not be used if (a) the automobile has previously been depreciated using a method other than straight-line for its estimated useful life, (b) additional first-year depreciation has been claimed, or (c) the taxpayer has used the Accelerated Cost Recovery System (ACRS) or Modified Accelerated Cost Recovery System (MACRS) under § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile from ACRS or MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's estimated useful life (subject to the applicable depreciation deduction limitations under § 280F for any passenger automobile).

SEC. 6. RURAL MAIL CARRIER SPECIAL MILEAGE RATE

.01 *Special mileage rate.* For taxable years beginning after December 31, 1987, § 6008 of the Technical and Miscellaneous Revenue Act of 1988, 1988-3 C.B. 347, allows employees of the United States Postal Service to use a special mileage rate in computing the amount allowable as a deduction for business use of an automobile in performing qualifying services. Qualifying services are services involving the collection and delivery of mail on a "rural route," as that term is defined by the Postal Service. The special mileage rate is equal to 150 percent of the business standard mileage rate, and is 46.5 cents per mile for transportation expenses paid or incurred on or after January 1, 1996 (150 percent of the business standard mileage rate of 31 cents per mile). The special mileage rate applies to all business use of an automobile while performing qualifying services. It will be adjusted annually (to the extent warranted) by the Service to reflect changes in the business standard mileage rate, and any such adjustment will be applied prospectively.

.02 *Depreciation.* In determining the adjusted basis of an automobile used to perform qualifying services, depreciation will be computed as provided in section 5.05, except as provided in section 6.03.

.03 *Special depreciation rules.* The special mileage rate is not available for any automobile if, for any taxable year beginning after December 31, 1987, the employee claims depreciation for such automobile. For this purpose, claiming depreciation means the deduction of any amount under § 167, 168, or 179 (including any such deduction attributable to use in a trade or business that does not involve the performance of qualifying services). The availability of the special mileage rate is not affected by depreciation claimed for taxable years beginning before January 1, 1988. Thus, the special mileage rate is available even if the automobile was fully depreciated in taxable years beginning before January 1, 1988, and regardless of the year the automobile was placed in service.

.04 *Rural mail carrier special mileage rate in lieu of operating and fixed costs.* The rules provided under section 5.03 also apply to use of the special mileage rate.

.05 *Parking fees, tolls, interest, and taxes.* The rules provided under section 5.04 also apply to the use of the special mileage rate.

SEC. 7. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATE

.01 *Charitable.* Section 170(i) provides a standard mileage rate of 12 cents per mile for purposes of computing the charitable deduction for use of a passenger automobile in connection with rendering gratuitous services to a charitable organization under § 170.

.02 *Medical and moving.* The standard mileage rate is 10 cents per mile for use of a passenger automobile (a) to obtain medical care described in § 213, or (b) as part of a move for which the expenses are deductible under § 217. The standard mileage rates for medical and moving transportation expenses will be adjusted annually (to the extent warranted) by the Service, and any such adjustment will be applied prospectively.

.03 *Charitable, medical, or moving expense standard mileage rate in lieu of operating expenses.* A deduction

computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of operating expenses (including gasoline and oil) of the automobile allocable to such purposes. Costs for such items as depreciation, maintenance and repairs, tires, insurance, and registration fees are not deductible, and are not included in such standard mileage rates.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local taxes (other than those included in the cost of gasoline) may be deducted as separate items, but only to the extent that the interest and taxes are allowable deductions under § 163 or 164, respectively.

SEC. 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 *In general.*

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile in connection with the performance of services as an employee of the employer will be deemed substantiated (in an amount determined under section 9) when a payor reimburses such expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of this section (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in approximating the actual expenses of employees receiving the allowance.

.02 *Definitions.*

(1) *FAVR allowance.* A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes

any optional high mileage payments; however, such optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes when paid. See section 9.05. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment.* A periodic fixed payment covers the projected fixed costs (including depreciation, insurance, registration and license fees, and personal property taxes) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs for the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment.* A periodic variable payment covers the projected operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected operating costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in

the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality.* A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection with the performance of services as an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally the geographic locality or region in which the employee resides. For purposes of determining the amount of operating costs, the base locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile.* A standard automobile is the passenger automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost.* The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of such an automobile. Further, the standard automobile cost may not exceed \$26,100.

(7) *Annual mileage.* Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage.* Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage.* A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the

reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

| <i>Annual business mileage</i> | <i>Business use percentage</i> |
|-------------------------------------|--------------------------------|
| 6,250 or more but less than 10,000 | 45 percent |
| 10,000 or more but less than 15,000 | 55 percent |
| 15,000 or more but less than 20,000 | 65 percent |
| 20,000 or more | 75 percent |

(10) *Retention period.* A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. Such period may not be less than two calendar years.

(11) *Retention mileage.* Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value.* The residual value of a standard automobile is the projected amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual values for a standard automobile computed as a percentage of the standard automobile cost:

| <i>Retention period</i> | <i>Residual value</i> |
|-------------------------|-----------------------|
| 2-year | 70 percent |
| 3-year | 60 percent |
| 4-year | 50 percent |

.03 FAVR allowance in lieu of operating and fixed costs.

(1) Except as provided in section 8.03(2), a deduction computed using a FAVR allowance is in lieu of all the operating and fixed costs paid or incurred by an employee in driving the automobile in connection with the performance of services as an employee of the employer.

(2) Parking fees and tolls attributable to an employee driving the standard

automobile in connection with the performance of services as an employee of the employer are not included in fixed and operating costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 Depreciation.

(1) A FAVR allowance may not be paid with respect to an automobile for which the employee has claimed (a) depreciation using a method other than straight-line for its estimated useful life, (b) additional first-year depreciation, or (c) depreciation using ACRS or MACRS under § 168. If an employee uses actual costs for an automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's estimated useful life (subject to the applicable depreciation deduction limitations under § 280F for any passenger automobile).

(2) The total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of such depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) for the requirement that the employer report the depreciation component of a periodic fixed payment to the employee.

.05 FAVR allowance limitations.

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the

entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.62-21(f)(5) and (6), excluding the \$100,000 limitation in paragraph (f)(5)(iii)).

(3) At no time during a calendar year may a majority of the employees covered by a FAVR allowance be management employees.

(4) At all times during a calendar year at least 10 employees of an employer must be covered by one or more FAVR allowances.

(5) A FAVR allowance may be paid only with respect to an automobile (a) owned by the employee receiving the payment, (b) the cost of which, when new, is at least 90 percent of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account such rate-increasing factors as poor driving records or young drivers.

(7) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage limits used to compute the periodic fixed payment under that FAVR allowance.

.06 Employee reporting. Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if such coverage has lapsed, the employee by written declaration must provide the payor with the following information: (a) the make, model, and year of the automobile owned by the employee, (b) written proof of the insurance coverage limits on the automobile, (c) the odometer reading of the automobile, (d) the purchase price of the automobile, and (e) whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1).

The information described in (a), (b), and (c) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 Payor recordkeeping and reporting.

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement listing the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and explaining that by receiving a FAVR allowance the employee has elected to exclude the automobile from ACRS and MACRS pursuant to § 168(f)(1).

.08 Failure to meet section 8 requirements. If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8, the employee may not be treated as covered by any FAVR allowance of the payor during the period of such failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 to the extent the requirements of those sections are met.

SEC. 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 or 6.01 multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that

relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the rules provided in section 9.01, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home), (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation), and (c) of § 1.274-5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274-5T(f), as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274-5T(c). See § 1.62-2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62-2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)) any portion of such an allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of such an allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage allowance of \$70 based on an anticipated 200 business miles at 35 cents per mile (at a time when the applicable business standard mileage rate is 31 cents per mile), and the employee substantiates 120 business

miles. The requirement to return excess amounts will be treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles (\$28) even though the employee is not required to return the portion of the allowance (\$4.80) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 (\$37.20) for the 120 substantiated business miles. However, the \$4.80 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62-2(g)), (a) the portion (if any) of the periodic variable payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01, provided the employee substantiates in accordance with section 9.02. See § 1.274-5T(f)(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from the withholding and payment of employment taxes. See §§ 1.62-2(c)(2) and (c)(4).

.05 An employee is required to include in gross income only the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01, provided the employee substantiates in accordance with section 9.02. See § 1.274-5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See §§ 1.62-2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06 If the amount of the expenses deemed substantiated under the rule

provided in section 9.01 is less than the amount of the employee's business transportation expenses, the employee may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274-5T(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.07 An employee may deduct an amount computed pursuant to section 5.01 or 6.01 only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 in determining adjusted gross income under § 62(a)(1).

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See §§ 1.62-2(c)(3), (c)(5), and (h)(2).

SEC. 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES.

.01 The portion of a mileage allowance (other than a FAVR al-

lowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in this section 10.01 is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. See § 1.62-2(h)(2)(i)(B)(2).

(2) In the case of a mileage allowance paid as an advance, the excess described in this section 10.01 is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. See § 1.62-2(h)(2)(i)(B)(3). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (e.g., a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8), the payor must compute the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) periodically (no less frequently than quarterly) by comparing the total mileage allowance paid for the period to the applicable standard mileage rate in section 5.01 or 6.01 multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 35 cents per mile (when the business standard mileage rate is 31 cents per mile). The employer does not require the return of the portion of the allowance (4 cents) that exceeds the business standard mileage rate for the business miles substantiated. In June, the employer advances an employee \$175 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns \$35 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is \$124 and the employee is not required to return the remaining \$16. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on \$16.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) is subject to withholding and payment of employment taxes. See § 1.62-2(h)(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62-2(h)(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SEC. 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94-73, 1994-2 C.B. 816, is hereby superseded for mileage allowances paid to an employee on or after January 1, 1996, with respect to transportation expenses paid or incurred on or after January 1, 1996, and, for purposes of computing the amount allowable as a deduction, for transporta-

tion expenses paid or incurred on or after January 1, 1996.

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.

Rev. Proc. 95-55

SECTION 1. PURPOSE

.01 This revenue procedure updates Rev. Proc. 94-74, 1994-2 C.B. 823, and identifies circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under § 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under § 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provision (including the negligence or disregard provisions of the § 6662 accuracy-related penalty).

.02 This revenue procedure applies to any return filed on 1995 tax forms for a taxable year beginning in 1995, and to any return filed on 1995 tax forms in 1996 for short taxable years beginning in 1996.

SEC. 2. CHANGES FROM REV. PROC. 94-74

Editorial changes only have been made in this revenue procedure.

SEC. 3. BACKGROUND

.01 If § 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of certain gross valuation misstatements.) Under § 6662(b)(2), § 6662 applies to the portion of an underpayment that is attributable to a substantial understatement of income tax.

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required

to be shown on the return for the taxable year or \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). Section 6662(d)(2) defines an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (within the meaning of § 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, § 6662(d)-(2)(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed on the return or on a statement attached to the return, and there is a reasonable basis for the tax treatment of such item by the taxpayer.

.04 In general, this revenue procedure provides guidance in determining when disclosure is adequate for purposes of § 6662(d). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable. Guidance under § 6662(d) for returns filed in 1993, 1994, and 1995 is provided in Rev. Proc. 93-33, 1993-2 C.B. 470; Rev. Proc. 94-36, 1994-1 C.B. 682; and Rev. Proc. 94-74, 1994-2 C.B. 823, respectively.

SEC. 4. PROCEDURE

.01 Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under § 6662(d) provided that the forms and attachments are completed in a clear manner and in accordance with their instructions. The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(1) Form 1040, Schedule A, Itemized Deductions:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expense: Complete lines 10 through 14, supplying all required information. This section 4.01(1)(c) does not apply to (i) amounts disallowed under § 163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) amounts disallowed under § 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Merely entering the amount of the donation on Schedule A, however, will not constitute adequate disclosure if the taxpayer receives a substantial benefit from the donation shown. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds \$500, a properly completed Form 8283, Noncash Charitable Contributions, must be attached to the return. This section 4.01(1)(d) will not apply to any contribution of \$250 or more unless the contemporaneous written acknowledgement requirement of § 170(f)(8) is satisfied.

(e) Casualty and Theft Losses: Complete Form 4684, Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section 4.01(2), the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.01(1)(e) above must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section 4.01(2)(b) does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or nondeductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed."

This section 4.01(2)(d) does not apply to "golden parachute" payments, as defined under § 280G. This section 4.01(2)(d) will not apply to the extent that remuneration paid or incurred exceeds the \$1 million employee remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section 4.01(2)(e) does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Form 1120, Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, provided:

(a) The amount of the deviation from the financial books and records is not the result of a computation that includes the netting of items; and

(b) The information provided reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report.

(b) Intercompany Transactions: Transactions and amounts shown on Schedule M (Form 5471), Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons, lines 19 and 20, and Form 5472, Part IV, Monetary Transactions Between Reporting Corporations and Foreign Related Party, lines 7 and 18.

(5) Other:

(a) Moving Expenses: Complete Form 3903, Moving Expenses, or Form 3903-F, Foreign Moving Expenses, and attach to the return.

(b) Sale or Exchange of Your Main Home: Complete Form 2119, Sale of Your Home, and attach to the return.

(c) Employee Business Expenses: Complete Form 2106, Employee Business Expenses, or Form 2106-EZ, Unreimbursed Employee Business Expenses, and attach to the return. This section 4.01(5)(c) does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on a trip.

(d) Fuels Credit: Complete Form 4136, Credit for Federal Tax Paid on Fuels, and attach to the return.

(e) Investment Credit: Complete Form 3468, Investment Credit, and attach to the return.

SEC. 5. EFFECTIVE DATE

.01 This revenue procedure applies to any return filed on 1995 tax forms for a taxable year beginning in 1995, and to any return filed on 1995 tax forms in 1996 for short taxable years beginning in 1996.

Social Security Contribution and Benefit Base

Under authority contained in the Social Security Act ("the Act"), the Commissioner, Social Security Administration, has determined and announced (60 F.R. 54751, dated October 25, 1995) that the contribution and benefit base for remuneration paid in 1996, and self-employment income earned in taxable years beginning in 1996 is \$62,700.

"Old-Law" Contribution and Benefit Base

General. The 1996 "old-law" contribution and benefit base is \$46,500. This is the base that would have been effective under the Act without the enactment of the 1977 amendments. The base is computed under section 230(b) of the Act as it read prior to the 1977 amendments.

The "old-law" contribution and benefit base is used by:

(a) the Railroad Retirement program to determine certain tax liabilities and tier II benefits payable under that program to supplement the tier I payments which correspond to basic Social Security benefits,

(b) the Pension Benefit Guaranty Corporation to determine the maximum amount of pension guaranteed under the Employee Retirement Income Security Act (as stated in section 230(d) of the Act),

(c) Social Security to determine a year of coverage in computing the special minimum benefit, as described earlier, and

(d) Social Security to determine a year of coverage (acquired whenever earnings equal or exceed 25 percent of the "old-law" base for this purpose only) in computing benefits for persons who are also eligible to receive pensions based on employment not covered under section 210 of the Act.

Treasury Directive No. 15-42

Delegation of Authority to the Commissioner, Internal Revenue Service, To Perform Functions Under the Money Laundering Control Act of 1986, as Amended

September 11, 1995.

1. *Purpose.* This Directive delegates to the Commissioner, Internal Revenue Service (IRS), investigatory, seizure and forfeiture authority under the Money Laundering Control Act of 1986, Public Law 99-570, Subtitle H (October 27, 1986), as amended.

2. *Delegation.* By virtue of the authority vested in the Secretary of the Treasury by 18 U.S.C. §§ 981, 1956(e), 1957(e) and the authority delegated to the Under Secretary (Enforcement) by Treasury Order (TO) 101-05, there is hereby delegated to the Commissioner, IRS:

a. investigatory authority over violations of 18 U.S.C. §§ 1956 and 1957 where the underlying conduct is subject to investigation under Title 26 or under the Bank Secrecy Act, as amended; 31 U.S.C. §§ 5311-5328 (other than violations of 31 U.S.C. § 5316);

b. seizure and forfeiture authority over violations of 18 U.S.C. § 981 relating to violations of:

(1) 31 U.S.C. §§ 5313 and 5324; and

(2) 18 U.S.C. §§ 1956 and 1957 which are within the investigatory jurisdiction of IRS pursuant to paragraph 2.a.; and

c. seizure authority relating to any other violation of 18 U.S.C. § 1956 or 1957 if the bureau with investigatory authority is not present to make the seizure. Property seized under 18 U.S.C. § 981 where investigatory jurisdiction is solely with another bureau not present at the time of the seizure shall be turned over to that bureau.

3. *Forfeiture Remission.* The Commissioner, IRS, is authorized to remit or mitigate forfeitures of property valued at not more than \$500,000 seized pursuant to paragraph 2.b.

4. *Redelegation.* The authority delegated by this directive may be redelegated.

5. *Coordination.*

a. If at any time during an investigation of a violation of 18 U.S.C. § 1956 or 1957, IRS discovers evidence of a

matter within the jurisdiction of another Treasury bureau, to the extent authorized by law, IRS shall immediately notify that bureau of the investigation and invite that bureau to participate in the investigation. The Commissioner, IRS, shall attempt to resolve disputes over investigatory jurisdiction with other Treasury bureaus at the field level.

b. The Under Secretary (Enforcement) shall settle disputes that cannot be resolved by the bureaus in consultation with the Commissioner, IRS.

c. With respect to matters discovered within the investigatory jurisdiction of a Department of Justice bureau or the Postal Service, IRS shall adhere to the provisions on notice and coordination in the "Memorandum of Understanding Among the Secretary of the Treasury, the Attorney General and the Postmaster General Regarding Money Laundering Investigations," dated August 16, 1990, or any such subsequent memorandum of understanding entered pursuant to 18 U.S.C. § 1956(e) or 1957(e).

d. With respect to seizure and forfeiture operations and activities within its investigative jurisdiction, IRS shall comply with the policy, procedures, and directives developed and maintained by the Treasury Executive Office for Asset Forfeiture. Compliance will include adhering to the oversight, reporting, and administrative requirements relating to seizure and forfeiture contained in such policy, procedures, and directives.

6. *Authorities.*

a. 18 U.S.C. §§ 981, 1956 and 1957.

b. 31 U.S.C. §§ 5311-5328 (other than violations of 31 U.S.C. § 5316).

c. TO 101-05, "Reporting Relationships and Supervision of Officials, Offices and Bureaus, Delegation of Certain Authority, and Order of Succession in the Department of the Treasury."

d. TO 102-14, "Delegation of Authority with Respect to the Treasury Forfeiture Fund Act of 1992," dated January 10, 1995.

7. *Cancellation.* Treasury Directive 15-42, "Delegation of Authority to the Commissioner, Internal Revenue Service to Perform Functions Under the Money Laundering Control Act of 1986, as amended," dated May 1, 1991, is superseded.

8. *Expiration Date.* This Directive shall expire three years from the date

of issuance unless superseded or cancelled prior to that date.

9. *Office of Primary Interest.* Office of the Under Secretary (Enforcement).

Ronald K. Noble,
Under Secretary
(Enforcement).

(Filed by the Office of the Federal Register on September 15, 1995, 8:45 a.m., and published in the issue of the Federal Register for September 18, 1995, 60 F.R. 48199)

Treasury Directive No. 15-43

Delegation of Authority to the Commissioner, Internal Revenue Service, Under 31 U.S.C. 333, Misuse of Treasury Name or Symbol

Dated: July 24, 1995.

1. *Purpose.* This Directive delegates to the Commissioner, Internal Revenue Service, criminal investigatory authority and civil penalty enforcement authority under 31 U.S.C. 333 relating to misuse of the name or symbol of the Department of the Treasury or any Treasury component or employee thereof as specified below.

2. *Delegation.* By virtue of the authority vested in the Secretary of the Treasury by 31 U.S.C. 333, and the authority delegated to the Under Secretary (Enforcement) by Treasury Order (TO) 101-05, there is hereby delegated to the Commissioner, Internal Revenue Service, authority to investigate criminal violations of, and to assess civil penalties under, section 333 involving: (a) The misuse of the name or symbol of the Internal Revenue Service or the name of any IRS employee; or (b) the name or symbol of the Department of the Treasury or the Secretary or any Treasury employee in connection with activities within the jurisdiction of the Internal Revenue Service.

3. *Civil Penalty Authority.* The Commissioner, Internal Revenue Service, will assess, mitigate and collect civil penalties in accordance with guidelines issued by the Office of the Under Secretary (Enforcement).

4. *Redelegation.* The authority delegated by this Directive may be redelegated.

5. *Authorities.*

a. TO 101-05, "Reporting Relationships and Supervision of Officials, Offices and Bureaus, Delegation of

Certain Authority, and Order of Succession in the Department of the Treasury.’’

b. 31 U.S.C. 333.

6. *References.*

a. Treasury Directive (TD) 73-03, ‘‘Official Flags of the Department of the Treasury.’’

b. TD 73-04, ‘‘Official Seal of the Department of the Treasury.’’

c. 18 U.S.C. 701.

7. *Expiration Date.* This Directive shall expire three years from the date of issuance unless cancelled or superseded by that date.

8. *Office of Primary Interest.* Office of the Under Secretary (Enforcement).

Ronald K. Noble,
Under Secretary
(Enforcement).

(Filed by the Office of the Federal Register on July 31, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 1, 1995, 60 F.R. 39203)

DEPARTMENT OF THE TREASURY

Treasury Order No. 150-01

Regional and District Offices of the Internal Revenue Service

Dated: September 28, 1995.

Under the authority given to the President to establish and alter internal revenue districts by Section 7621 of the Internal Revenue Code of 1986, as amended, and vested in the Secretary of the Treasury by Executive Order 10289 (approved September 17,

1951, as amended) as made applicable to Section 7621 of the Internal Revenue Code of 1986, as amended (as previously contained in the Internal Revenue Code of 1954) by Executive Order 10574 (approved November 5, 1954); under the authority vested in the Secretary of the Treasury by 31 U.S.C. 321(a), (b) and Reorganization Plan No. 1 of 1952 as made applicable to the Internal Revenue Code of 1986, as amended, by Section 7804(a) of such Code; and under the authority vested in the Secretary of the Treasury by Sections 7801(a) and 7803 of the Internal Revenue Code of 1986, as amended; the following internal revenue districts and regions are established or continued as described in this Order. When fully implemented, this Order establishes fewer internal revenue regions and districts than designated in previous Orders.

1. *Regions.* Four regions are established which shall be identified as Northeast Region, headquartered at New York, New York; Southeast Region, headquartered at Atlanta, Georgia; Midstates Region, headquartered at Dallas, Texas; and Western Region, headquartered at San Francisco, California. The head of each regional office shall bear the title ‘‘Regional Commissioner’’ identified by the region name. The geographic areas and internal revenue districts within each region are shown in the Attachment to this Order.

2. *Districts.* Thirty-three districts are established. Each shall be known as an internal revenue district and shall be identified by the names listed in the Attachment. The head of each district

office shall be titled ‘‘Director’’ identified by the district name as specified in the Attachment. The geographic areas within each district are shown in the Attachment.

3. *U.S. Territories and Insular Possessions.* The Commissioner of Internal Revenue shall, to the extent of authority vested in the Commissioner, provide for the administration of the United States internal revenue laws in the U.S. territories and insular possessions and other areas of the world.

4. *Implementation.* The district and regional organization described above shall be implemented on dates determined by the Commissioner of Internal Revenue. Until such dates, the existing offices are authorized to continue. Effective immediately, the Commissioner is authorized to effect such transfers of functions, personnel, positions, equipment and funds as may be necessary to implement the provisions of this Order.

5. *Other Offices.* This Order affects only the regional and district offices subject to this Order and does not affect service centers or other offices in existence within the Internal Revenue Service.

6. *Effect On Prior Treasury Orders.* a. TO 150-01, ‘‘Designation of Internal Revenue Districts,’’ dated October 27, 1987, is superseded.

b. TO 150-03, ‘‘Designation of Internal Revenue Regions and Regional Service Centers,’’ dated January 24, 1986, is superseded.

Robert E. Rubin,
Secretary of
the Treasury.

REGIONAL AND DISTRICT OFFICES OF THE INTERNAL REVENUE SERVICE

| District name | Headquarters | Area covered |
|----------------------------------|---------------------------------|---|
| Southeast Region | Atlanta, Georgia | Alabama, Delaware, the District of Columbia, Florida, Georgia, Indiana, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia. |
| North Florida District | Jacksonville, Florida | Florida counties: Alachua, Baker, Bay, Bradford, Brevard, Calhoun, Citrus, Clay, Columbia, Dixie, Duval, Escambia, Flagler, Franklin, Gadsden, Gilchrist, Gulf, Hamilton, Hernando, Hillsborough, Holmes, Jackson, Jefferson, Lafayette, Lake, Leon, Levy, Liberty, Madison, Marion, Nassau, Okaloosa, Orange, Osceola, Pasco, Pinellas, Polk, Putnam, Santa Rosa, Seminole, St. Johns, Sumter, Suwannee, Taylor, Union, Volusia, Wakulla, Walton and Washington. |

REGIONAL AND DISTRICT OFFICES OF THE INTERNAL REVENUE SERVICE—Continued

| District name | Headquarters | Area covered |
|------------------------------------|------------------------------------|---|
| South Florida District | Fort Lauderdale, Florida | Florida counties: Broward, Charlotte, Collier, Dade, DeSoto, Glades, Hardee, Hendry, Highlands, Indian River, Lee, Manatee, Martin, Monroe, Okeechobee, Palm Beach, Sarasota and St. Lucie. |
| Georgia District | Atlanta, Georgia | Georgia. |
| Indiana District | Indianapolis, Indiana | Indiana. |
| Gulf Coast District | New Orleans, Louisiana | Louisiana, Mississippi and Alabama. |
| Delaware-Maryland District | Baltimore, Maryland | Delaware, Maryland and the District of Columbia. |
| North-South Carolina | Grensboro, North Carolina. | North Carolina and South Carolina. |
| District | | |
| Kentucky-Tennessee | Nashville, Tennessee | Kentucky and Tennessee. |
| District | | |
| Virginia-West Virginia | Richmond, Virginia | Virginia and West Virginia. |
| District | | |
| Northeast Region | New York, New York | Connecticut, Maine, Massachusetts, Michigan, New Hampshire, New Jersey, New York, Ohio, Pennsylvania, Rhode Island and Vermont. |
| Connecticut-Rhode Island | Hartford, Connecticut | Connecticut and Rhode Island. |
| District | | |
| Ohio District | Cincinnati, Ohio | Ohio. |
| Michigan District | Detroit, Michigan | Michigan. |
| New England District | Boston, Massachusetts | Maine, Massachusetts, New Hampshire and Vermont. |
| New Jersey District | Newark, New Jersey | New Jersey. |
| Brooklyn District | Brooklyn, New York | New York counties: Kings, Nassau, Queens and Suffolk. |
| Upstate New York District | Buffalo, New York | New York counties: Albany, Allegany, Broome, Cattaraugus, Cayuga, Chautaugua, Chemung, Chenango, Clinton, Columbia, Cortland, Delaware, Dutchess, Erie, Essex, Franklin, Fulton, Genesee, Greene, Hamilton, Herkimer, Jefferson, Lewis, Livingston, Madison, Monroe, Montgomery, Niagara, Oneida, Onondaga, Ontario, Orange, Orleans, Oswego, Otsego, Putnam, Rensselaer, Saratoga, Schenectady, Schoharie, Schuyler, Seneca, Steuben, St. Lawrence, Sullivan, Tioga, Tompkins, Ulster, Warren, Washington, Wayne, Wyoming and Yates. |
| Manhattan District | New York, New York | New York counties: Bronx, New York, Richmond, Rockland and Westchester. |
| Pennsylvania District | Philadelphia, Pennsylvania | Pennsylvania. |
| Midstates Region | Dallas, Texas | Arkansas, Illinois, Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, Oklahoma, South Dakota, Texas and Wisconsin. |
| Illinois District | Chicago, Illinois | Illinois. |
| North Central District | St. Paul, Minnesota | Minnesota, North Dakota and South Dakota. |
| Midwest District | Milwaukee, Wisconsin | Iowa, Nebraska and Wisconsin. |
| Kansas-Missouri District | St. Louis, Missouri | Kansas and Missouri. |
| Arkansas-Oklahoma District | Oklahoma City, Oklahoma. | Arkansas and Oklahoma. |
| North Texas District | Dallas, Texas | Texas counties: Anderson, Andrews, Angelina, Archer, Armstrong, Bailey, Baylor, Borden, Bowie, Briscoe, Brown, Callahan, Camp, Carson, Cass, Castro, Cherokee, Childress, Clay, Cochran, Coke, Coleman, Collin, Collingsworth, Comanche, Concho, Cooke, Cottle, Crane, Crockett, Crosby, Dallam, Dallas, Dawson, Deaf Smith, Delta, Denton, Dickens, Donley, Eastland, Ector, Ellis, Erath, Fannin, Fisher, Floyd, Foard, Franklin, Gaines, Garza, Glasscock, Gray, Grayson, Gregg, Hale, Hall, Hansford, Hardeman, Harrison, Hartley, Haskell, Hemphill, Hender-son, Hockley, Hood, Hopkins, Houston, Howard, Hunt, Hutchinson, Irion, Jack, Johnson, Jones, Kaufman, Kent, King, Knox, Lamar, Lamb, Lipscomb, Loving, Lubbock, Lynn, Marion, Martin, Menard, Midland, Mills, Mitchell, Montague, Moore, Morris, Motley, Nacogdoches, Navarro, Nolan, Ochiltree, Oldham, Palo Pinto, Panola, Parker, |

REGIONAL AND DISTRICT OFFICES OF THE INTERNAL REVENUE SERVICE—Continued

| District name | Headquarters | Area covered |
|---|-------------------------------------|--|
| North Texas District—
Cont. | Dallas, Texas—Cont. | Parmer, Potter, Rains, Randall, Reagan, Red River, Roberts, Rockwall, Runnels, Rusk, Sabine, San Augustine, Schleicher, Scurry, Shackelford, Shelby, Sherman, Smith, Stephens, Sterling, Stonewall, Sutton, Swisher, Tarrant, Taylor, Terry, Throckmorton, Titus, Tom Green, Upshur, Upton, Van Zandt, Ward, Wheeler, Wichita, Wilbarger, Winkler, Wise, Wood, Yoakum and Young. |
| South Texas District | Austin, Texas | Texas counties: Aransas, Atascosa, Austin, Bandera, Bastrop, Bee, Bell, Bexar, Blanco, Bosque, Brazos, Brewster, Brooks, Burleson, Burnet, Caldwell, Calhoun, Cameron, Colorado, Comal, Coryell, Culberson, DeWitt, Dimmitt, Duval, Edwards, El Paso, Falls, Fayette, Freestone, Frio, Gillespie, Goliad, Gonzales, Grimes, Guadalupe, Hamilton, Hays, Hidalgo, Hill, Hudspeth, Jackson, Jeff Davis, Jim Hogg, Jim Wells, Karnes, Kendall, Kenedy, Kerr, Kimble, Kinney, Kleberg, Lampasas, LaSalle, Lavaca, Lee, Leon, Limestone, Live Oak, Llano, McCulloch, McLennan, McMullen, Madison, Mason, Matagorda, Maverick, Medina, Milam, Nueces, Pecos, Presidio, Real, Reeves, Refugio, Robertson, San Patricio, San Saba, Somervell, Starr, Terrell, Travis, Uvalde, Val Verde, Victoria, Waller, Washington, Webb, Wharton, Willacy, Williamson, Wilson, Zapata and Zavala. |
| Houston District | Houston, Texas | Texas counties: Brazoria, Chambers, Fort Bend, Galveston, Hardin, Harris, Jasper, Jefferson, Liberty, Montgomery, Newton, Orange, Polk, San Jacinto, Trinity, Tyler and Walker. |
| Western Region | San Francisco, California | Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington and Wyoming. |
| Southwest District | Phoenix, Arizona | Arizona, Nevada and New Mexico. |
| Rocky Mountain District | Denver, Colorado | Colorado, Idaho, Montana, Utah and Wyoming. |
| Northern California
District | Oakland, California | Northern California counties: Alameda, Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Francisco, San Joaquin, San Mateo, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo and Yuba. |
| Central California District | San Jose, California | Mid-state California counties: Fresno, Inyo, Kern, Kings, Madera, Mariposa, Merced, Mono, Monterey, San Benito, San Luis Obispo, Santa Barbara, Santa Clara, Santa Cruz, Stanislaus, Tulare, Tuolumne and Ventura. |
| Los Angeles District | Los Angeles, California | County of Los Angeles, except for that portion served by the Southern California District. |
| Southern California
District | Laguna Niguel, California | Southern California counties: Imperial, Orange, Riverside, San Bernardino, San Diego, and that portion of Los Angeles County serviced by the Carson post of duty (the geographic area covered by 1995 U.S. Postal Service zip codes 90254, 90274, 90277, 90278, 90501, 90502, 90503, 90504, 90505, 90506, 90507, 90508, 90509, 90510, 90701, 90702, 90703, 90704, 90706, 90707, 90710, 90711, 90712, 90713, 90714, 90715, 90716, 90717, 90731, 90732, 90733, 90734, 90744, 90745, 90746, 90747, 90748, 90749, 90801, 90802, 90803, 90804, 90805, 90806, 90808, 90809, 90810, 90813, 90814, 90815, 90822, 90831, 90832, 90833, 90834, 90835, 90840, 90844, 90846, 90853). |
| Pacific Northwest District | Seattle, Washington | Alaska, Hawaii, Oregon and Washington. |

(Filed by the Office of the Federal Register on October 6, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 10, 1995, 60 F.R. 52726)

Notice of Proposal Rulemaking

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The "Proposed regulations" heading in the index contains a list of Code sections affected, the subject matter and the number and page.

Notice of Proposed Rulemaking

Notice of Proposed Rulemaking

Transfers to Investment Companies

CO-19-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document proposes amendments to regulations relating to transfers to investment companies. The amendments are necessary to clarify existing regulations relating to certain transfers to a controlled corporation. Generally, the regulations will be amended to provide when certain transfers will not cause a diversification of the transferors' interests.

DATES: Written comments and requests for a public hearing must be received by November 8, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (CO-19-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (CO-19-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 351 of the Internal Revenue Code of 1986. Section 351(a) provides that no gain or loss will be recognized if one or more persons transfer property to a corporation solely in exchange for stock in the corporation and immediately after the exchange the transferors control the transferee corporation. Section 351(e)(1) provides that section 351(a) will not apply to a transfer of property to an investment company.

The rule of section 351(e)(1) was enacted as part of the Foreign Investors Tax Act of 1966, with the goal of

preventing individuals from achieving tax-free diversification by the transfer of one or a few stocks or securities to a corporation (referred to as a swap fund). See generally H. Rep. No. 1049, 94th Cong., 2d Sess. (Apr. 27, 1976).

Section 1.351-1(c)(1) states that a transfer to an investment company will occur when (i) the transfer results in diversification of the transferors' interests, and (ii) the transferee is a Regulated Investment Company (RIC), Real Estate Investment Trust (REIT), or a corporation more than 80 percent of the value of whose assets (excluding cash and non-convertible debt obligations) are readily marketable stocks or securities. Section 1.351-1(c)(5) provides that a transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets to a corporation in the exchange.

As part of the Tax Reform Act of 1976 (the 1976 Act), Congress enacted sections 683(a) and 721(b), which incorporate the section 351(e) rules for transfers to a trust and a partnership, respectively.

The 1976 Act also addressed reorganizations of investment companies by enacting section 368(a)(2)(F). This legislation was intended to prevent the tax-free merger of a closely held corporation holding an undiversified group of assets into a publicly held diversified investment company, resulting in a tax-free diversification of the interests of the target shareholders.

Section 368(a)(2)(F)(i) provides that a transaction between two "investment companies" otherwise qualifying as a reorganization will not qualify as a reorganization for any corporation in the transaction that is not a RIC, REIT, or corporation described in section 368(a)(2)(F)(ii). Section 368(a)(2)(F)(iii) defines an investment company as a RIC, REIT, or corporation with at least 50 percent of its assets comprised of stocks or securities and 80 percent of its assets held for investment. A corporation satisfies section 368(a)(2)(F)(ii) if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of five or fewer issuers. For purposes of the section 368(a)(2)(F)(ii) test, all mem-

bers of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. Also, a person holding stock in a RIC, REIT, or other investment company (as defined in section 368(a)(2)(F)(iii)) that meets the requirements of section 368(a)(2)(F)(ii) shall be treated as holding its proportionate share of the assets held by the company. Section 368(a)(2)(F)(iv) provides that in determining total assets, certain assets shall be excluded, including cash and cash items (including receivables), Government securities, and assets acquired to meet section 368(a)(2)(F)(ii) or to cease to be an investment company. Section 368(a)(2)(F)(v) provides that section 368(a)(2)(F) shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions. Section 368(a)(2)(F)(vii) defines securities for purposes of clauses (ii) and (iii) of section 368(a)(2)(F).

Reasons for Change

The IRS wants to clarify that 1.351-1(c)(5) does not prevent tax-free combinations of already diversified portfolios, and that combinations of already diversified portfolios are not inconsistent with the purposes of section 351(e) (*i.e.*, preventing the tax-free transfer of one or a few stocks or securities to swap funds). For example, RICs often transfer portfolios of investment assets to partnerships under section 721(a) (which is subject to the section 351(e) rules pursuant to section 721(b)). These transactions are appropriately tax-free because the RICs are not transferring one or a few stocks or securities, but rather, the RICs are transferring diversified portfolios of stocks and securities.

Also, the nonidentical asset standard of 1.351-1(c)(5) is stricter than the test applied for combinations of investment companies under the corporate reorganization provisions (see section 368(a)(2)(F)(ii)). Transfers of certain diversified portfolios to a corporation may be taxable under section 351(e), while the same portfolios could be combined through a merger that may qualify as a tax-free reorganization.

Explanation of Provisions

The proposed amendments to 1.351-1(c) provide that transfers of assets will

not be treated as transfers that result in diversification of the transferors' interests for purposes of 1.351-1(c)(1)(i) if each transferor transfers assets that satisfy section 368(a)(2)(F)(ii), as modified. Under this rule, no transfers of nonidentical assets to a corporation described in 1.351-1(c)(1)(ii) will qualify for nonrecognition treatment under section 351 unless each transferor transfers assets that satisfy section 368(a)(2)(F)(ii), as modified.

For purposes of 1.351-1(c), relevant provisions of section 368(a)(2)(F) will apply to the section 368(a)(2)(F)(ii) test. Those provisions include the controlled group and look-through rules found in clause (ii) (members of a controlled group of corporations are considered as one issuer and persons holding stock in certain investment companies are treated as holding a proportionate share of the investment company's assets), the common ownership rule found in clause (v) (diversification will not be considered to occur if the interests in the assets to be transferred are held substantially by the same persons in the same proportions as the interests in the transferee), and the definition of securities found in clause (vii) (the term securities includes investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36))). The definition of total assets in section 368(a)(2)(F)(iv) will apply, except that Government securities will be included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

The proposed modification of the definition of total assets to include Government securities addresses a problem caused by transfers of funds consisting mostly of Government securities. For example, if 95 percent of a money market fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, the Government securities would not be treated as securities (see section 368(a)(2)(F)(vii)) and, without the modification, would be excluded from total assets for purposes of the 25 and 50 percent test of section 368(a)(2)(F)(ii). As a result, the unmodified test would treat 100 percent of the fund's assets as X stock and the fund would not satisfy the 25 and 50 percent test of section 368(a)(2)(F)(ii). The modified test would include Government securities in

total assets. The fund would satisfy the modified test because the stock of one issuer would constitute only five percent of the fund's portfolio. The IRS believes that the modification is appropriate because the presence of a small amount of nondiversified property in a Government securities portfolio (otherwise qualifying under section 368(a)(2)(F)(ii)) should not disqualify the portfolio from tax-free treatment.

The adoption of the modified section 368(a)(2)(F)(ii) test is intended to limit section 351(e) to cases more analogous to the typical swap fund cases that were the focus of the section 351(e) legislation. Also, the adoption of this test should minimize the different tax treatment of a section 351 transfer and a section 368 reorganization under economically similar situations. This test will also apply for purposes of sections 683(a) and 721(b). Finally, a proposed revision to 1.584-4(a) adopts this test.

Proposed Effective Date

These regulations are proposed to apply to transfers of assets occurring on or after the date of publication as final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to

the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 as proposed to be amended in a document published elsewhere in *** [CO-26-95, page 45 this Bulletin] continues to read in part as follows:

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

Section 1.351-1 also issued under 26 U.S.C. 351 * * * .

Par. 2. Section 1.351-1 is amended by:

1. Redesignating paragraph (c)(6) as paragraph (c)(7).

2. Adding new paragraph (c)(6) to read as follows:

1.351-1 Transfer to corporation controlled by transferor.

* * * * *

(c) * * *

(6) For purposes of paragraph (c)(5) of this section, a transfer of assets will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of assets. For purposes of this paragraph, a portfolio of assets is diversified if it satisfies section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F), except that, in applying section 368(a)(2)(F)(iv), Government securities are included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

* * * * *

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on August 9, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 10, 1995, 60 F.R. 40794)

Notice of Proposed Rulemaking and Notice of Public Hearing

Consolidated Groups—Intercompany Transactions and Related Rules

CO-24-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In *** [T.D. 8598, page 188, this Bulletin], the IRS is issuing temporary regulations that provide rules for disallowing loss and excluding gain for certain dispositions and other transactions involving stock of the common parent of a consolidated group. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by October 16, 1995. Outlines of topics to be discussed at the public hearing scheduled for November 16, 1995 must be received by October 26, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (CO-24-95), Room 5228, Internal Revenue Service, P.O.B. 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (CO-24-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. The hearing will be held in the IRS Auditorium, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in *** [T.D. 8598, page 188, this Bulletin] amend

the Income Tax Regulations (26 CFR part 1) relating to section 1502. The temporary regulations provide rules for disallowing loss and excluding gain for certain dispositions and other transactions involving stock of the common parent of a consolidated group.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 16, 1995 at 10 a.m., in the IRS Auditorium. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by October 26, 1995 and submit an outline of the topics (signed original and eight (8) copies) to be discussed by October 26, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after

the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In §1.1502-13, paragraph (f)(6) is added to read as follows:

§1.1502-13 Intercompany transactions.

[The text of proposed paragraph (f)(6) is the same as the text of §1.1502-13T(f)(6) published elsewhere in *** [T.D. 8598, this Bulletin].]

Michael P. Dolan,
*Acting Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on July 12, 1995, 12:56 p.m., and published in the issue of the Federal Register for July 18, 1995, 60 F.R. 36755)

Notice of Proposed Rulemaking and Notice of Public Hearing

Treatment of Underwriters in Section 351 and Section 721 Transactions

CO-26-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document proposes rules for transfers of cash to a corporation or a partnership. The proposed regulations will affect taxpayers in transactions intended to qualify under section 351 and section 721 when there is an offering of stock or partnership interests through an underwriter. This

document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 8, 1995. Requests to speak at the public hearing scheduled for Wednesday, January 17, 1996, at 10 a.m., with outlines of oral comments, must be received by Wednesday, December 27, 1995.

ADDRESSES: Send submissions: CC:DOM:CORP:T:R (CO-26-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (CO-26-95), Courier's Desk, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. The hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Section 351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in the corporation and immediately after the exchange the person or persons are in control (as defined in section 368(c)) of the corporation.

Section 721(a) provides that no gain or loss is recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.

Rev. Rul. 78-294, 1978-2 C.B. 141, involves the incorporation of an existing sole proprietorship by an individual to raise capital through a public offering. The individual sought the assistance of an underwriter. In accordance with the plan, the individual organized a new corporation, which had capital stock of 1,000 authorized but unissued shares.

Situation 1 describes a transaction that was considered to fall within the general definition of a "best efforts" underwriting. Pursuant to an agreement among the individual, the new corporation, and the underwriter, the individual transferred all the business property to the new corporation in exchange for

500 shares of stock. The underwriter agreed to use its best efforts as an agent of the corporation to sell the 500 unissued shares to the general public at \$200 per share. The underwriter succeeded in selling the stock within two weeks of the initial offering with no change in the terms of the offering.

Situation 2 describes a transaction that was considered to fall within the general definition of a "firm commitment" underwriting. Pursuant to an agreement among the individual, the new corporation, and the underwriter, the individual transferred all the business property to the new corporation in exchange for 500 shares of stock, and the underwriter transferred \$100,000 in cash to the new corporation in exchange for the remaining 500 shares. At the time of the underwriter's purchase, the underwriter had not entered into a binding contract to dispose of its stock in the new corporation. However, the underwriter intended to sell its 500 shares, but, if unsuccessful, was required to retain them. Following the exchanges, the underwriter sold its 500 shares of stock in the new corporation to the general public within two weeks of the initial offering. The individual retained the 500 shares of stock in the new corporation.

In Situation 1, the ruling holds that the individual who transferred the business property to the corporation and the investors in the public offering were co-transferors in a single transaction that qualified under section 351. In Situation 2, the ruling holds that the firm commitment underwriter was a transferor along with the individual and that their control was not defeated by the subsequent resale of 50 percent of the stock in the public offering.

The IRS and Treasury believe that Situation 2 of Rev. Rul. 78-294 does not reflect current underwriting practices. In addition, the IRS and Treasury believe that underwritings of partnership interests should be treated similarly to underwritings of stock. Further, the proposed regulations are necessary to prevent inappropriate imposition and inappropriate avoidance of tax.

The proposed regulations, under certain circumstances, disregard underwriters of stock and partnership interests for purposes of section 351 and section 721. The proposed treatment of underwriters is similar to their treatment under 1.382-3(j)(7) and 1.1273-2(e).

Explanation of Provisions

Proposed Amendment Adding 1.351-1(a)(3)

This document proposes to add 1.351-1(a)(3) to 26 CFR part 1. The proposed regulation provides that, for the purpose of section 351, if a person acquires stock from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the stock from the underwriter is treated as transferring cash directly to the corporation in exchange for the stock and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of stock is transitory. The proposed regulation would render Rev. Rul. 78-294 obsolete. No inference is intended as to transactions not within the scope of the proposed regulation.

Proposed Amendment Adding 1.721-1(c)

This document proposes to add 1.721-1(c) to 26 CFR part 1. The proposed regulation provides that, for the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest from the underwriter is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory. No inference is intended as to transactions not within the scope of the proposed regulation.

Comments Solicited

The IRS and Treasury invite public comment on the proposed regulations. In particular, the IRS and Treasury solicit comments on (a) whether the proposed rules should apply for all tax purposes; (b) whether the proposed rules should be limited to underwriters;

and (c) whether the proposed rules should be limited to cash transactions.

Proposed Effective Dates

New 1.351-1(a)(3) and new 1.721-1(c) are proposed to be effective for qualified underwriting transactions occurring on or after the date of publication as final regulations in the Federal Register.

Effect on other documents

The following publication would become obsolete as of the date of publication in the Federal Register of the final regulations: Rev. Rul. 78-294, 1978-2 C.B. 141.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the Internal Revenue Service. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, January 17, 1996, beginning at 10 a.m., in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments, an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by Wednesday, December 27, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.351-1 also issued under 26 U.S.C. 351. * * *

Section 1.721-1 also issued under 26 U.S.C. 721. * * *

Par. 2. In 1.351-1, paragraph (a)(3) is added to read as follows:

1.351-1 Transfer to corporation controlled by transferor.

(a) * * *

(3) *Underwritings of stock*—(i) *In general.* For the purpose of section 351, if a person acquires stock of a corporation from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires stock from the underwriter is treated as transferring cash directly to the corporation in exchange for stock of the corporation and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a corporation issues stock for cash in an underwriting in which either the underwriter is an agent of the corporation or the underwriter's ownership of the stock is transitory.

(ii) *Effective date.* This paragraph

(a)(3) is effective for qualified underwriting transactions occurring on or after the date of publication of the final regulation in the Federal Register.

* * * * *

Par. 3. In 1.721-1, paragraph (c) is added to read as follows:

1.721-1 Nonrecognition of gain or loss on contribution.

* * * * *

(c) *Underwritings of partnership interests*—(1) *In general.* For the purpose of section 721, if a person acquires a partnership interest from an underwriter in exchange for cash in a qualified underwriting transaction, the person who acquires the partnership interest is treated as transferring cash directly to the partnership in exchange for the partnership interest and the underwriter is disregarded. A qualified underwriting transaction is a transaction in which a partnership issues partnership interests for cash in an underwriting in which either the underwriter is an agent of the partnership or the underwriter's ownership of the partnership interests is transitory.

(2) *Effective date.* This paragraph (c) is effective for qualified underwriting transactions occurring on or after the date of publication of the final regulation in the Federal Register.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 9, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 10, 1995, 60 F.R. 40792)

Notice of Proposed Rulemaking

Notice, Consent, and Election Requirements Under Sections 411(a)(11) and 417

EE-24-93

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8620, page 63, this Bulletin], the IRS is issuing

temporary regulations that provide guidance concerning the notice and consent requirements under section 411(a)(11) and the notice and election requirements of section 417. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments must be received by December 21, 1995.

ADDRESSES: Send submissions to CC:DOM:CORP:T:R (EE-24-93), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:T:R (EE-24-93), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507).

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224. To ensure that comments on the collection of information may be given full consideration during the review by OMB, these comments should be received by December 21, 1995.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information is in the provisions of §§1.411(a)-11(c)(2)(iii) and 1.417(e)-1(b)(3)(ii) that require the plan administrator to inform a participant that the participant has a right to at least 30 days to consider distribution options. Existing regulations implement the mandate of section 417(a)(3) that a qualified plan

provide a written explanation of distribution options to each participant. Under existing regulations, a distribution cannot be made until 30 days after the explanation is provided. The provisions of this notice of proposed rulemaking give plans the flexibility to make a distribution within 30 days provided the participant is clearly informed of the right to at least 30 days for consideration of the distribution options. The IRS requires this information to be provided to participants to assure they have adequate time to evaluate their distribution options.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

The collection of information under this notice of proposed rulemaking can be satisfied by the addition of a statement to the explanation already provided by plan administrators to participants under existing regulations. Therefore, this collection of information results in a minor increase in an existing burden. Estimated total annual reporting burden: 8333 hours. The estimated burden per respondent varies from 0 hours to 2 hours, depending on individual circumstances, with an estimated average of .011 hours.

Estimated number of respondents: 750,000.

Estimated annual frequency of responses: One time per year.

Background

Temporary regulations in *** [T.D. 8620, page 00, this Bulletin] amend the Income Tax Regulations (26 CFR part 1) relating to section 411(a)(11) and section 417. The temporary regulations contain rules relating to the notice, consent, and election requirements of those sections. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined

in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

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

Par. 2. Section 1.411(a)-11 is amended by

1. Revising paragraphs (c)(2)(ii) and (iii).
2. Adding paragraphs (c)(2)(iv) and (v) and (c)(8).

The revisions and additions read as follows:

§1.411(a)-11 Restriction and valuation of distributions.

[The text of proposed paragraphs (c)(2)(ii) through (c)(2)(v) and (c)(8)

are the same as the text of §1.411(a)-11T published elsewhere in *** [T.D. 8620, this Bulletin].]

Par. 3. Section 1.417(e)-1 is amended by:

1. Revising paragraph (b)(3).
2. Adding paragraph (b)(4).

The revision and addition read as follows:

§1.417(e)-1 Restrictions and valuations of distributions from plans subject to sections 401(a)(11) and 417.

[The text of proposed paragraphs (b)(3) and (4) is the same as the text of §1.417(e)-1T published elsewhere in *** [T.D. 8620, this Bulletin].]

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on September 15, 1995, 4:00 p.m., and published in the issue of the Federal Register for September 22, 1995, 60 F.R. 49236)

Notice of Proposed Rulemaking

Time for Performance of Acts Where Last Day Falls on Saturday, Sunday, or Legal Holiday

IA-36-91

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the time for performance of acts by taxpayers and by the Commissioner, a district director, or the director of a regional service center, where the last day for performance falls on a Saturday, Sunday, or legal holiday. In particular, the proposed regulations would remove the list of legal holidays and other outdated material.

DATES: Written comments and requests for a public hearing must be received by December 26, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (IA-36-91), Room 5228, Internal Revenue Service,

POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (IA-36-91), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Procedure and Administration Regulations (26 CFR part 301) that would revise the paragraphs in the regulations that specify the legal holidays and provide other related information.

Explanation of Provisions

This document proposes to amend §301.7503-1, which explains and supplements section 7503 of the Internal Revenue Code pertaining to the performance of any act prescribed under authority of the internal revenue laws when the last day for performance of the act falls on Saturday, Sunday, or a legal holiday. First, §301.7503-1(a) would be amended to reflect a change to the name of the Court of Claims, which, as of October 29, 1992, became the Court of Federal Claims.

Second, §301.7503-1(b), which provides a list of the legal holidays and other related information, would be revised. The current list of holidays is outdated. However, in light of the aim toward tax simplification, the list of holidays in paragraph (b) would be replaced by citations to the law from which the holidays must be discerned. In this way, future changes in the law with respect to the holidays will not require amendments to the regulations.

Third, §301.7503-1(c), which provides that section 7503 is applicable in any case where the last day for performance of an act occurs after August 16, 1954, would be removed because this information is obsolete.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of

the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person who timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7503-1 is amended as follows:

1. In the fourth sentence of paragraph (a), the language "Thursday, November 22, 1956 (Thanksgiving Day), the suit will be timely if filed on Friday, November 23, 1956, in the Court of Claims" is removed and the language "Thursday, November 23, 1995 (Thanksgiving Day), the suit will be timely if filed on Friday, November

24, 1995, in the Court of Federal Claims'' is added in its place.

2. Paragraph (b) is revised as set forth below.

3. Paragraph (c) is removed.

The revision reads as follows:

§301.7503-1 Time for performance of acts where last day falls on Saturday, Sunday, or legal holiday.

* * * * *

(b) *Legal holidays.* For the purpose of section 7503, the term *legal holiday* includes the legal holidays in the District of Columbia as found in D.C. Code Ann. 28-2701. In the case of any return, statement, or other document required to be filed, or any other act required under the authority of the internal revenue laws to be performed, at an office of the Internal Revenue Service, or any other office or agency of the United States, located outside the District of Columbia but within an internal revenue district, the term *legal holiday* includes, in addition to the legal holidays in the District of Columbia, any statewide legal holiday of the state where the act is required to be performed. If the act is performed in accordance with law at an office of the Internal Revenue Service or any other office or agency of the United States located in a territory or possession of the United States, the term *legal holiday* includes, in addition to the legal holidays in the District of Columbia, any legal holiday that is recognized throughout the territory or possession in which the office is located.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on September 22, 1995, 8:45 a.m., and published in the issue of the Federal Register for September 25, 1995, 60 F.R. 49356)

Notice of Proposed Rulemaking and Notice of Public Hearing

Deductibility, Substantiation, and Disclosure of Certain Charitable Contributions

IA-44-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding the allowance of certain charitable contribution deductions, the substantiation requirements for charitable contributions of \$250 or more, and the disclosure requirements for *quid pro quo* contributions in excess of \$75. The proposed regulations will affect organizations described in section 170(c) and individuals and entities that make payments to those organizations.

DATES: Written comments must be received by November 1, 1995. Requests to appear and outlines of oral comments to be presented at the public hearing scheduled for November 1, 1995, must be received by October 11, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (IA-44-94), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, D.C. 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (IA-44-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C. The Public Hearing scheduled for November 1, 1995, at 10:00 a.m., will be held in the IRS Auditorium, 7th floor, 1111 Constitution Avenue, N.W., Washington, D.C.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, D.C. 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collections of information are in §§1.170A-13(f)(1), (f)(10), (f)(14), and 1.6115-1. This information is required by the IRS to determine the deductibility of certain charitable contribu-

tions. The likely respondents are individuals or households, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

Estimated total annual recordkeeping burden: 100,000 hours.

Estimated average annual burden per recordkeeper: .10 hour.

Estimated number of recordkeepers: 1,000,000.

Estimated total annual reporting burden: 1,875,000 hours.

Estimated average burden per respondent: 2.5 hours.

Estimated number of respondents: 750,000.

Estimated frequency of responses: On occasion.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) that provide guidance under sections 170(a), 170(f)(8), and 6115 of the Internal Revenue Code of 1986.

Sections 170(f)(8) and 6115 were added to the Code by sections 13172 and 13173 of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 455, 1993-3 C.B. 43. Temporary regulations (TD 8544 [1994-2 C.B. 28]) and a notice of proposed rulemaking by cross-reference to temporary regulations under section 170(f)(8) were published in the Federal Register for May 27, 1994 (52 FR 27458, 27515 [IA-74-93, 1994-2 C.B. 873]). The temporary and proposed regulations primarily address contributions made by payroll deduction and a donor's receipt of goods or services with insubstantial value. A public hearing was held on November 10, 1994. On March 22, 1995, the Service released Notice 95-15, which was published in 1995-1 C.B. 299. Notice 95-15 provides transitional relief (for 1994) from the substantiation requirement.

Explanation of Statutory Provisions

Section 170(a) allows a deduction for certain charitable contributions to or for the use of an organization described in section 170(c). Under section 170(f)(8), taxpayers who claim a deduction for a charitable contribution of \$250 or more are responsible for obtaining from the

donee organization, and maintaining in their records, substantiation of that contribution. See H.R. Conf. Rep. 2264, 103d Cong., 1st Sess. 565 (1993). Specifically, section 170(f)(8) provides that no charitable contribution deduction will be allowed under section 170(a) for a contribution of \$250 or more unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment from the donee organization.

Section 170(f)(8)(B) provides that an acknowledgment meets the requirements of that section if it includes the following information: (1) the amount of cash paid and a description (but not necessarily the value) of any property other than cash transferred to a donee organization; (2) whether or not the donee organization provided any goods or services in consideration for the cash or property; and (3) a description and good faith estimate of the value of any goods or services provided by the donee organization in consideration for the cash or property. A written acknowledgment is contemporaneous, within the meaning of section 170(f)(8)(C), if it is obtained on or before the earlier of: (1) the date the taxpayer files its original return for the taxable year in which the contribution was made, or (2) the due date (including extensions) for filing the taxpayer's original return for that year.

Section 170(f)(8) does not prescribe a format for the written acknowledgment. Any document that contains the required information, including but not limited to a letter, postcard, computer-generated form, or tax form, is an acceptable means of providing a taxpayer with a written acknowledgment. For example, a private foundation may use a copy of its Form 990-PF, Return of Private Foundation, as a written acknowledgment for a taxpayer's charitable contribution of \$250 or more if it contains the necessary information. Any documents that are used as a written acknowledgment of a taxpayer's charitable contribution must be contemporaneous within the meaning of section 170(f)(8)(C).

Section 6115 generally requires an organization described in section 170(c) that receives a "quid pro quo contribution" in excess of \$75 to provide a written disclosure statement to the donor. The written disclosure statement must contain the following information: (1) a statement that the deductibility of the donor's contribution is limited to

the excess of the amount of any money or the value of any property contributed by the donor over the value of the goods or services provided to the donor by the organization, and (2) a good faith estimate of the value of the goods or services provided by the organization. Section 6115(b) defines a quid pro quo contribution as a payment made partly as a contribution and partly in consideration for goods or services provided by the organization.

Explanation of Regulatory Provisions

Deductibility of a Payment in Exchange for Consideration

In *United States v. American Bar Endowment*, 477 U.S. 105 (1986), the Supreme Court set forth a two-part test for determining whether a payment that is partly in consideration for goods or services is deductible under section 170(a). First, a payment to an organization described in section 170(c) is deductible only if, and to the extent that, the payment exceeds the fair market value of the benefits received. Second, the excess payment must be made with the intent to make a charitable contribution. See also Rev. Rul. 67-246, 1967-2 C.B. 104.

The proposed regulations adopt this two-part test for determining whether a payment is deductible under section 170(a). Specifically, the regulations provide that, in order for a charitable contribution deduction to be allowed, a taxpayer must intend to make a payment in an amount that exceeds the fair market value of the goods or services received in return, and must actually make a payment in an amount that exceeds that fair market value.

Certain Goods or Services Disregarded

Under current law, a taxpayer who receives membership benefits in return for a payment to an organization described in section 170(c) may not claim a charitable contribution deduction for more than the amount by which the payment exceeds the fair market value of the membership benefits. *United States v. American Bar Endowment*, 477 U.S. 105 (1986). See also Rev. Rul. 68-432, 1968-2 C.B. 104; Rev. Rul. 67-246, 1967-2 C.B. 104. Accordingly, taxpayers and donee organizations must determine the fair market value of any membership bene-

fits the donee organization provides to its donors.

It is often difficult to value membership benefits, especially rights or privileges that are not limited as to use, such as free or discounted admission or parking, and gift shop discounts. In the course of preparing these proposed regulations, the IRS and the Treasury Department have considered the extent of the difficulty of valuation and have concluded that it is appropriate to provide limited relief with respect to certain types of customary membership benefits while preserving the IRS's ability to administer the law fairly and consistently. Accordingly, the proposed regulations provide that both the donee organization and the donor may disregard certain membership benefits when they are provided in return for a payment to the organization.

Section 1.170A-13T(a) already allows donors and donee organizations to disregard goods or services that are treated as having insubstantial value under existing IRS guidelines. See Rev. Proc. 90-12, 1990-1 C.B. 471, and Rev. Proc. 92-49, 1992-1 C.B. 987. The guidelines cover low cost articles (items costing \$6.60 or less for 1995), newsletters that are not commercial quality publications, and benefits worth 2% or less of a payment, up to a maximum of \$66 for 1995. The substance of this section has been incorporated into section 1.170A-13(f)(8)(i).

Under the proposed regulations, other benefits may be disregarded only if they are given as part of an annual membership offered in return for a payment of \$75 or less and fall into one of two categories. The first category is admission to events that are open only to members and for which the donee organization reasonably projects that the cost per person (excluding allocable overhead) for each event will be less than or equal to the standard for low cost articles under section 513(h)-(2)(C) (\$6.60 for 1995). An example is a modest reception where light refreshments are served to members of a donee organization before an event. The second category is rights or privileges that members can exercise frequently during the membership period. An example is free admission to a museum.

The items described in the previous two paragraphs may be disregarded for purposes of determining whether the taxpayer has made a charitable contribution, the amount of any charitable

contribution that has been made, and whether any goods or services have been provided that must be substantiated under section 170(f)(8) or disclosed under section 6115. Thus, the effect of these provisions is broader than that of the temporary regulations, which provided less comprehensive relief and then only for items of insubstantial value.

Goods or Services Provided to Donor's Employees

The proposed regulations also contain relief where donee organizations provide goods or services to the employees of their donors. Goods or services that may be disregarded for the purposes specified above when provided directly to a donor may also be disregarded for the same purposes when provided to a donor's employees.

Any other goods or services provided to the donor's employees must be taken into account for purposes of calculating any charitable contribution the donor claims as a deduction. If a contemporaneous written acknowledgment of the donor's contribution is required under section 170(f)(8), it must include a description of these goods or services. However, the proposed regulations provide that the contemporaneous written acknowledgment may omit the otherwise required good faith estimate of the value of these goods or services; similarly, the proposed regulations provide that a written disclosure statement required by section 6115 for a payment made in exchange for these goods or services may include a description of them in lieu of the otherwise required good faith estimate of their value.

Good Faith Estimate

For purposes of sections 170 and 6115, the proposed regulations define a good faith estimate of the value of goods or services provided by an organization described in section 170(c) as an estimate of the fair market value of those goods or services. The fair market value of goods or services may differ from their cost to the donee organization. The organization may use any reasonable methodology that it applies in good faith in making the good faith estimate. However, a taxpayer is not required to determine how the donee organization made the estimate.

The proposed regulations further provide that a donee organization may make a good faith estimate of the value of goods or services that are not available in a commercial transaction by reference to the fair market value of similar or comparable goods or services. Goods or services may be similar or comparable even though they do not have the unique qualities of the goods or services that are being valued.

Reliance on Donee Estimates

The proposed regulations provide that a taxpayer generally may treat an estimate of the value of goods or services as the fair market value for purposes of section 170(a) if the estimate is in a contemporaneous written acknowledgment (as required by section 170(f)(8)) or a written disclosure statement (as required by section 6115). Thus, a taxpayer that makes a payment to an organization described in section 170(c) and receives an item in return generally may rely on the organization's estimate of the value of the item in calculating its charitable contribution deduction if the estimate is included in a contemporaneous written acknowledgment or a written disclosure statement.

However, a taxpayer may not treat an estimate as the fair market value of the goods or services if the taxpayer knows, or has reason to know, that such treatment is unreasonable. For example, if the taxpayer is a dealer in the type of goods or services it receives from an organization described in section 170(c), or if the goods or services are readily valued, it is unreasonable for the taxpayer to treat the donee organization's estimate as the fair market value of the goods or services if that estimate is in error and the taxpayer knows, or has reason to know, the fair market value of the goods or services.

An estimate of the value of goods or services in a contemporaneous written acknowledgment or written disclosure statement is not in error if the estimate is within the typical range of retail prices for the goods or services. For example, if an organization provides a book in exchange for a \$100 payment, and the book is sold at retail prices ranging from \$18 to \$25, the taxpayer may rely on any estimate of the organization that is within the \$18 to \$25 range.

Substantiation of Contributions to a Split Interest Trust

Section 170(f)(8)(E) provides the Secretary with authority to issue regulations that relieve taxpayers, in appropriate cases, from some or all of the requirements of section 170(f)(8).

The grantor of a charitable lead trust, a charitable remainder annuity trust, or a charitable remainder unitrust is not required to designate a specific organization as the charitable beneficiary at the time the grantor transfers property to the trust. As a result, there is often no designated donee organization available to provide a contemporaneous written acknowledgment to a taxpayer. In addition, even if a specific beneficiary is designated, the designation is often revocable. In contrast, a pooled income fund is created and maintained by one charitable organization to which the remainder interest is contributed.

The IRS and the Treasury Department believe that for these reasons it is appropriate to exempt from the requirements of section 170(f)(8) transfers of property to charitable lead trusts, charitable remainder annuity trusts, or charitable remainder unitrusts while not exempting transfers to pooled income funds.

Substantiation of Out-of-Pocket Expenses

Section 1.170A-1(g) provides that an unreimbursed expenditure made incident to the rendition of services to a donee organization may be a deductible charitable contribution. Some taxpayers may make individual unreimbursed expenditures of \$250 or more (such as for a plane ticket) that will require substantiation under section 170(f)(8). The IRS and the Treasury Department recognize that a donee organization typically has no knowledge of the amount of out-of-pocket expenditures incurred by a taxpayer, and therefore, would have difficulty providing taxpayers with substantiation of unreimbursed expenditures.

To address this concern, the proposed regulations provide that where a taxpayer has individual unreimbursed expenditures made incident to the rendition of services and of an amount requiring substantiation, the expenditures may be substantiated by the donor's normal records (see §1.170A-13(a)) and an abbreviated written ac-

knowledge provided by the donee organization. This written acknowledgment from the donee organization must contain a description of the services provided by the donor, the date the services were provided, whether or not the donee organization provided any goods or services in return and, if the donee organization provided any goods or services, a description and good faith estimate of the fair market value of those goods or services. This written acknowledgment must be obtained by the taxpayer on or before the earlier of the date the taxpayer files its original return for the taxable year in which the contribution was made, or the due date (including extensions) for filing the taxpayer's original return for that year.

Contributions Made by a Partnership or an S Corporation

The proposed regulations provide that if a partnership or an S corporation makes a charitable contribution of \$250 or more, the partnership or S corporation will be treated as the taxpayer for purposes of section 170(f)(8). Therefore, the partnership or S corporation is required to obtain a contemporaneous written acknowledgment for each charitable contribution of \$250 or more that it reports on its income tax return (regardless of whether any partner's or shareholder's distributive share of the contribution is less than \$250). Because the partnership or S corporation must satisfy the requirements of section 170(f)(8) in order to list charitable contributions of \$250 or more on the schedules provided to its partners or shareholders, the partners and shareholders are not required to obtain any additional contemporaneous written acknowledgments before taking a deduction for their allocable shares of the partnership's or S corporation's charitable contribution.

Contributions Made By Payroll Deduction

These proposed regulations reserve two paragraphs so that the balance of the temporary and proposed regulations published in the Federal Register for May 27, 1994, may be incorporated into §1.170A-13(f) upon finalization.

Proposed Effective Date

These regulations are proposed to be effective on the date they are published

in the Federal Register as final regulations. Taxpayers may, however, rely on the proposed regulations for contributions made on or after January 1, 1994.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

Comments and Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 1, 1995, at 10:00 a.m. in the IRS Auditorium, 7th floor, 1111 Constitution Avenue, N.W., Washington, D.C. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing is scheduled to begin.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments by November 1, 1995, and submit an outline (a signed original and eight copies) of the topics to be discussed and the time to be devoted to each topic by October 11, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding a new entry for Section 1.170A-1 and revising the entry for Section 1.170A-13 to read as follows:

Authority: 26 U.S.C. 7805.

Section 1.170A-1 also issued under 26 U.S.C. 170(a).

Section 1.170A-13 also issued under 26 U.S.C. 170(f)(8). * * *

Par. 2. Section 1.170A-1 is amended as follows:

1. Paragraph (h) is redesignated as paragraph (j).

2. Paragraph (i) is redesignated as paragraph (k) and is revised.

3. Paragraph (h) is added.

4. Paragraph (i) is added and reserved.

The additions and revisions read as follows:

§1.170A-1 Charitable, etc., contributions and gifts; allowance of deduction.

* * * * *

(h) *Payment in exchange for consideration—(1) Burden on taxpayer to show that all or part of payment is a charitable contribution or gift.* No part of a payment that a taxpayer makes to or for the use of an organization described in section 170(c) that is in consideration for goods or services (as defined in §1.170A-13(f)(5)) is a contribution or gift within the meaning of section 170(c) unless the taxpayer—

(i) Intends to make a payment in an amount that exceeds the fair market value of the goods or services; and

(ii) Makes a payment in an amount that exceeds the fair market value of the goods or services.

(2) *Limitation on amount deductible—(i) In general.* The charitable contribution deduction under section 170(a) for a payment a taxpayer

makes partly in consideration for goods or services may not exceed the excess of—

(A) The amount of any cash paid and the fair market value of any property (other than cash) transferred by the taxpayer to an organization described in section 170(c); over

(B) The fair market value of the goods or services the organization provides in return.

(ii) *Special rules.* For special limits on the deduction for charitable contributions of ordinary income and capital gain property, see section 170(e) and §§1.170A-4 and 1.170A-4A.

(3) *Certain goods or services disregarded.* For purposes of section 170(a) and paragraphs (h)(1) and (h)(2) of this section, goods or services described in §1.170A-13(f)(8)(i) or §1.170A-13(f)(9)(i) are disregarded.

(4) *Donee estimates of the value of goods or services may be treated as fair market value—(i) In general.* For purposes of section 170(a), a taxpayer may rely on either a contemporaneous written acknowledgment provided under section 170(f)(8) and §1.170A-13(f) or a written disclosure statement provided under section 6115 for the fair market value of any goods or services provided to the taxpayer by the donee organization.

(ii) *Exception.* A taxpayer may not treat an estimate of the value of goods or services as their fair market value if the taxpayer knows, or has reason to know, that such treatment is unreasonable. For example, if the taxpayer knows, or has reason to know, that there is an error in an estimate provided by an organization described in section 170(c) pertaining to goods or services that have a readily ascertainable value, it is unreasonable for the taxpayer to treat the estimate as the fair market value of the goods or services. Similarly, if the taxpayer is a dealer in the type of goods or services provided in consideration for its payment and knows, or has reason to know, that the estimate is in error, it is unreasonable for the taxpayer to treat the estimate as the fair market value of the goods or services.

(5) *Examples.* The following examples illustrate the rules of this paragraph (h).

Example 1. Certain goods or services disregarded. Taxpayer makes a \$50 payment to Charity B, an organization described in section 170(c), in exchange for a family membership.

The family membership entitles Taxpayer and members of Taxpayer's family to certain benefits. These benefits include free admission to weekly poetry readings, discounts on merchandise sold by B in its gift shop or by mail order, and invitations to special events for members only, such as lectures or informal receptions. When B first offers its membership package for the year, B reasonably projects that each special event for members will have a cost to B, excluding any allocable overhead, of \$5 or less per person. Because the family membership benefits are disregarded pursuant to §1.170A-13(f)(8)(i), Taxpayer may treat the \$50 payment as a contribution or gift within the meaning of section 170(c), regardless of Taxpayer's intent and whether or not the payment exceeds the fair market value of the goods or services. Furthermore, any charitable contribution deduction available to Taxpayer may be calculated without regard to the membership benefits.

Example 2. Treatment of good faith estimate at auction as the fair market value. Taxpayer attends an auction held by Charity C, an organization described in section 170(c). Prior to the auction, C publishes a catalog that meets the requirements for a written disclosure statement under section 6115(a) (including C's good faith estimate of the value of items that will be available for bidding). A representative of C gives a copy of the catalog to each individual (including Taxpayer) who attends the auction. Taxpayer notes that in the catalog C's estimate of the value of a vase is \$100. Taxpayer has no reason to doubt the accuracy of this estimate. Taxpayer successfully bids and pays \$500 for the vase. Because Taxpayer knew, prior to making her payment, that the estimate in the catalog was less than the amount of her payment, Taxpayer satisfies the requirement of paragraph (h)(1)(i) of this section. Because Taxpayer makes a payment in an amount that exceeds that estimate, Taxpayer satisfies the requirements of paragraph (h)(1)(ii) of this section. Taxpayer may treat C's estimate of the value of the vase as its fair market value in determining the amount of her charitable contribution deduction.

Example 3. Good faith estimate not in error. Taxpayer makes a \$200 payment to Charity D, an organization described in section 170(c). In return for Taxpayer's payment, D gives Taxpayer a book that Taxpayer could buy at retail prices typically ranging from \$18 to \$25. D provides Taxpayer with a good faith estimate, in a written disclosure statement under section 6115(a), of \$20 for the value of the book. Because the estimate is within the range of typical retail prices for the book, the estimate contained in the written disclosure statement is not in error. Although Taxpayer knows that the book is sold for as much as \$25, Taxpayer may treat the estimate of \$20 as the fair market value of the book in determining the amount of his charitable contribution deduction.

(i) [Reserved]

* * * * *

(k) *Effective date.* In general this section applies to contributions made in taxable years beginning after December 31, 1969. Paragraph (j)(11) of this section, however, applies only to out-of-pocket expenditures made in taxable years beginning after December 31,

1976. In addition, paragraph (h) of this section applies only to payments made on or after the date these regulations are published in the Federal Register as final regulations. However, taxpayers may rely on the rules of paragraph (h) of this section for payments made on or after January 1, 1994.

Par. 3. Section 1.170A-13 is amended as follows:

1. Paragraph (e) is added and reserved.

2. Paragraph (f) is added.

The additions read as follows:

§1.170A-13 Recordkeeping and return requirements for deductions for charitable contributions.

* * * * *

(e) [Reserved]

(f) *Substantiation of charitable contributions of \$250 or more—(1) In general.* No deduction is allowed under section 170(a) for all or part of any contribution of \$250 or more unless the taxpayer substantiates the contribution with a contemporaneous written acknowledgment from a donee organization. Section 170(f)(8) does not apply to a payment of \$250 or more if the amount contributed (as determined under §1.170A-1(h)) is less than \$250.

(2) *Written acknowledgment.* Except as otherwise provided in paragraphs (f)(8) and (f)(9) of this section, a written acknowledgment from a donee organization must provide the following information—

(i) The amount of any cash the taxpayer paid and a description (but not necessarily the value) of any property other than cash the taxpayer transferred to the donee organization;

(ii) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for any of the cash or other property transferred to the donee organization;

(iii) If the donee organization provides any goods or services other than intangible religious benefits (as described in section 170(f)(8)), a description and good faith estimate of the value of those goods or services; and

(iv) If the donee organization provides any intangible religious benefits, a statement to that effect.

(3) *Contemporaneous.* A written acknowledgment is contemporaneous if it is obtained by the taxpayer on or before the earlier of—

(i) The date the taxpayer files its original return for the taxable year in which the contribution was made; or

(ii) The due date (including extensions) for filing the taxpayer's original return for that year.

(4) *Donee organization.* For purposes of this paragraph (f), a donee organization is an organization described in section 170(c).

(5) *Goods or services.* Goods or services means cash, property, services, benefits, and privileges.

(6) *In consideration for.* A donee organization provides goods or services in consideration for a taxpayer's payment if, at the time the taxpayer makes the payment to the donee organization, the taxpayer receives or expects to receive goods or services in exchange for that payment. Goods or services a donee organization provides in consideration for a payment by a taxpayer include goods or services provided in a year other than the year in which the taxpayer makes the payment to the donee organization.

(7) *Good faith estimate.* For purposes of this section, good faith estimate means the donee organization's estimate of the fair market value of any goods or services, without regard to the manner in which the organization in fact made that estimate. See §1.170A-1(h)(4) for rules regarding when a taxpayer may treat a donee organization's estimate of the value of goods or services as the fair market value.

(8) *Certain goods or services disregarded—(i) In general.* For purposes of section 170(f)(8), the following goods or services are disregarded—

(A) Goods or services that have insubstantial value under the guidelines provided in Revenue Procedures 90-12, 1990-1 C.B. 471, 92-49, 1992-1 C.B. 987, and any successor documents. (See §601.601(d)(2)(ii) of the Statement of Procedural Rules, 26 CFR part 601.); and

(B) Annual membership benefits offered to a taxpayer for a payment of \$75 or less per year that consist of—

(1) Any rights or privileges, other than those described in section 170(l), that the taxpayer can exercise frequently during the membership period. Examples of such rights and privileges include, but are not limited to, free or discounted admission to the organization's facilities or events, free or discounted parking, preferred access to goods or services, and discounts on the purchase of goods or services; and

(2) Admission to events during the membership period that are open only to members of the donee organization and for which the donee organization reasonably projects that the cost per person (excluding any allocable overhead) for each such event is within the limits established for "low cost articles" under section 513(h)(2). The projected cost to the donee organization is determined at the time the organization first offers its membership package for the year (using section 3.07 of Revenue Procedure 90-12, or any successor documents, to determine the cost if items or services are donated).

(ii) *Examples.* The following examples illustrate the rules of this paragraph (f)(8).

Example 1. Membership benefits disregarded. Performing Arts Center *E* is an organization described in section 170(c). In return for a payment of \$75, *E* offers a package of basic membership benefits that includes the right to purchase tickets to performances one week before they go on sale to the general public, free parking in *E*'s garage during evening and weekend performances, and a 10% discount on merchandise sold in *E*'s gift shop. In return for a payment of \$150, *E* offers a package of preferred membership benefits that includes all of the benefits in the \$75 package as well as a poster that is sold in *E*'s gift shop for \$20. The basic membership and the preferred membership are each valid for twelve months, and there are approximately 50 performances of various productions at *E* during a twelve month period. *E*'s gift shop is open for several hours each week and at performance times. *F*, a patron of the arts, is solicited by *E* to make a contribution. *E* offers *F* the preferred membership benefits in return for a payment of \$150 or more. *F* makes a payment of \$300 to *E*. *F* can satisfy the substantiation requirement of section 170(f)(8) by obtaining a contemporaneous written acknowledgment from *E* that includes a description of the poster and a good faith estimate of its fair market value (\$20) and disregards the remaining membership benefits.

Example 2. Rights or privileges that cannot be exercised frequently. Community Theater Group *G* is an organization described in section 170(c). Every summer, *G* performs four different plays. Each play is performed two times. In return for a membership fee of \$60, *G* offers its members free admission to any of its performances. Nonmembers may purchase tickets on a performance by performance basis for \$15 a ticket. *H*, an individual who is a sponsor of the theater, is solicited by *G* to make a contribution. *G* tells *H* that the membership benefit will be provided in return for any payment of \$60 or more. *H* chooses to make a payment of \$350 to *G* and receives in return the membership benefit. *G*'s membership benefit of free admission is not described in paragraph (f)(8)(i)(B) of this section because it is not a privilege that can be exercised frequently (due to the limited number of performances offered by *G*). Therefore, to meet the requirements of section 170(f)(8), a contemporaneous written acknowledgment of *H*'s \$350 payment must include a description of the free admission benefit and a good faith estimate of its value.

(9) *Goods or services provided to employees of donors—(i) Certain goods or services disregarded.* For purposes of section 170(f)(8), goods or services provided by a donee organization to a taxpayer's employees in return for a payment to the organization may be disregarded to the extent that the goods or services provided to each employee are the same as those described in paragraph (f)(8)(i) of this section.

(ii) *No good faith estimate required for other goods or services.* If a taxpayer makes a contribution of \$250 or more to a donee organization and, in return, the donee organization offers the taxpayer's employees goods or services other than those described in paragraph (f)(9)(i) of this section, the contemporaneous written acknowledgment of the taxpayer's contribution is not required to include a good faith estimate of the value of such goods or services but must include a description of those goods or services.

(iii) *Example.* The following example illustrates the rules of this paragraph (f)(9).

Example. Museum *J* is an organization described in section 170(c). For a payment of \$40, *J* offers a package of basic membership benefits that includes free admission and a 10% discount on merchandise sold in *J*'s gift shop. *J*'s other membership categories are for supporters who contribute \$100 or more. Corporation *K* makes a payment of \$50,000 to *J* and in return, *J* offers *K*'s employees free admission, a tee-shirt with *J*'s logo that costs \$4.50, and a gift shop discount of 25%. The free admission for *K*'s employees is the same as the benefit made available to holders of the \$40 membership and is otherwise described in paragraph (f)(8)(i)(B) of this section. The tee-shirt given to each of *K*'s employees is described in paragraph (f)(8)(i)(A) of this section. Therefore, a contemporaneous written acknowledgment of *K*'s payment is not required to include a description or good faith estimate of the value of the free admission or the tee-shirts. However, because the gift shop discount offered to *K*'s employees is different than that offered to those who purchase the \$40 membership, the discount is not described in paragraph (f)(8)(i) of this section. Therefore, the contemporaneous written acknowledgment of *K*'s payment is required to include a description of the 25% discount offered to *K*'s employees.

(10) *Substantiation of out-of-pocket expenses.* A taxpayer that incurs unreimbursed expenditures incident to the rendition of services, within the meaning of §1.170A-1(g), is treated as having obtained a contemporaneous written acknowledgment of those expenditures if the taxpayer—

(i) Has adequate records under paragraph (a) of this section to substantiate the amount of the expenditures; and

(ii) Obtains by the date prescribed in paragraph (f)(3) of this section a statement prepared by the donee organization containing—

(A) A description of the services provided by the taxpayer;

(B) The date the services were provided;

(C) A statement of whether or not the donee organization provides any goods or services in consideration, in whole or in part, for the unreimbursed expenditures; and

(D) The information required by paragraphs (f)(2)(iii) and (iv) of this section.

(11) *Contributions made by payroll deduction.* [Reserved]

(12) *Distributing organizations as donees.* [Reserved]

(13) *Transfers to certain trusts.* Section 170(f)(8) does not apply to a transfer of property to a trust described in section 170(f)(2)(B), a charitable remainder annuity trust (as defined in section 664(d)(1)), or a charitable remainder unitrust (as defined in section 664(d)(2)). Section 170(f)(8) does apply, however, to a transfer to a pooled income fund (as defined in section 642(c)(5)).

(14) *Substantiation of charitable contributions made by a partnership or an S corporation.* If a partnership or an S corporation makes a charitable contribution of \$250 or more, the partnership or S corporation will be treated as the taxpayer for purposes of section 170(f)(8). Therefore, the partnership or S corporation must substantiate the contribution with a contemporaneous written acknowledgment from the donee organization before reporting the contribution on its income tax return for the year in which the contribution was made and must maintain the contemporaneous written acknowledgment in its records. A partner of a partnership or a shareholder of an S corporation is not required to obtain any additional substantiation for his or her share of the partnership's or S corporation's charitable contribution.

(15) *Substantiation of matched payments—(i) In general.* For purposes of section 170, if a taxpayer's payment to a donee organization is matched, in whole or in part, by another payor, and the taxpayer receives goods or services in consideration for its payment and some or all of the matching payment, those goods or services will be treated as provided in consideration for the

taxpayer's payment and not in consideration for the matching payment.

(ii) *Example.* The following example illustrates the rules of this paragraph (f)(15).

Example. Taxpayer makes a \$400 payment to Charity *L*, a donee organization. Pursuant to a matching payment plan, Taxpayer's employer matches Taxpayer's \$400 payment with an additional payment of \$400. In consideration for the combined payments of \$800, *L* gives Taxpayer an item that it estimates has a fair market value of \$100. *L* does not give the employer any goods or services in consideration for its contribution. The contemporaneous written acknowledgment provided to the employer must include a statement that no goods or services were provided in consideration for the employer's \$400 payment. The contemporaneous written acknowledgment provided to Taxpayer must include the amount of Taxpayer's payment, a description of the item received by Taxpayer, and a statement that *L*'s good faith estimate of the value of the item received by Taxpayer is \$100.

(16) *Effective date.* This paragraph (f) applies to contributions made on or after the date that these regulations are published in the Federal Register as final regulations. However, taxpayers may rely on the rules of this paragraph (f) for contributions made on or after January 1, 1994.

Par. 4. Section 1.6115-1 is added under the undesignated centerheading "Miscellaneous Provisions" to read as follows:

§1.6115-1 Disclosure requirements for quid pro quo contributions.

(a) *Good faith estimate defined—(1) In general.* A good faith estimate of the value of goods or services provided by an organization described in section 170(c) in consideration for a taxpayer's payment to that organization is an estimate of the fair market value, within the meaning of §1.170A-1(c)(2), of the goods or services. The organization may use any reasonable methodology in making a good faith estimate, provided it applies the methodology in good faith. If the organization fails to apply the methodology in good faith, the organization will be treated as not having met the requirements of section 6115. See section 6714 for the penalties that apply for failure to meet the requirements of section 6115.

(2) *Good faith estimate for goods or services that are not commercially available.* A good faith estimate of the value of goods or services that are not generally available in a commercial

transaction may be determined by reference to the fair market value of similar or comparable goods or services. Goods or services may be similar or comparable even though they do not have the unique qualities of the goods or services that are being valued.

(3) *Examples.* The following examples illustrate the rules of this paragraph (a).

Example 1. Facility not available on a commercial basis. Museum *M*, an organization described in section 170(c), is located in Community *N*. In return for a payment of \$50,000 or more, *M* allows a donor to hold a private event in a room located in *M*. No other private events are permitted to be held in *M*. In Community *N*, there are four hotels, *O*, *P*, *Q*, and *R*, that have ballrooms with the same capacity as the room in *M*. Of these hotels, only *O* and *P* have ballrooms that offer amenities and atmosphere that are similar to the amenities and atmosphere of the room in *M* (although *O* and *P* lack the unique collection of art that is displayed in the room of *M*). Because the capacity, amenities, and atmosphere of ballrooms in *O* and *P* are comparable to the capacity, amenities, and atmosphere of the room in *M*, a good faith estimate of the benefits received from *M* may be determined by reference to the cost of renting either the ballroom in *O* or the ballroom in *P*. The cost of renting the ballroom in *O* is \$2500 and, therefore, a good faith estimate of the fair market value of the right to host a private event in the room at *M* is \$2500. In this example, the ballrooms in *O* and *P* are considered similar and comparable facilities to the room in *M* for valuation purposes, notwithstanding the fact that the room in *M* displays a unique collection of art.

Example 2. Services available on a commercial basis. Charity *S* is an organization described in section 170(c). *S* offers to provide a one-hour tennis lesson with Tennis Professional *T* in return for the first payment of \$500 or more that it receives. *T* provides one-hour tennis lessons on a commercial basis for \$100. Taxpayer pays \$500 to *S* and in return receives the tennis lesson with *T*. A good faith estimate of the fair market value of the lesson provided in exchange for Taxpayer's payment is \$100.

Example 3. Celebrity presence. Charity *U* is an organization described in section 170(c). In return for the first payment of \$1000 or more that it receives, *U* will provide a dinner for two followed by an evening tour of Museum *V* conducted by Artist *W*, whose most recent works are on display at *V*. *W* does not provide tours of *V* on a commercial basis. Typically, tours of *V* are free to the public. Taxpayer pays \$1000 to *U* and in return receives a dinner valued at \$100 and an evening tour of *V* conducted by *W*. Because tours of *V* are typically free to the public, a good faith estimate of the value of the evening tour conducted by *W* is \$0. In this example, the fact that Taxpayer's tour of *V* is conducted by *W* rather than *V*'s regular tour guides does not render the tours dissimilar or incomparable for valuation purposes.

(b) *Certain goods or services disregarded.* For purposes of section 6115, an organization described in

section 170(c) may disregard goods or services described in §1.170A-13(f)(8)(i).

(c) *Goods or services provided to employees of donors—*

(1) *Certain goods or services disregarded.* For purposes of section 6115, goods or services provided by an organization described in section 170(c) to a taxpayer's employees in return for a payment to the organization may be disregarded to the extent that the goods or services provided to each employee are the same as those described in §1.170A-13(f)(8)(i).

(2) *Description permitted in lieu of good faith estimate for other goods or services.* If a taxpayer makes a quid pro quo contribution in excess of \$75 to an organization described in section 170(c) and, in return, the organization offers the taxpayer's employees goods or services other than those described in paragraph (c)(1) of this section, the organization's written disclosure statement required by section 6115 may include a description of the goods or services in lieu of a good faith estimate of the value of the goods or services, provided that the statement otherwise satisfies the requirements of section 6115.

(d) *Effective date.* This section applies to contributions made on or after the date that these regulations are published in the Federal Register as final regulations. However, taxpayers may rely on the rules of this section for contributions made on or after January 1, 1994.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on August 3, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 4, 1995, 60 F.R. 39896)

Notice of Proposed Rulemaking and Notice of Public Hearing

Methods of Signing

IA-10-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In *** [T.D. 8603, page 281, this Bulletin], the IRS is issuing temporary regulations relating to the signing of returns, statements, or other documents. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by October 19, 1995. Outlines of topics to be discussed at the public hearing scheduled for November 2, 1995, must be received by October 12, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (IA-10-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (IA-10-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in *** [T.D. 8603, page 281, this Bulletin], amend the Income Tax Regulations (26 CFR part 1) relating to section 6695 and the Procedure and Administration Regulations (26 CFR part 301) relating to section 6061. The temporary regulations relate to signing returns, statements, or other documents.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and

therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 2, 1995, at 10 am in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by October 19, 1995, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 12, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

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

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

Par. 2. In §1.6695-1, the first sentence of paragraph (b) (1) is revised to read as follows:

§1.6695-1 Other assessable penalties with respect to the preparation of income tax returns for other persons.

[The text of the proposed amendment to paragraph (b)(1) is the same as the text of §1.6695-1T(b) published elsewhere in *** [T.D. 8603, this Bulletin].

Par. 3. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

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

Section 301.6061-1 also issued under 26 U.S.C. 6061.

Par. 4. Section 301.6061-1 is amended as follows:

1. The text in §301.6061-1 is designated as paragraph (a) and a heading is added.

2. Paragraphs (b) and (c) are added. The additions read as follows:

§301.6061-1 Signing of returns and other documents.

(a) *In general.* * * *

[The text of proposed paragraphs (b) and (c) is the same as the text of §301.6061-1T(b) and (c) published elsewhere in *** [T.D. 8603, page 281, this Bulletin].

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 20, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 21, 1995, 60 F.R. 37621)

Notice of Proposed Rulemaking

Reporting of Nonpayroll Withheld Tax Liabilities

IA-30-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8624, page 258, this Bulletin], the IRS is issuing temporary regulations relating to the reporting of nonpayroll withheld income taxes under section 6011 of the Internal Revenue Code. The text of the temporary regulations also serves as the text for this notice of proposed rulemaking.

DATES: Written comments and requests for a public hearing must be received by December 15, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (IA-30-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (IA-30-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Ave. NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507). The collection of information is in §31.6011(a)-4T(b). This information is required by the IRS to monitor compliance with the federal tax rules related to the reporting and deposit of nonpayroll withheld taxes.

Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. To ensure that comments on the collection of information may be given full consideration during the review by the Office of Management and Budget, comments on the collection of information should be received by December 15, 1995.

An agency may not conduct or sponsor, and a person is not required to

respond to, a collection of information unless the collection of information displays a valid control number.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Estimates of the reporting burden in this Notice of Proposed Rulemaking will be reflected in the burden of Form 945.

Background

The temporary regulations published in *** [T.D. 8624, page 258, this Bulletin] contain an amendment to the Regulations on Employment Taxes and Collection of Income Tax at Source (26 CFR part 31). This amendment relates to the reporting of nonpayroll withheld tax liabilities. The temporary regulations change the rule regarding the filing of Form 945, Annual Return of Withheld Federal Income Tax, for a calendar year in which there is no liability.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consid-

eration will be given to any written comments (preferably a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 continues to read in part as follows:

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

Par. 2. In §31.6011(a)-4, paragraph (b) is revised to read as follows:

§31.6011(a)-4 Returns of income tax withheld.

* * * * *

(b) [The text of this proposed paragraph (b) is the same as the text of §31.6011(a)-4T(b) published elsewhere in *** [T.D. 8624, this Bulletin].]

* * * * *

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on October 13, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 16, 1995, 60 F.R. 53561)

Notice of Proposed Rulemaking and Notice of Public Hearing

Definition of Foreign Base Company Income and Foreign Personal Holding Company Income of a Controlled Foreign Corporation

INTL-75-92

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed Income Tax Regulations relating to the definitions of subpart F income and foreign personal holding company income of a controlled foreign corporation and the allocation of deficits for purposes of computing the deemed-paid foreign tax credit. These proposed regulations are necessary to provide guidance that coordinates with guidance provided in final regulations under section 954, published elsewhere in *** [T.D. 8618, page 89, this Bulletin]. These regulations will affect United States shareholders of controlled foreign corporations. This document also contains a notice of hearing on these regulations.

DATES: Written comments must be received by December 6, 1995. Outlines of topics to be discussed at the public hearing scheduled for January 4, 1996 at 10 a.m. must be received by December 14, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (INTL-0075-92), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (INTL-0075-92), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington DC. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This notice of proposed rulemaking does not contain collections of informa-

tion and, therefore, it has not been submitted to the Office of Management and Budget for review under the Paperwork Reduction Act (44 U.S.C. 3504(h)).

Background

This document contains proposed regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 952, 954(c) and 960 of the Internal Revenue Code. These regulations are also issued under authority contained in section 7805 of the Internal Revenue Code. In final regulations under section 954, published elsewhere in *** [T.D. 8618, page 89, this Bulletin], the section relating to the treatment of tax-exempt interest under the foreign personal holding company income rules was reserved. These proposed regulations would provide rules for the treatment of tax-exempt interest and would also provide guidance under sections 952 and 960 to coordinate with the final regulations.

Explanation of Provisions

§§1.952-1(e) and (f) and 1.960-1(i)

Section 1.954-1(c)(1)(ii), published elsewhere in [T.D. 8618, this Bulletin], provides generally that if the amount in any category of foreign base company income or foreign personal holding company income is less than zero, the loss may not reduce any other category of foreign base company income or foreign personal holding company income except by operation of the earnings and profits limitation of section 952(c)(1). The earnings and profits limitation will apply when subpart F income exceeds current earnings and profits. This notice of proposed rulemaking provides rules under section 952(c)(1)(A) to determine how the excess of subpart F income over current earnings and profits will reduce categories of foreign base company income or foreign personal holding company income.

These rules apply both to determine the amount that is included in the U.S. shareholder's gross income in each category of subpart F income under section 951(a)(1)(A) from each section 904(d) separate category, and to determine the subpart F category and the section 904(d) separate category from which an amount will be recharac-

terized as subpart F income under section 952(c)(2). Separate rules are provided in this notice of proposed rulemaking to compute post-1986 undistributed earnings under section 960.

Section 1.952-1(e) provides that for post-1986 years, when the subpart F income of a controlled foreign corporation exceeds its current earnings and profits, this excess, first, proportionately reduces subpart F income in each separate category in which current earnings and profits are zero or less than zero, second, proportionately reduces subpart F income in each separate category in which subpart F income exceeds current earnings and profits, and third, proportionately reduces subpart F income in other separate categories. If a single separate category contains more than one category of subpart F income, the categories of subpart F income in the separate category will be proportionately reduced.

Section 1.952-1(f) provides that the amount and category of subpart F income in each separate category that is reduced by operation of the earnings and profits limitation, as determined under paragraph (e), constitutes a recapture account. In any year in which earnings and profits exceed subpart F income, the recapture accounts in each separate category of the corporation will be recharacterized, on a proportionate basis, as subpart F income to the extent of this excess. An amount that is recharacterized as subpart F income is treated as income in the same separate category as the recapture account from which it was derived.

Under paragraph (f), a recapture account is reduced either when amounts in the account are recharacterized as subpart F income or when the corporation makes an actual distribution from the separate category containing the recapture account. A distribution out of section 959(c)(3) earnings and profits is treated as made first on a proportionate basis out of the recapture accounts in each separate category. If a distribution from earnings and profits described in section 959(c)(3) occurs in the same year that an amount is recharacterized, the recharacterization rules will apply first. Examples are provided to illustrate the rules of paragraphs (e) and (f).

Regulations are proposed under section 960 that apply the principles of section 902 to determine the portion of the controlled foreign corporation's

post-1986 foreign income taxes deemed to be paid by a United States corporate shareholder in connection with a subpart F inclusion. If the corporate shareholder computes an amount under both sections 902 and 960 for a taxable year, section 960 is applied first.

These proposed regulations also provide rules to determine how deficits in post-1986 undistributed earnings are allocated for purposes of sections 902 and 960. In accordance with the approach of Notice 88-70 (1988-2 C.B. 369), §1.960-1(i)(4) provides that a post-1986 accumulated deficit in a separate category is allocated pro rata against post-1986 undistributed earnings in other separate categories to compute post-1986 undistributed earnings. The deficit does not permanently reduce earnings in these other separate categories. Rather, after deemed-paid taxes are computed, it is carried forward in the same separate category in which it was incurred. Paragraph (i)(3) clarifies that the numerator of the deemed-paid credit fraction cannot exceed the denominator because deemed-paid taxes may not exceed taxes paid or accrued by the controlled foreign corporation. Examples are provided to illustrate these rules.

The proposed regulations attempt to coordinate, to the extent possible, the allocation of deficits for purposes of determining the amounts of subpart F inclusions and deemed-paid taxes out of the controlled foreign corporation's separate foreign tax credit limitation categories under sections 952, 954, and 960. Complete coordination is not possible in all cases, because subpart F income and the earnings and profits limitation of section 952(c)(1)(A) are determined on the basis of earnings and profits of only the current year, whereas deemed-paid taxes are calculated under section 960 on the basis of multi-year pools of earnings and profits and taxes. In addition, potential differences in the calculation of income and earnings and profits, cf. section 952(c)(3), complicate the coordination.

The proposed rules attempt to minimize the incidence of subpart F inclusions out of separate categories with no current earnings which, in the absence of sufficient accumulated earnings, may carry no deemed-paid taxes. Comments are requested as to whether the proposed allocation methods or some alternative approach would best achieve appropriate foreign tax credit results.

§1.954-2(b)(3)

Under §1.954-2T(b)(6), interest income that is exempt from tax under section 103 is included in the foreign personal holding company income of the controlled foreign corporation. However, the net foreign base company income that is attributable to tax-exempt interest is treated as tax-exempt interest in the hands of the United States shareholder upon a deemed distribution under subpart F. Therefore, for regular tax purposes, the tax-exempt interest is not currently included in the gross income of the United States shareholder under subpart F. However, the deemed distribution of tax-exempt interest may subject the United States shareholder to the alternative minimum tax.

Section 1.954-2(b)(3) of the proposed regulations would amend the rule in the temporary regulations to provide that foreign personal holding company income includes interest income that is exempt from tax under section 103. The tax-exempt interest would not retain its character as such in the hands of the United States shareholder upon a deemed distribution under subpart F. This proposed rule closely parallels the domestic rule for tax-exempt interest. The controlled foreign corporation realizes the tax benefit associated with the receipt of interest income described in section 103 because no United States withholding tax is collected on the income when it is paid to the controlled foreign corporation. As in the domestic context, however, this tax benefit is limited to the corporate level and is not retained when the tax-exempt interest is distributed to the United States shareholders or included in their gross income under subpart F. This rule simplifies the interaction of the tax-exempt interest and alternative minimum tax provisions, and avoids the double-taxation and administrative problems associated with the current rule.

These regulations are proposed to be effective for taxable years of the foreign corporation beginning after 60 days after the date these regulations are published as final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a

significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 4, 1996, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons that wish to present oral comments at the hearing must submit written comments by December 6, 1995, and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by December 14, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for Part 1 is amended by adding the following citation in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *
Section 1.960-1 also issued under 26 U.S.C. 960(a). * * *

Par. 2. Section 1.952-1 is amended by adding paragraphs (e) and (f) to read as follows:

§1.952-1 Subpart F income defined.

* * * * *

(e) *Application of current earnings and profits limitation*—(1) *In general.* If the subpart F income (as defined in section 952(a)) of a controlled foreign corporation exceeds the foreign corporation's earnings and profits for the taxable year, the subpart F income includible in the income of the corporation's United States shareholders is reduced under section 952(c)(1)(A) in accordance with the following rules. The excess of subpart F income over current year earnings and profits shall—

(i) First, proportionately reduce subpart F income in each separate category of the controlled foreign corporation, as defined in §1.904-5(a)(1), in which current earnings and profits are zero or less than zero;

(ii) Second, proportionately reduce subpart F income in each separate category in which subpart F income exceeds current earnings and profits; and

(iii) Third, proportionately reduce subpart F income in other separate categories.

(2) *Allocation to a category of subpart F income.* An excess amount that is allocated under paragraph (e)(1) of this section to a separate category must be further allocated to a category of subpart F income if the separate category contains more than one category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in §1.954-1(c)(1)(iii)(A)(I) or (2). In such case, the excess amount that is allocated to the separate category must be allocated to the various categories of subpart F income within that separate category on a proportionate basis.

(3) *Recapture of subpart F income reduced by operation of earnings and*

profits limitation. Any amount in a category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in §1.954-1(c)(1)(iii)(A)(I) or (2) that is reduced by operation of the current year earnings and profits limitation of section 952(c)(1)(A) and this paragraph (e) shall be subject to recapture in a subsequent year under the rules of section 952(c)(2) and paragraph (f) of this section.

(4) *Coordination with sections 953 and 954.* The rules of this paragraph (e) shall be applied after the application of sections 953 and 954 and the regulations under those sections, except as provided in §1.954-1(d)(4)(ii).

(5) *Earnings and deficits retain separate limitation character.* The income reduction rules of paragraph (e)(1) of this section shall apply only for purposes of determining the amount of an inclusion under section 951(a)(1)(A) from each separate category as defined in §1.904-5(a)(1) and the separate categories in which recapture accounts are established under section 952(c)(2) and paragraph (f) of this section. For rules applicable in computing post-1986 undistributed earnings, see generally section 902 and the regulations under that section. For rules relating to the allocation of deficits for purposes of computing foreign taxes deemed paid under section 960 with respect to an inclusion under section 951(a)(1)(A), see §1.960-1(i).

(f) *Recapture of subpart F income in subsequent taxable year*—(1) *In general.* If a controlled foreign corporation's subpart F income for a taxable year is reduced under the current year earnings and profits limitation of section 952(c)(1)(A) and paragraph (e) of this section, recapture accounts will be established and subject to recharacterization in any subsequent taxable year to the extent the recapture accounts were not previously recharacterized or distributed, as provided in paragraphs (f)(2) and (3) of this section.

(2) *Rules of recapture*—(i) *Recapture account.* If a category of subpart F income described in section 952(a) or, in the case of foreign base company income, described in §1.954-1(c)(1)(iii)(A)(I) or (2) is reduced under the current year earnings and profits limitation of section 952(c)(1)(A) and paragraph (e) of this section for a taxable year, the amount of such reduction shall constitute a recapture account.

(ii) *Recapture.* Each recapture account of the controlled foreign corporation will be recharacterized, on a proportionate basis, as subpart F income in the same separate category (as defined in §1.904-5(a)(1)) as the recapture account to the extent that current year earnings and profits exceed subpart F income in a taxable year. The United States shareholder must include his pro rata share (determined under the rules of §1.951-1(e)) of each recharacterized amount in income as subpart F income in such separate category for the taxable year.

(iii) *Reduction of recapture account and corresponding earnings.* Each recapture account, and post-1986 undistributed earnings in the separate category containing the recapture account, will be reduced in any taxable year by the amount which is recharacterized under paragraph (f)(2)(ii) of this section. In addition, each recapture account, and post-1986 undistributed earnings in the separate category containing the recapture account, will be reduced in the amount of any distribution out of that account (as determined under the ordering rules of section 959(c) and paragraph (f)(3)(ii) of this section).

(3) *Distribution ordering rules—(i) Coordination of recapture and distribution rules.* If a controlled foreign corporation distributes an amount out of earnings and profits described in section 959(c)(3) in a year in which current year earnings and profits exceed subpart F income and there is an amount in a recapture account for such year, the recapture rules will apply first.

(ii) *Distributions reduce recapture accounts first.* Any distribution made by a controlled foreign corporation out of earnings and profits described in section 959(c)(3) shall be treated as made first on a proportionate basis out of the recapture accounts in each separate category to the extent thereof (even if the amount in the recapture account exceeds post-1986 undistributed earnings in the separate category containing the recapture account). Any remaining distribution shall be treated as made on a proportionate basis out of the remaining earnings and profits of the controlled foreign corporation in each separate category. See section 904(d)(3)(D).

(4) *Examples.* The application of paragraphs (e) and (f) of this section may be illustrated by the following examples:

Example 1. (i) A, a U.S. person, is the sole shareholder of CFC, a controlled foreign corporation formed on January 1, 1996, whose functional currency is the *u*. In 1996, CFC earns 100u of foreign base company sales income that is general limitation income described in section 904(d)(1)(I) and incurs a (200u) loss attributable to activities that would have produced general limitation income that is not subpart F income. In 1996 CFC also earns 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A), and 100u of foreign personal holding company income that is dividend income subject to a separate limitation described in section 904(d)(1)(E) for dividends from a noncontrolled section 902 corporation. CFC's subpart F income for 1996, 300u, exceeds CFC's current earnings and profits, 100u, by 200u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 100u, all of which is included in A's gross income under section 951(a)(1)(A). The 200u of CFC's 1996 subpart F income that is not included in A's income in 1996 by reason of section 952(c)(1)(A) is subject to recapture under section 952(c)(2) and paragraph (f) of this section.

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture account, the rules of paragraphs (e)(1) and (2) of this section apply. Under paragraph (e)(1)(i), the amount by which CFC's subpart F income exceeds its earnings and profits for 1996, 200u, first reduces from 100u to 0 CFC's subpart F income in the general limitation category, which has a current year deficit of (100u) in earnings and profits. Next, under paragraph (e)(1)(iii) of this section, the remaining 100u by which CFC's 1996 subpart F income exceeds earnings and profits is applied proportionately to reduce CFC's subpart F income in the separate categories for passive income (100u) and dividends from the noncontrolled section 902 corporation (100u). Thus, A includes 50u of passive limitation/foreign personal holding company income and 50u of dividends from the noncontrolled section 902 corporation/foreign personal holding company income in gross income in 1996. CFC has 100u in its general limitation/foreign base company sales income recapture account attributable to the 100u of foreign base company sales income that is not included in A's income by reason of the earnings and profits limitation of section 952(c)(1)(A). CFC also has 50u in its passive limitation recapture account, all of which is attributable to foreign personal holding company income, and 50u in its recapture account for dividends from the noncontrolled section 902 corporation, all of which is attributable to foreign personal holding company income.

(iii) For purposes of computing post-1986 undistributed earnings, the rules of sections 902 and 960, including the rules of §1.960-1(i), apply. Under §1.960-1(i), the general limitation deficit of (100u) is allocated proportionately to reduce passive limitation earnings of 100u and noncontrolled section 902 dividend earnings of 100u. Thus, passive limitation earnings are reduced by 50u to 50u (100u passive limitation earnings/200u total earnings in positive separate categories \times (100u) general limitation deficit = 50u reduction), and the noncontrolled section 902 corporation earnings are reduced by 50u to 50u (100u noncontrolled section 902 corporation earnings/200u total earnings in positive separate categories \times (100u) general limitation deficit =

50u reduction). All of CFC's post-1986 foreign income taxes with respect to passive limitation income and dividends from the noncontrolled section 902 corporation are deemed paid by A under section 960 with respect to the subpart F inclusions (50u inclusion/50u earnings in each separate category). After the inclusion and deemed-paid taxes are computed, at the close of 1996 CFC has a (100u) deficit in general limitation earnings (100u subpart F earnings + (200u) nonsubpart F loss), 50u of passive limitation earnings (100u of earnings attributable to foreign personal holding company income - 50u inclusion) with a corresponding passive limitation/foreign personal holding company income recapture account of 50u, and 50u of earnings subject to a separate limitation for dividends from the noncontrolled section 902 corporation (100u earnings - 50u inclusion) with a corresponding noncontrolled section 902 corporation/foreign personal holding company income recapture account of 50u.

Example 2. (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1997, CFC earns 100u of foreign base company sales income that is general limitation income and 100u of foreign personal holding company income that is passive limitation income. In addition, CFC incurs (10u) of expenses that are allocable to its separate limitation for dividends from the noncontrolled section 902 corporation. Thus, CFC's subpart F income for 1997, 200u, exceeds CFC's current earnings and profits, 190u, by 10u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to CFC's current earnings and profits of 190u, all of which is included in A's gross income under section 951(a)(1)(A).

(ii) For purposes of determining the amount and type of income included in A's gross income and the amount and type of income in CFC's recapture accounts, the rules of paragraphs (e)(1) and (2) of this section apply. While CFC's general limitation post-1986 undistributed earnings for 1997 are 0 ((100u) opening balance + 100u subpart F income), CFC's general limitation subpart F income (100u) does not exceed its general limitation current earnings and profits (100u) for 1997. Accordingly, under paragraph (e)(1)(iii) of this section, the amount by which CFC's subpart F income exceeds its earnings and profits for 1997, 10u, is applied proportionately to reduce CFC's subpart F income in the separate categories for general limitation income, 100u, and passive income, 100u. Thus, A includes 95u of general limitation foreign base company sales income and 95u of passive limitation foreign personal holding company income in gross income in 1997. At the close of 1997 CFC has 105u in its general limitation/foreign base company sales income recapture account (100u from 1996 + 5u from 1997), 55u in its passive limitation/foreign personal holding company income recapture account (50u from 1996 + 5u from 1997), and 50u in its dividends from the noncontrolled section 902 corporation/foreign personal holding company income recapture account (all from 1996).

(iii) For purposes of computing post-1986 undistributed earnings in each separate category, the rules of sections 902 and 960, including the rules of §1.960-1(i), apply. Thus, post-1986 undistributed earnings (or an accumulated deficit) in each separate category are increased (or reduced) by current earnings and profits or current deficits in each separate category. The accumulated deficit in CFC's general limitation

earnings and profits (100u) is reduced to 0 by the addition of 100u of 1997 earnings and profits. *CFC's* passive limitation earnings of 50u are increased by 100u to 150u, and *CFC's* noncontrolled section 902 corporation earnings of 50u are decreased by (10u) to 40u. After the addition of current year earnings and profits and deficits to the separate categories there are no deficits remaining in any separate category. Thus, the allocation rules of §1.960-1(i)(4) do not apply in 1997. Accordingly, in determining the post-1986 foreign income taxes deemed paid by *A*, post-1986 undistributed earnings in each separate category are unaffected by earnings in the other categories. Foreign taxes deemed paid under section 960 for 1997 would be determined as follows for each separate category: with respect to the inclusion of 95u of foreign base company sales income out of general limitation earnings, the section 960 fraction is 95u inclusion/0 total earnings; with respect to the inclusion of 95u of passive limitation income the section 960 fraction is 95u inclusion/150u passive earnings. Thus, no general limitation taxes would be associated with the inclusion of the general limitation earnings because there are no accumulated earnings in the general limitation category. After the deemed-paid taxes are computed, at the close of 1997 *CFC* has a (95u) deficit in general limitation earnings and profits ((100u) opening balance + 100u current earnings - 95u inclusion), 55u of passive limitation earnings and profits (50u opening balance + 100u current foreign personal holding company income - 95u inclusion), and 40u of earnings and profits subject to the separate limitation for dividends from the noncontrolled section 902 corporation (50u opening balance + (10u) expense).

Example 3. (i) *A*, a U.S. person, is the sole shareholder of *CFC*, a controlled foreign corporation whose functional currency is the *u*. At the beginning of 1996, *CFC* has post-1986 undistributed earnings of 275u, all of which are general limitation earnings described in section 904(d)(1)(I). *CFC* has no previously-taxed earnings and profits described in section 959(c)(1) or (c)(2). In 1996, *CFC* has a (200u) loss in the shipping category described in section 904(d)(1)(D), 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A), and 125u of general limitation manufacturing earnings that are not subpart F income. *CFC's* subpart F income for 1996, 100u, exceeds *CFC's* current earnings and profits, 25u, by 75u. Under section 952(c)(1)(A) and paragraph (e) of this section, subpart F income is limited to *CFC's* current earnings and profits of 25u, all of which is included in *A's* gross income under section 951(a)(1)(A). The 75u of *CFC's* 1996 subpart F income that is not included in *A's* income in 1996 by reason of section 952(c)(1)(A) is subject to recapture under section 952(c)(2) and paragraph (f) of this section.

(ii) For purposes of determining the amount and type of income included in *A's* gross income and the amount and type of income in *CFC's* recapture account, the rules of paragraphs (e)(1) and (2) of this section apply. Under paragraph (e)(1) of this section, the amount of *CFC's* subpart F income in excess of earnings and profits for 1996, 75u, reduces the 100u of passive limitation foreign personal holding company income. Thus, *A* includes 25u of passive limitation foreign personal holding company income in gross income, and *CFC* has 75u in its passive limitation/foreign personal holding company income recapture account.

(iii) For purposes of computing post-1986 undistributed earnings in each separate category the rules of sections 902 and 960, including the rules of §1.960-1(i), apply. Under §1.960-1(i), the shipping limitation deficit of (200u) is allocated proportionately to reduce general limitation earnings of 400u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 160u to 240u (400u general limitation earnings/500u total earnings in positive separate categories × (200u) shipping deficit = 160u reduction), and passive limitation earnings are reduced by 40u to 60u (100u passive earnings/500u total earnings in positive separate categories × (200u) shipping deficit = 40u reduction). Five-twelfths of *CFC's* post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by *A* under section 960 with respect to the subpart F inclusion (25u inclusion/60u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1996 *CFC* has 400u of general limitation earnings (275u opening balance + 125u current earnings), 75u of passive limitation earnings (100u of foreign personal holding company income - 25u inclusion), and a (200u) deficit in shipping limitation earnings.

Example 4. (i) The facts are the same as in *Example 3* with the addition of the following facts. In 1997, *CFC* earns 50u of general limitation earnings that are not subpart F income and 75u of passive limitation income that is foreign personal holding company income. Thus, *CFC* has 125u of current earnings and profits. *CFC* distributes 200u to *A*. Under paragraph (f)(3)(ii) of this section, the recapture rules are applied first. Thus, the amount by which 1997 current earnings and profits exceed subpart F income, 50u, is recharacterized as passive limitation foreign personal holding company income. *CFC's* total subpart F income for 1997 is 125u of passive limitation foreign personal holding company income (75u current earnings plus 50u recapture account), and the passive limitation/foreign personal holding company income recapture account is reduced from 75u to 25u.

(ii) *CFC* has 150u of previously-taxed earnings and profits described in section 959(c)(2) (25u attributable to 1996 and 125u attributable to 1997), all of which is passive limitation earnings and profits. Under section 959(c), 150u of the 200u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). Under paragraph (f)(3)(i) of this section, the dividend distribution is deemed to be made first out of the passive limitation recapture account to the extent thereof (25u). Under paragraph (f)(2)(iii) of this section, the passive limitation recapture account is reduced from 25u to 0. The remaining distribution of 25u is treated as made out of *CFC's* general limitation earnings and profits.

(iii) For purposes of computing post-1986 undistributed earnings, the rules of section 902 and 960, including the rules of §1.960-1(i), apply. Thus, the shipping limitation accumulated deficit of (200u) reduces general limitation earnings and profits of 450u and passive limitation earnings and profits of 150u on a proportionate basis. Thus, 100% of *CFC's* post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by *A* under section 960 with respect to the 1997 subpart F inclusion of 125u (100u inclusion (numerator limited to denominator)/100u passive

earnings). No post-1986 foreign income taxes remain to be deemed paid under section 902 in connection with the 25u distribution from the passive limitation/foreign personal holding company income recapture account. One-twelfth of *CFC's* post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by *A* under section 902 with respect to the distribution of 25u general limitation earnings and profits described in section 959(c)(3) (25u inclusion/300u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1997 *CFC* has 425u of general limitation earnings and profits (400u opening balance + 50u current earnings - 25u distribution), 0 of passive limitation earnings (75u recapture account + 75u current foreign personal holding company income - 125u inclusion - 25u distribution), and a (200u) deficit in shipping limitation earnings.

Par. 3. In §1.952-2, paragraph (c)(1) is revised to read as follows:

§1.952-2 Determination of gross income and taxable income of a foreign corporation.

* * * * *

(c) *Special rules for purposes of this section—(1) Nonapplication of certain provisions.* Except where otherwise distinctly expressed, the provisions of section 103 and subchapters F, G, H, L, M, N, S, and T of chapter 1 of the Internal Revenue Code shall not apply.

* * * * *

Par. 4. In §1.954-2, paragraph (b)(3) is added to read as follows:

§1.954-2 Foreign personal holding company income.

* * * * *

(b) * * *

(3) *Treatment of tax exempt interest.* Foreign personal holding company income includes all interest income, including interest that is described in section 103 (see §1.952-2(c)(1)).

* * * * *

Par. 5. In §1.960-1, paragraph (i) is added to read as follows:

§1.960-1 Foreign tax credit with respect to taxes paid on earnings and profits of controlled foreign corporations.

* * * * *

(i) *Computation of deemed-paid taxes in post-1986 taxable years—(1) General rule.* If a domestic corporation is eligible to compute deemed-paid

taxes under section 960(a)(1) with respect to an amount included in gross income under section 951(a), then, such domestic corporation shall be deemed to have paid a portion of such foreign corporation's post-1986 foreign income taxes determined under section 902 and the regulations under that section in the same manner as if the amount so included were a dividend paid by such foreign corporation (determined by applying section 902(c) in accordance with section 904(d)(3)(B)).

(2) *Ordering rule for computing deemed-paid taxes under sections 902 and 960.* If a domestic corporation computes deemed-paid taxes under both section 902 and section 960 in the same taxable year, section 960 shall be applied first. After the deemed-paid taxes are computed under section 960 with respect to a deemed income inclusion, post-1986 undistributed earnings and post-1986 foreign income taxes in each separate category shall be reduced by the appropriate amounts before deemed-paid taxes are computed under section 902 with respect to a dividend distribution.

(3) *Computation of post-1986 undistributed earnings.* Post-1986 undistributed earnings (or an accumulated deficit in post-1986 undistributed earnings) are computed under section 902 and the regulations under that section.

(4) *Allocation of accumulated deficits.* For purposes of computing post-1986 undistributed earnings under sections 902 and 960, a post-1986 accumulated deficit in a separate category shall be allocated proportionately to reduce post-1986 undistributed earnings in the other separate categories. However, a deficit in any separate category shall not permanently reduce earnings in other separate categories, but after the deemed-paid taxes are computed the separate limitation deficit shall be carried forward in the same separate category in which it was incurred. In addition, because deemed-paid taxes may not exceed taxes paid or accrued by the controlled foreign corporation, in computing deemed-paid taxes with respect to an inclusion out of a separate category that exceeds post-1986 undistributed earnings in that separate category, the numerator of the deemed-paid credit fraction (deemed inclusion from the separate category) may not exceed the denominator (post-1986 undistributed earnings in the separate category).

(5) *Examples.* The application of this paragraph (i) may be illustrated by the

following examples. See §1.952-1(f)(4) for additional illustrations of these rules.

Example 1. (i) *A*, a U.S. person, is the sole shareholder of *CFC*, a controlled foreign corporation formed on January 1, 1996, whose functional currency is the *u*. In 1996 *CFC* earns 100u of general limitation income described in section 904(d)(1)(I) that is not subpart F income and 100u of foreign personal holding company income that is passive income described in section 904(d)(1)(A). In 1996 *CFC* also incurs a (50u) loss in the shipping category described in section 904(d)(1)(D). *CFC*'s subpart F income for 1996, 100u, does not exceed *CFC*'s current earnings and profits of 150u. Accordingly, all 100u of *CFC*'s subpart F income is included in *A*'s gross income under section 951(a)(1)(A). Under section 904(d)(3)(B) of the Code and paragraph (i)(1) of this section, *A* includes 100u of passive limitation income in gross income for 1996.

(ii) For purposes of computing post-1986 undistributed earnings under sections 902, 904(d) and 960 with respect to the subpart F inclusion, the shipping limitation deficit of (50u) is allocated proportionately to reduce general limitation earnings of 100u and passive limitation earnings of 100u. Thus, general limitation earnings are reduced by 25u to 75u (100u general limitation earnings/200u total earnings in positive separate categories × (50u) shipping deficit = 25u reduction), and passive limitation earnings are reduced by 25u to 75u (100u passive earnings/200u total earnings in positive separate categories × (50u) shipping deficit = 25u reduction). All of *CFC*'s post-1986 foreign income taxes with respect to passive limitation earnings are deemed paid by *A* under section 960 with respect to the 100u subpart F inclusion of passive income (75u inclusion (numerator limited to denominator under paragraph (i)(4) of this section)/75u passive earnings). After the inclusion and deemed-paid taxes are computed, at the close of 1996 *CFC* has 100u of general limitation earnings, 0 of passive limitation earnings (100u of foreign personal holding company income – 100u inclusion), and a (50u) deficit in shipping limitation earnings.

Example 2. (i) The facts are the same as in *Example 1* with the addition of the following facts. In 1997, *CFC* distributes 150u to *A*. *CFC* has 100u of previously-taxed earnings and profits described in section 959(c)(2) attributable to 1996, all of which is passive limitation earnings and profits. Under section 959(c), 100u of the 150u distribution is deemed to be made from earnings and profits described in section 959(c)(2). The remaining 50u is deemed to be made from earnings and profits described in section 959(c)(3). The entire dividend distribution of 50u is treated as made out of *CFC*'s general limitation earnings and profits. See section 904(d)(3)(D).

(ii) For purposes of computing post-1986 undistributed earnings under section 902 with respect to the 1997 dividend of 50u, the shipping limitation accumulated deficit of (50u) reduces general limitation earnings and profits of 100u to 50u. Thus, 100% of *CFC*'s post-1986 foreign income taxes with respect to general limitation earnings are deemed paid by *A* under section 902 with respect to the 1997 dividend of 50u (50u dividend/50u general limitation earnings). After the deemed-paid taxes are computed, at the close of 1997 *CFC* has 50u of general limitation earnings (100u opening balance – 50u distribution), 0 of passive limitation earnings, and a (50u) deficit in shipping limitation earnings.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on September 6, 1995, 8:45 a.m., and published in the issue of the Federal Register for September 7, 1995, 60 F.R. 46548)

Withdrawal of Notice of Proposed Rulemaking; Notice of Proposed Rulemaking; Notice of Public Hearing

Taxpayer Identifying Numbers (TIN)

INTL-24-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document withdraws the notice of proposed rulemaking relating to taxpayer identifying numbers published in the Federal Register on September 27, 1990, at 55 FR 39486 [IA-224-82, 1990-2 C.B. 739]. This document also contains proposed amendments to the regulations relating to requirements for furnishing a taxpayer identifying number on returns, statements, or other documents. These amendments set forth procedures for requesting a taxpayer identifying number for certain alien individuals for whom a social security number is not available. These numbers would be called "IRS individual taxpayer identification numbers." These amendments also require certain foreign persons to furnish a taxpayer identifying number on their tax returns. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of the oral comments to be presented at the public hearing scheduled for 10 a.m. on September 28, 1995, must be received by September 7, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (INTL-0024-94), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5

p.m. to: CC:DOM:CORP:T:R (INTL-0024-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. The public hearing will be held in the Internal Revenue Service Auditorium, 7400 corridor, 1111 Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office in Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collection of information from certain resident alien individuals and foreign persons required to furnish taxpayer identifying numbers under section 6109 of the Internal Revenue Code (Code) is found in § 301.6109-1. This information will be used by the IRS for tax administration purposes. The likely respondents and recordkeepers are certain resident alien individuals and foreign persons such as nonresident alien individuals and foreign corporations who make a return of tax.

The burden for the collection of information contained in § 301.6109-1(d) is reflected in the burden of Form W-7.

Background

This document withdraws the notice of proposed rulemaking under section 6109 published in the **Federal Register** on September 27, 1990 at 55 FR 39486. This document also contains proposed amendments to 26 CFR part 301 to provide rules under section 6109 of the Internal Revenue Code relating to a new type of taxpayer identifying number.

Explanation of Provisions

In General

Section 6109(a) of the Code provides

that, when required by regulations, a person must furnish a taxpayer identifying number (TIN) for securing proper identification of that person on any return, statement, or other document made under the Code. The assignment of a unique and permanent number to each taxpayer is important for the effective operation of the IRS automatic data processing system. The numbering system improves the IRS' ability to identify and access database records; to match information provided on tax and information returns, statements, and other documents with the proper taxpayers; and to provide better customer service to taxpayers.

The Treasury Department and the IRS are concerned about individuals who are filing tax returns but who are unable to obtain a social security number. In order to insure that all taxpayers required to provide a TIN for tax purposes are able to obtain one, the IRS is developing a separate numbering system that will make unique and permanent numbers available to those individuals. The proposed regulations explain how alien individuals, whether resident or nonresident, can obtain an IRS individual taxpayer identification number from the IRS.

The regulations require any foreign person who makes a return to provide a TIN on the return. This TIN may be an employer identification number, a social security number, or a new IRS individual taxpayer identification number in the case of an alien individual who does not have a social security number and cannot obtain one.

The Treasury Department and the IRS are also considering changes to the procedures that apply to withholding tax on payments to foreign persons in order to encourage compliance and reduce paperwork burden. The Treasury Department and the IRS are aware that significant changes in this area will impact some aspects of transactions subject to withholding. Accordingly, the Treasury Department and the IRS intend to move very cautiously, particularly by considering the possible effect of changes in these procedures on investment decisions by foreign persons and by considering the adequacy of existing procedures for those taxpayers who wish to continue to comply with current rules. Generally, no new procedures will be adopted without adequate opportunity for public comment and appropriate transition periods before taking effect. This will

not, however, preclude the Treasury Department and the IRS from adopting new procedures to replace the current address rule for dividends.

Specific Changes

The most significant changes proposed by these regulations are described below. The first change is the introduction of a new IRS-issued TIN for use by alien individuals who currently do not have, and are not eligible to obtain, social security numbers. The number is called an IRS individual taxpayer identification number (ITIN). This number is intended to be issued to alien individuals, whether resident or nonresident, who are currently required to furnish a number for tax purposes but who are not entitled to obtain social security numbers. Therefore, these amendments are designed to help taxpayers maintain compliance with TIN requirements under the Code and regulations. The Social Security Administration limits its assignment of social security numbers to individuals who are U.S. citizens and alien individuals legally admitted to the United States for permanent residence or under other immigration categories which authorize U.S. employment. Therefore, IRS-issued numbers are necessary for those individuals who need a TIN but cannot qualify for a social security number.

The second change is to modify the existing rule set forth in § 301.6109-1(g) that currently excludes from the general requirement of providing a TIN, foreign persons that do not have either (1) income effectively connected with the conduct of a U.S. trade or business or (2) a U.S. office or place of business or a U.S. fiscal or paying agent. Under the proposed regulations, the exclusion is modified to require that any foreign person who makes a return of tax furnish its TIN on that return. This change is intended solely to address the IRS' and Treasury's concern that, without TINs, taxpayers cannot be identified and tax returns cannot be processed effectively.

The Treasury Department and the IRS are giving added thought to applying the TIN requirement to facilitate changes to the procedures that apply to withholding taxes on payments to foreign persons. Decisions with respect to the withholding tax system have yet to be made, and when made, will be proposed in subsequent regula-

tions. The Treasury Department and the IRS will proceed cautiously in expanding the scope of the TIN requirement and will consider the adequacy of existing procedures for those taxpayers who wish to continue to comply with current rules.

The IRS individual taxpayer identification numbers issued under this regulation will differ from, and replace, the "temporary" TINs the IRS currently issues under the authority of section 6109(c). For example, after declaring in Rev. Rul. 84-158, 1984-2 C.B. 262, that a partnership must request the social security numbers of its individual partners (including a nonresident alien limited partner), the IRS announced in Rev. Rul. 85-61, 1985-1 C.B. 355, that it would issue temporary numbers to nonresident alien limited partners who do not have, and cannot obtain, social security numbers. All of these temporary numbers, however, will be retired upon subsequent revocation of these revenue rulings.

IRS individual taxpayer identification numbers are intended for tax use only. For example, the numbers will create no inference regarding the immigration status of a foreign person or the right of that person to be legally employed in the United States. The IRS individual taxpayer identification numbers and the information obtained by the IRS as a result of issuing numbers constitute confidential taxpayer information. Section 6103 strictly prohibits the disclosure of this information to other government agencies, private entities, or citizens. Disclosure in violation of the restrictions under section 6103 may lead to civil or criminal penalties.

Section-By-Section Analysis

Proposed § 301.6109-1(a)(1)(i) provides a general description of the types of TINs, including the new IRS individual taxpayer identification number. The IRS individual taxpayer identification number will begin with a specific number designated by the IRS and will otherwise resemble a social security number. Proposed § 301.6109-1(a)(1)(ii) provides general rules for use of the different TINs, including the rule for an estate to obtain and furnish its employer identification number when required, such as in its capacity as a payor or payee of royalties. This rule for estates was announced previously in the proposed regulations under section 6109 published in the

Federal Register at 55 FR 39486 on September 27, 1990.

The requirement for foreign persons to provide a TIN if they have income effectively connected with the conduct of a U.S. trade or business, if they have a U.S. office or place of business, or a U.S. fiscal or paying agent during the taxable year, or if they are treated as resident alien individuals under section 6013(g) or (h), is restated without change in proposed §§ 301.6109-1(b)(2) and (c). However, proposed § 301.6109-1(b)(2)(iv) modifies the exclusion currently provided in § 301.6109-1(g) with respect to other foreign persons by providing that a foreign person filing a return of tax is subject to the TIN requirements under section 6109. For this purpose, a return of tax includes income, estate, and gift tax returns but excludes information returns, statements or other documents. This requirement is proposed to be effective for foreign persons who file returns of tax after December 31, 1995.

The provisions of § 301.6109-1(d)(2) dealing with obtaining an employer identification number are unchanged except to specify that a Form SS-4 will be available from U.S. consular offices abroad. This change is intended to accommodate those foreign persons that are required to provide an employer identification number.

The procedures governing the new IRS individual taxpayer identification number, including procedures for obtaining such a number, are set forth in proposed § 301.6109-1(d)(3). An IRS individual taxpayer identification number is applied for on Form W-7, Application for IRS Individual Taxpayer Identification Number. Under normal procedures, the application is submitted to the IRS for processing together with required documentation designed to substantiate foreign status, as well as true identity. Further guidance will be issued to specify the types of acceptable documentation. Because the IRS intends to rely as much as possible on the identifying documents that are customarily used in a foreign jurisdiction to identify a resident in that jurisdiction, the documentation requirements are likely to vary from country to country. Comments and suggestions are solicited regarding the type of documents that could be used reliably to establish the identity of taxpayers and their foreign status.

The IRS is planning a wide distribution of application forms in the United

States and abroad and will insure that the form is easily available to the public. Further, in order to facilitate the application process and to expedite the issuance of the TINs, the regulations propose to authorize agreements that would permit certain persons to act as an applicant's agent. These agents are called acceptance agents. Generally, an acceptance agent may include financial institutions or educational institutions, *i.e.*, institutions that are likely to come in contact with a large number of foreign taxpayers earning U.S. source income and that can establish to the IRS that they have the resources and procedures necessary to undertake the duties expected from an acceptance agent.

Under an agreement with the IRS, an acceptance agent would assume responsibility for providing the necessary information to the IRS for the issuance of a number, together with a certification that the applicant is a foreign person. The certification would be issued on the basis of prescribed documentation obtained from the applicant. Under this procedure, no documentation generally would be required to be furnished to the IRS, except as part of a verification process by which the IRS may periodically verify the agent's compliance with the agreement. In order to streamline the process and facilitate the agent's due diligence under the agreement, the agreement would specify the type of documentation that must be obtained to verify foreign status and true identity of an applicant.

Proposed § 301.6109-1(d)(4) provides rules for the coordination of the different TINs. A person entitled to a social security number will not be issued an IRS individual taxpayer identification number. Once a person has a social security number, that number must be used for all tax purposes, even though the person is a nonresident alien. A nonresident alien who is issued an IRS individual taxpayer identification number and later becomes entitled to a social security number (*e.g.*, becomes a U.S. resident under an immigration visa) must apply for a social security number and must stop using the IRS number. IRS matching systems will help the IRS detect taxpayers who are incorrectly using an IRS individual taxpayer identification number. The IRS will contact those individuals and request that they obtain a social security number.

Section 301.6109-1(f) is modified to cross reference the new penalty provisions under sections 7621 through 6724.

Proposed § 301.6109-1(g)(1) provides the general rule that, in the IRS records, a person with a social security number or an employer identification number will normally be identified as a U.S. person. Regulations to be issued at a later time may make it important for a person to be identified correctly in the IRS records as a U.S. or a foreign person. Accordingly, these proposed regulations provide that the foreign person with a social security number or an employer identification number may establish foreign status with the IRS. Any foreign person that holds an employer identification number issued prior to the effective date of this proposed regulation may continue to use its employer identification number for tax purposes. However, when requested by the IRS, such persons must apply for a new employer identification number that is exclusively dedicated to foreign persons. Proposed § 301.6109-1(g)(1) also provides that an IRS individual taxpayer identification number is considered by the IRS to belong to a nonresident alien individual if the foreign status of the individual is established upon initial application for the number. If foreign status is not established, the IRS will generally require the individual to apply for a social security number. In rare cases when a resident alien individual is not eligible for a social security number, the taxpayer will be entitled to use an IRS individual taxpayer identification number, and the IRS will note in its records that the number belongs to a U.S. person.

No re-filings are required in order to maintain foreign status described in proposed § 301.6109-1(g)(1). However, proposed § 301.6109-1(g)(2) provides that if circumstances change (for example, a taxpayer becomes a U.S. resident), then the taxpayer must notify the IRS to record the change of status. The IRS will issue guidance on procedures for notifying the IRS of a person's status or changes thereof.

Proposed § 301.6109-1(g)(3) concerns disclosure provisions. In order to make the acceptance agent's procedures possible, it is necessary that taxpayers requesting a TIN through an acceptance agent authorize the disclosure of taxpayer information to the extent necessary to allow communications between

the IRS and the acceptance agent in the course of the issuance and administration of the number. Accordingly, the application form will include a waiver of the prohibition against disclosure of taxpayer information in order to permit the IRS to communicate with an acceptance agent regarding matters related to the assignment of a TIN.

Proposed Effective Date

These regulations would apply to returns, statements, or documents filed after December 31, 1995, except the provision relating to the requirement for an estate to obtain an employer identification number applies on and after January 1, 1984. Thus, these regulations would apply to foreign persons described in proposed § 301.6109-1(b)(2)(iv) who file a return of tax after December 31, 1995.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight (8) copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for 10 a.m. on September 28, 1995. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic by September 7, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Withdrawal of Proposed Regulations

The previously proposed regulations under § 301.6109-1, as published in the **Federal Register** on September 27, 1990, at 55 FR 39486, are hereby withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding an entry in numerical order to read in part as follows:

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

Section 301.6109-1 also issued under 26 U.S.C. 6109(a), (c), and (d). * * *

Par. 2. Section § 301.6109-1 is amended as follows:

1. Paragraphs (a)(1), (b), (c), and (d)(2) are revised.

2. Paragraphs (d)(3) and (4) are added.

3. Paragraphs (f), (g), and (h) are revised.

The revisions and additions read as follows:

§ 301.6109-1 Identifying numbers.

(a) *In general*—(1) *Taxpayer identifying numbers*—(i) *Types*. There are generally three types of taxpayer identifying numbers: social security numbers, Internal Revenue Service (IRS) individual taxpayer identification numbers, and employer identification numbers. Social security numbers take the form

000-00-0000, IRS individual taxpayer identification numbers take the form 000-00-0000 but begin with a specific number designated by the IRS, and employer identification numbers take the form 00-0000000. Both social security numbers and IRS individual taxpayer identification numbers identify individual persons. For the definition of social security number and employer identification number, see §§ 301.7701-11 and 301.7701-12, respectively. For the definition of IRS individual taxpayer identification number, see paragraph (d)(3) of this section.

(ii) *Uses.* Except as otherwise provided in applicable regulations under this title or on a return, statement, or other document, and related instructions, taxpayer identifying numbers must be used as follows:

(A) Except as otherwise provided in paragraphs (a)(1)(ii)(B) and (D) of this section, an individual required to furnish a taxpayer identifying number must use a social security number.

(B) Except as otherwise provided in paragraph (a)(1)(ii)(D) of this section, an individual required to furnish a taxpayer identifying number but who is not eligible to obtain a social security number, must use an IRS individual taxpayer identification number.

(C) Any person other than an individual (such as corporations, partnerships, nonprofit associations, trusts, estates, and similar nonindividual persons) that is required to furnish a taxpayer identifying number must use an employer identification number.

(D) An individual, whether U.S. or foreign, who is an employer or who is engaged in trade or business as a sole proprietor should use an employer identification number as required by returns, statements, or other documents and their related instructions.

* * * * *

(b) *Requirement to furnish one's own number*—(1) *U.S. persons.* Every U.S. person who makes under this title a return, statement, or other document must furnish its own taxpayer identifying number as required by the forms and the accompanying instructions. A U.S. person whose number must be included on a document filed by another person must give the taxpayer identifying number so required to the other person on request. For penalties

for failure to supply taxpayer identifying numbers, see sections 6721 through 6724. For provisions dealing specifically with the duty of employees with respect to their social security numbers, see § 31.6011(b)-2 (a) and (b) of this chapter (Employment Tax Regulations). For provisions dealing specifically with the duty of employers with respect to employer identification numbers, see § 31.6011(b)-1 of this chapter (Employment Tax Regulations).

(2) *Foreign persons.* The provisions of paragraph (b)(1) of this section regarding the furnishing of one's own number shall apply to the following foreign persons)

(i) A foreign person that has income effectively connected with the conduct of a U.S. trade or business at any time during the taxable year;

(ii) A foreign person that has a U.S. office or place of business or a U.S. fiscal or paying agent at any time during the taxable year;

(iii) A nonresident alien treated as a resident under section 6013(g) or (h); and

(iv) Any other foreign person who makes a return of tax under this title (including income, estate, and gift tax returns) but excluding information returns, statements, or documents.

(c) *Requirement to furnish another's number.* Every person required under this title to make a return, statement, or other document must furnish such taxpayer identifying numbers of other U.S. persons and foreign persons that are described in paragraph (b)(2)(i), (ii), or (iii) of this section as required by the forms and the accompanying instructions. If the person making the return, statement, or other document does not know the taxpayer identifying number of the other person, such person must request the other person's number. A request should state that the identifying number is required to be furnished under authority of law. When the person making the return, statement, or other document does not know the number of the other person, and has complied with the request provision of this paragraph, such person must sign an affidavit on the transmittal document forwarding such returns, statements, or other documents to the Internal Revenue Service, so stating. A person required to file a taxpayer identifying number shall correct any errors in such filing when such person's attention has been drawn to them.

(d) * * *

(2) *Employer identification number.* Any person required to furnish an employer identification number must apply for one, if not done so previously, on Form SS-4. A Form SS-4 may be obtained from any office of the Internal Revenue Service, U.S. consular office abroad, or from an acceptance agent described in paragraph (d)(3)(iv) of this section. The person must make such application in advance of the first required use of the employer identification number to permit issuance of the number in time for compliance with such requirement. The form, together with any supplementary statement, must be prepared and filed in accordance with the form, accompanying instructions, and relevant regulations, and must set forth fully and clearly the requested data.

(3) *IRS individual taxpayer identification number*—(i) *Definition.* The term *IRS individual taxpayer identification number* means a taxpayer identifying number issued to an alien individual by the Internal Revenue Service, upon application, for use in connection with filing requirements under this title. The term *IRS individual taxpayer identification number* does not refer to a social security number or an account number for use in employment for wages. For purposes of this section, the term *alien individual* means an individual who is not a citizen or national of the United States.

(ii) *General rule for obtaining number.* Any individual who is not eligible to obtain a social security number and is required to furnish a taxpayer identifying number must apply for an IRS individual taxpayer identification number on Form W-7, Application for IRS Individual Taxpayer Identification Number, or such other form as may be prescribed by the Internal Revenue Service. Form W-7 may be obtained from any office of the Internal Revenue Service, U.S. consular office abroad, or any acceptance agent described in paragraph (d)(3)(iv) of this section. The individual shall furnish the information required by the form and accompanying instructions, including the individual's name, address, foreign tax identification number (if any), and specific reason for obtaining an IRS individual taxpayer identification number. The individual must make such application in advance of the first required use of the IRS individual taxpayer identification number to permit issuance of the

number in time for compliance with such requirement. The application form, together with any supplementary statement and documentation, must be prepared and filed in accordance with the form, accompanying instructions, and relevant regulations, and must set forth fully and clearly the requested data.

(iii) *General rule for assigning number.* Under procedures issued by the Internal Revenue Service, an IRS individual taxpayer identification number will be assigned to an individual upon the basis of information reported on Form W-7 (or such other form as may be prescribed by the Internal Revenue Service) and any such accompanying documentation that may be required by the Internal Revenue Service. An applicant for an IRS individual taxpayer identification number must submit such documentary evidence as the Internal Revenue Service may prescribe in order to establish alien status and identity. Examples of acceptable documentary evidence for this purpose may include items such as an original (or a certified copy of the original) passport, driver's license, birth certificate, identity card, or U.S. visa.

(iv) *Acceptance agents—(A) Agreements with acceptance agents.* A person described in paragraph (d)(3)-(iv)(B) of this section will be accepted by the Internal Revenue Service to act as an acceptance agent for purposes of the regulations under this section upon entering into an agreement with the Internal Revenue Service, under which the acceptance agent will be authorized to act on behalf of taxpayer seeking to obtain a taxpayer identifying number from the Internal Revenue Service. The agreement must contain such terms and conditions as are necessary to insure proper administration of the process by which the Internal Revenue Service issues taxpayer identifying numbers to foreign persons, including proof of their identity and foreign status. In particular, the agreement may contain—

(1) Procedures for providing Form SS-4 and Form W-7, or such other necessary form to applicants for obtaining a taxpayer identifying number;

(2) Procedures for providing assistance to applicants in completing the application form or completing it for them;

(3) Procedures for collecting, reviewing, and maintaining, in the nor-

mal course of business, a record of the required documentation for assignment of a taxpayer identifying number;

(4) Procedures for submitting the application form and required documentation to the Internal Revenue Service, or if permitted under the agreement, submitting the application form together with a certification that the acceptance agent has reviewed the required documentation and that it has no actual knowledge or reason to know that the documentation is not complete or accurate;

(5) Procedures for assisting taxpayers with notification procedures described in paragraph (g)(2) of this section in the event of change of foreign status;

(6) Procedures for making all documentation or other records furnished by persons applying for a taxpayer identifying number promptly available for review by the Internal Revenue Service, upon request; and

(7) Provisions that the agreement may be terminated in the event of a material failure to comply with the agreement, including failure to exercise due diligence under the agreement.

(B) *Persons who may be acceptance agents.* An acceptance agent may include any financial institution as defined in section 265(b)(5) or § 1.165-12(c)(1)(v) of this chapter, any college or university that is an educational organization as defined in § 1.501(c)-3-1(d)(3)(i) of this chapter, any federal agency as defined in section 6402(f) or any other person or categories of persons that may be authorized by regulations or Internal Revenue Service procedures. A person described in this paragraph (d)(3)(iv)(B) that seeks to qualify as an acceptance agent must have an employer identification number for use in any communication with the Internal Revenue Service. In addition, it must establish to the satisfaction of the Internal Revenue Service that it has adequate resources and procedures in place to comply with the terms of the agreement described in paragraph (d)(3)(iv)(A) of this section.

(4) *Coordination of taxpayer identifying numbers—(i) Social security number.* Any individual who is duly assigned a social security number or who is entitled to a social security number will not be issued an IRS individual taxpayer identification number. The individual can use the social security number for all tax purposes

under this title, even though the individual is, or later becomes, a nonresident alien individual. Further, an individual who has an application pending with the Social Security Administration will be issued an IRS individual taxpayer identification number only after the Social Security Administration has notified the individual that a social security number cannot be issued. Any alien individual duly issued an IRS individual taxpayer identification number who later becomes a U.S. citizen, or an alien lawfully permitted to enter the United States either for permanent residence or under authority of law permitting U.S. employment, will be required to obtain a social security number. Any individual who has an IRS individual taxpayer identification number and a social security number, due to the circumstances described in the preceding sentence, must notify the Internal Revenue Service of the acquisition of the social security number and must use the newly-issued social security number as the taxpayer identifying number on all future returns, statements, or other documents filed under this title.

(ii) *Employer identification number.* Any individual with both a social security number (or an IRS individual taxpayer identification number) and an employer identification number may use the social security number (or the IRS individual taxpayer identification number) for individual taxes, and the employer identification number for business taxes as required by returns, statements, and other documents and their related instructions. Any alien individual duly assigned an IRS individual taxpayer identification number who also is required to obtain an employer identification number must furnish the previously-assigned IRS individual taxpayer identification number to the Internal Revenue Service on Form SS-4 at the time of application for the employer identification number. Similarly, where an alien individual has an employer tax identification number and is required to obtain an IRS individual taxpayer identification number, the individual must furnish the previously-assigned employer identification number to the Internal Revenue Service on Form W-7, or such other form as may be prescribed by the Internal Revenue Service, at the time of application for the IRS individual taxpayer identification number.

(f) *Penalty.* For penalties for failure to supply taxpayer identifying numbers, see sections 6721 through 6724.

(g) *Special rules for taxpayer identifying numbers issued to foreign persons*—(1) *General rule*—(i) *Social security number.* A social security number is generally identified in the records and database of the Internal Revenue Service as a number belonging to a U.S. citizen or resident alien individual. A person may establish a different status for the number by providing proof of foreign status with the Internal Revenue Service under such procedures as the Internal Revenue Service shall prescribe, including the use of a form as the Internal Revenue Service may specify. Upon accepting an individual as a nonresident alien individual, the Internal Revenue Service will assign this status to the individual's social security number.

(ii) *Employer identification number.* An employer identification number is generally identified in the records and database of the Internal Revenue Service as a number belonging to a U.S. person. However, the Internal Revenue Service may establish a separate class of employer identification numbers solely dedicated to foreign persons which will be identified as such in the records and database of the Internal Revenue Service. A person may establish a different status for the number either at the time of application or subsequently by providing proof of U.S. or foreign status with the Internal Revenue Service under such procedures as the Internal Revenue Service shall prescribe, including the use of a form as the Internal Revenue Service may specify. The Internal Revenue Service may require a person to apply for the type of employer identification number that reflects the status of that person as a U.S. or foreign person.

(iii) *IRS individual taxpayer identification number.* An IRS individual taxpayer identification number is generally identified in the records and database of the Internal Revenue Service as a number belonging to a nonresident alien individual. If the Internal Revenue Service determines at the time of application or subsequently, that an individual is not a nonresident alien individual, the Internal Revenue Service may require that the individual

apply for a social security number. If a social security number is not available, the Internal Revenue Service may accept that the individual use an IRS individual taxpayer identification number, which the Internal Revenue Service will identify as a number belonging to a U.S. resident alien.

(2) *Change of foreign status.* Once a taxpayer identifying number is identified in the records and database of the Internal Revenue Service as a number belonging to a U.S. or foreign person, the status of the number is permanent until the circumstances of the taxpayer change. A taxpayer whose status changes (for example, a nonresident alien individual with a social security number becomes a U.S. resident alien) must notify the Internal Revenue Service of the change of status under such procedures as the Internal Revenue Service shall prescribe, including the use of a form as the Internal Revenue Service may specify.

(3) *Waiver of prohibition to disclose taxpayer information when acceptance agent acts.* As part of its request for an IRS individual taxpayer identification number or submission of proof of foreign status with respect to any taxpayer identifying number, where the foreign person acts through an acceptance agent, the foreign person will agree to waive the limitations in section 6103 regarding the disclosure of certain taxpayer information. However, the waiver will apply only for purposes of permitting the Internal Revenue Service and the acceptance agent to communicate with each other regarding matters related to the assignment of a taxpayer identifying number and change of foreign status.

(h) *Effective date.* The provisions of this section generally are effective for any return, statement, or other document to be filed after December 31, 1995. However, the provision of paragraph (a)(1)(ii) of this section that requires an estate to obtain an employer identification number applies on and after January 1, 1984.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 7, 1995, 8:45 a.m., and published in the issue of the Federal Register for June 8, 1995, 60 F.R. 30211)

Notice of Proposed Rulemaking

Definitions Under Subchapter S of the Internal Revenue Code

PS-268-82

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations for S corporations and their shareholders relating to the definitions and the special rule provided in section 1377 of the Internal Revenue Code of 1986. The proposed regulations reflect changes to the law made by the Subchapter S Revision Act of 1982. The proposed regulations are necessary to provide guidance needed by taxpayers to comply with the law.

DATES: Written comments and requests for a public hearing must be received by October 10, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-268-82), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS-268-82), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

A collection of information is required under §1.1377-1(b). This infor-

mation is required by the IRS to verify the event giving rise to the making of an election under section 1377(a)(2) by an S corporation. The likely respondents and/or recordkeepers will be S corporations and shareholders of S corporations.

Estimated total annual reporting burden: 1,000 hours.

The estimated annual burden per respondent varies from .2 hour to .5 hour, depending on individual circumstances, with an estimated average of .25 hour.

Estimated number of respondents: 4,000.

Estimated annual frequency of responses: 1.

Background

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 1377 of the Internal Revenue Code (Code). Section 18.1377-1 was issued by TD 7872 [1983-1 C.B. 193] (48 FR 3590). The proposed regulations would conform the regulations to the addition of section 1377 to the Code by section 2 of the Subchapter S Revision Act of 1982, Pub. L. 97-354 (1982-2 C.B. 702, 710).

Explanation of Provisions

Shareholder's pro rata share of items of income, loss, deduction, and credit

Section 1366(a)(1) requires a shareholder of an S corporation to take into account the shareholder's pro rata share of the corporation's items of income, loss, deduction, and credit. The proposed regulations provide that, except in the case of an election under section 1377(a)(2), each shareholder's pro rata share of an item for a taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation's taxable year, and then dividing that portion pro rata among the shares outstanding on that day.

The proposed regulations contain several special rules for determining a shareholder's pro rata share. First, solely for purposes of determining a shareholder's pro rata share of an item, an S corporation's taxable year does not include any day on which the corporation has no shareholders. This

rule ensures that the full amount of all items of the S corporation will be allocated to the corporation's shareholders. Second, a shareholder who disposes of stock of an S corporation is treated as the shareholder for the day of the disposition. Finally, a shareholder who dies is treated as the shareholder for the day of the shareholder's death.

Election to treat taxable year as separate taxable years

Under section 1377(a)(2), if a shareholder's interest in an S corporation is terminated during the taxable year and all persons who are shareholders during the taxable year agree, the corporation may elect (terminating election) to apply section 1377(a)(1) as if the taxable year of the S corporation consisted of two taxable years, the first of which ends on the date of the termination. The proposed regulations provide rules concerning the time and manner of making a terminating election and, therefore, it is proposed that §18.1377-1 (which provides temporary rules concerning the time and manner of making a terminating election) be removed. The proposed regulations also provide that the terminating election is irrevocable and is effective only for the terminating event for which it is made.

The proposed regulations clarify that a terminating election may be made only if a shareholder's entire interest as a shareholder in the S corporation is terminated. A shareholder's entire interest as a shareholder is terminated under the proposed regulations on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all of the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated under the proposed regulations if the shareholder retains ownership of any stock that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a share-

holder's entire interest in an S corporation has been terminated, any options held by the shareholder (other than options that are treated as stock under §1.1361-1(l)(4)(iii)) and any interest in the S corporation held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity are disregarded.

The proposed regulations also describe the effects of a terminating election. Under the proposed regulations, an S corporation that makes a terminating election must treat its taxable year as two separate taxable years for purposes of computing and allocating to each shareholder items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account (AAA), earnings and profits, and basis; and determining the tax effect of a distribution to the shareholders. This treatment is required to give full effect to treating the taxable year as two separate taxable years. The proposed regulations also require the S corporation to assign items of income, loss, deduction, and credit to each deemed separate taxable year using the corporation's normal method of accounting as determined under section 446(a). The proposed regulations provide that a terminating election does not affect the due date of the S corporation's tax return for the taxable year or the time when the shareholders must include their pro rata allocations of items from the S corporation. The proposed regulations also provide that a terminating election by an S corporation that is a partner in a partnership is treated as a sale or exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (closing of the partnership's taxable year) if the taxable year of the partnership ends after the shareholder's interest is terminated and within the full taxable year of the S corporation for which the terminating election is made. This rule conforms terminating elections with the rule for S termination years. See §1.1362-3(c)(1).

The proposed regulations coordinate the application of the terminating election under section 1377(a)(2) with the election under section 1362(e)(3) (election to have items assigned to each short taxable year of an S termination year under normal accounting rules rather than pro rata) and the election under §1.1368-1(g)(2) (election to ter-

minate the taxable year when there is a qualifying disposition). Under the proposed regulations, if a transfer results in a termination of the shareholder's entire interest as a shareholder and the transfer also constitutes a qualifying disposition under §1.1368-1(g)(2)(i), the terminating election rules under these proposed regulations take precedence and a qualifying disposition election cannot be made. If a termination of a shareholder's entire interest results in a termination under section 1362(d)(2) of the corporation's election to be an S corporation, however, the proposed regulations provide that the corporation may not make a terminating election. When a corporation's election to be an S corporation terminates, the portion of the corporation's taxable year ending at the close of the day preceding the day for which the terminating event is effective is treated as an S short year, and the remainder is treated as a C short year. Thus, because the day upon which a terminating event occurs is the first day of a C short year, as of that date there is no S corporation taxable year that may be divided into two separate years under section 1377(a)(2). Under section 1362(e)(2), the income or loss for the entire S termination year is allocated on a pro rata basis between the S and C short years. However, if the corporation makes an election under section 1362(e)(3), the corporation allocates income and loss to each short taxable year under the corporation's normal tax accounting rules. Thus, when a corporation makes an election under section 1362(e)(3), a shareholder of an S corporation may achieve a result similar to the result of an election under section 1377(a)(2) and these proposed regulations (which also require an allocation of income and loss to each short taxable year under normal accounting rules).

Post-termination transition period

Section 1377(b) provides that the term *post-termination transition period* (PTTP) for purposes of subchapter S of chapter 1 of the Code means: (1) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of the day which is 1 year after such last day, or the due date for filing the return for the last taxable year as an S corporation (including extensions); and (2) the 120-

day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year. The PTTP is relevant for purposes of section 1366(d)(3) (carryover of disallowed losses after the last taxable year for which a corporation is an S corporation) and section 1371(e) (distributions of money by a corporation with respect to its stock after termination of S corporation status).

The proposed regulations clarify that a PTTP arises following the termination under section 1362(d) of a corporation's S election. For example, a PTTP arises in the case of a C corporation that acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies. However, if an S corporation acquires the assets of another S corporation in a transaction to which section 381(a)(2) applies, a PTTP does not arise. Instead, under §1.1368-2(d)(2), the acquiring S corporation succeeds to and merges its AAA with the AAA of the distributor or transferor S corporation.

The proposed regulations clarify that the last day of a corporation's last taxable year as an S corporation is the last day of the short S taxable year under section 1362(e)(1)(A) or the date of transfer in the event that a C corporation acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies. The proposed regulations also provide that the special treatment under section 1371(e)(1) is available only to those shareholders who were shareholders in the S corporation at the time of the termination.

The proposed regulations provide additional guidance on the definition of a determination for purposes of ascertaining when a PTTP begins under section 1377(b)(1)(B). Under the proposed regulations, a determination includes a written agreement between an S corporation and the Commissioner that the corporation failed to qualify as an S corporation. The agreement must be signed by the appropriate district director and an authorized officer of the corporation. In addition, if there is no written agreement, a determination results from the expiration of the period specified in section 6226 for filing a petition for readjustment of a final S corporation administrative adjustment finding that the corporation failed to qualify as an S corporation, provided that no petition is filed prior to the expiration of the period. For corpora-

tions not subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A (dealing with the tax treatment of partnership items) a determination results from the expiration of the period for filing a petition under section 6213 for the shareholder's taxable year for which the Commissioner has made a finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period.

Effective date

The regulations under section 1377 are proposed to apply to taxable years of an S corporation beginning after the date of publication as final regulations in the Federal Register.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Parts 1 and 18

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 18 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1377-1 also issued under 26 U.S.C. 1377(a)(2) and (c).

Par. 2. Sections 1.1377-0, 1.1377-1, 1.1377-2, and 1.1377-3 are added under the heading “Small Business Corporations and Their Shareholders” to read as follows:

§1.1377-0 Table of contents.

The following table of contents is provided to facilitate the use of §§1.1377-1 through 1.1377-3:

§1.1377-1 Pro rata share.

- (a) Computation of pro rata shares.
 - (1) In general.
 - (2) Special rules.
 - (i) Days without shareholders.
 - (ii) Determining shareholder for day of stock disposition.
 - (b) Election to terminate year.
 - (1) In general.
 - (2) Effect of the terminating election.
 - (i) In general.
 - (ii) Due date of S corporation return.
 - (iii) Taxable year of inclusion by shareholder.
 - (iv) S Corporation that is a partner in a partnership.
 - (3) Determination of whether an S shareholder’s entire interest has terminated.
 - (4) Time and manner of making terminating election.
 - (i) In general.
 - (ii) Shareholders required to consent.
 - (iii) More than one terminating election.
 - (c) Examples.

§1.1377-2 Post-termination transition period.

- (a) In general.

(b) When a post-termination transition period arises.

- (c) Last day of last taxable year.
- (d) Determination defined.
- (e) Time of determination.
 - (1) Court decision.
 - (2) Closing agreement.
 - (3) Written agreement.
 - (4) Implied agreement.

§1.1377-3 Effective date.

§1.1377-1 Pro rata share.

(a) *Computation of pro rata shares—(1) In general.* For purposes of subchapter S of chapter 1 of the Code and this section, each shareholder’s pro rata share of any S corporation item described in section 1366(a) for any taxable year is the sum of the amounts determined with respect to the shareholder by assigning an equal portion of the item to each day of the S corporation’s taxable year, and then dividing that portion pro rata among the shares outstanding on that day. See paragraph (b) of this section for rules pertaining to the computation of each shareholder’s pro rata share when an election is made under section 1377(a)(2) to treat the taxable year of an S corporation as if it consisted of two taxable years in the case of a termination of a shareholder’s entire interest in the corporation.

(2) *Special rules—(i) Days without shareholders.* Solely for purposes of determining a shareholder’s pro rata share of an item for a taxable year under section 1377(a) and this section, an S corporation’s taxable year does not include any day on which the corporation has no shareholders.

(ii) *Determining shareholder for day of stock disposition.* A shareholder who disposes of stock in an S corporation is treated as the shareholder for the day of the disposition. A shareholder who dies is treated as the shareholder for the day of the shareholder’s death.

(b) *Election to terminate year—(1) In general.* If a shareholder’s entire interest in an S corporation is terminated during the S corporation’s taxable year and all persons who are shareholders during the taxable year agree (as prescribed in paragraph (b)(4) of this section), the S corporation may elect under section 1377(a)(2) and this paragraph (b) (terminating election) to treat its taxable year as if it consisted

of two separate taxable years, the first of which ends at the close of the day on which the shareholder’s entire interest in the S corporation is terminated. If the event resulting in the termination of the shareholder’s entire interest also constitutes a qualifying disposition as described in §1.1368-1(g)(2), the election under §1.1368-1(g)(2) cannot be made. An S corporation may not make a terminating election if the cessation of a shareholder’s interest occurs in a transaction which results in a termination under section 1362(d)(2) of the corporation’s election to be an S corporation. (See section 1362(e)(3) for an election to have items assigned to each short taxable year under normal tax accounting rules in the case of a termination of a corporation’s election to be an S corporation.) A terminating election is irrevocable and is effective only for the terminating event for which it is made.

(2) *Effect of the terminating election—(i) In general.* An S corporation that makes a terminating election for a taxable year must treat the taxable year as separate taxable years for purposes of allocating items of income (including tax-exempt income), loss, deduction, and credit; making adjustments to the accumulated adjustments account, earnings and profits, and basis; and determining the tax effect of a distribution to the shareholders. An S corporation that makes a terminating election must assign items of income (including tax-exempt income), loss, deduction, and credit to each deemed separate taxable year using its normal method of accounting as determined under section 446(a).

(ii) *Due date of S corporation return.* A terminating election does not affect the due date of the S corporation’s return required to be filed under section 6037(a) for a taxable year (determined without regard to a terminating election).

(iii) *Taxable year of inclusion by shareholder.* A terminating election does not affect the taxable year in which a shareholder (including any shareholder whose entire interest in the corporation has terminated during the corporation’s taxable year) must take into account the shareholder’s pro rata share of the S corporation’s items of income, loss, deduction, and credit.

(iv) *S corporation that is a partner in a partnership.* A terminating election by an S corporation that is a partner in a partnership is treated as a sale or

exchange of the corporation's entire interest in the partnership for purposes of section 706(c) (relating to closing the partnership taxable year), if the taxable year of the partnership ends after the shareholder's interest is terminated and within the taxable year of the S corporation (determined without regard to any terminating election) for which the terminating election is made.

(3) *Determination of whether an S shareholder's entire interest has terminated.* For purposes of section 1377(a)(2) and paragraph (b) of this section, a shareholder's entire interest in an S corporation is terminated on the occurrence of any event through which a shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift under section 102(a) of all the shareholder's stock; a spousal transfer under section 1041(a) of all the shareholder's stock; a redemption, as defined in section 317(b), of all the shareholder's stock, regardless of the tax treatment of the redemption under section 302; and the death of the shareholder. A shareholder's entire interest in an S corporation is not terminated if the shareholder retains ownership of any stock that would result in the shareholder continuing to be considered a shareholder of the corporation for purposes of section 1362(a)(2). Thus, in determining whether a shareholder's entire interest in an S corporation has been terminated, any options held by the shareholder (other than options that are treated as stock under §1.1361-1(l)(4)(iii)) and any interest held by the shareholder as a creditor, employee, director, or in any other non-shareholder capacity are disregarded. (See §1.1361-1(l)(4)(iii) for circumstances under which an option is treated as stock of the corporation and, therefore, the holder of the option is treated as owning a stock interest in the corporation.)

(4) *Time and manner of making terminating election*—(i) *In general.* An S corporation makes a terminating election by attaching a statement to its timely filed original or amended return required to be filed under section 6037(a) (that is, a Form 1120S) for the taxable year during which a shareholder's entire interest is terminated. A single election statement may be filed by the S corporation for all terminating elections for the taxable year. The election statement must include—

(A) A declaration by the S corporation that it is electing under section 1377(a)(2) and §1.1377-1(b) to treat the taxable year as if it consisted of two separate taxable years;

(B) Information setting forth when and how the shareholder's entire interest was terminated (for example, a sale or gift);

(C) The signature on behalf of the S corporation of an authorized officer of the corporation under penalties of perjury; and

(D) A notice of consent, signed by each person who is a shareholder in the S corporation during the taxable year (determined without regard to the terminating election), including any shareholder whose entire interest terminates during the taxable year, in which each shareholder consents to the S corporation making the terminating election.

(ii) *Shareholders required to consent.* For purposes of paragraph (b)(4)(i)(D) of this section, a shareholder of the S corporation for the taxable year is a shareholder as described in section 1362(a)(2). For example, the person who under §1.1362-6(b)(2) must consent to a corporation's S election in certain special cases is the person who must consent to the terminating election. In addition, an executor or administrator of an estate of a deceased shareholder may consent to the terminating election on behalf of the deceased shareholder.

(iii) *More than one terminating election.* A shareholder whose entire interest in an S corporation is terminated in an event for which a terminating election was made is not required to consent to a terminating election made with respect to a subsequent termination within the same taxable year of the entire interest of another shareholder.

(c) *Examples.* The following examples illustrate the provisions of this section.

Example 1. General rule. (i) On January 2, 1997, X, a calendar year corporation, is incorporated. On January 4, 1997, X acquires assets. On January 6, 1997, X issues 100 shares of common stock to each of A and B and files an election to be an S corporation effective for its 1997 taxable year. During its 1997 taxable year, X has nonseparately computed income (as defined in section 1366(a)(2)) of \$720,000.

(ii) Each shareholder's pro rata share of X's nonseparately computed income for 1997 is determined by assigning an equal portion of the income to each day of X's taxable year on which X had shareholders. In the present case, there are only 360 days on which X had shareholders because X had no shareholders until January 6,

1997. Thus, \$2,000 of nonseparately computed income is assigned to each day that X had shareholders ($\$720,000/360 \text{ days} = \$2,000 \text{ per day}$). The amount assigned to each day is multiplied by the percentage of shares held by the shareholder on that day. Because A and B each owned 50 percent of the shares of stock outstanding on each day that X had shareholders, each shareholder's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$2,000 \text{ per day} \times 50\%$). Finally, the amounts of each shareholder's daily pro rata shares are aggregated to produce the shareholder's pro rata share of X's nonseparately computed income for 1997. During 1997, A and B each held X stock for 360 days. Thus, each shareholder's pro rata share of X's nonseparately computed income for 1997 is \$360,000 ($\$1,000 \text{ per day} \times 360 \text{ days}$).

Example 2. Shareholder's pro rata share in the case of a partial disposition of stock. (i) X, a newly incorporated calendar year corporation, issues 100 shares of common stock on January 6, 1997, to each of A and B and files an election to be an S corporation for its 1997 taxable year. On July 24, 1997, B sells 50 shares of X stock to C. Thus, in 1997, A owned 50 percent of the outstanding shares of X on each day of X's 1997 taxable year on which X had shareholders, B owned 50 percent on each day from January 6, 1997, to July 24, 1997 (200 days), and 25 percent from July 25, 1997, to December 31, 1997 (160 days), and C owned 25 percent from July 25, 1997, to December 31, 1997 (160 days).

(ii) Because B's entire interest in X is not terminated when B sells 50 shares to C on July 24, 1997, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section for B's sale of 50 shares to C. Although B's sale of 50 shares to C is a qualifying disposition under §1.1368-1(g)(2)(i), X does not make an election to terminate its taxable year under §1.1368-1(g)(2). During its 1997 taxable year, X has nonseparately computed income of \$720,000.

(iii) For each day in X's 1997 taxable year, A's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$720,000/360 \text{ days} \times 50\%$). Thus, A's pro rata share of X's nonseparately computed income for 1997 is \$360,000 ($\$1,000 \times 360 \text{ days}$). B's daily pro rata share of X's nonseparately computed income is \$1,000 ($\$720,000/360 \times 50\%$) for the first 200 days of X's taxable year on which X has shareholders, and \$500 ($\$720,000/360 \times 25\%$) for the following 160 days in 1997. Thus, B's pro rata share of X's nonseparately computed income for 1997 is \$280,000 ($(\$1,000 \times 200 \text{ days}) + (\$500 \times 160 \text{ days})$). C's daily pro rata share of X's nonseparately computed income is \$500 ($\$720,000/360 \times 25\%$) for 160 days in 1997. Thus, C's pro rata share of X's nonseparately computed income for 1997 is \$80,000 ($\$500 \times 160 \text{ days}$).

Example 3. Shareholder's pro rata share when an S corporation makes a terminating election under section 1377(a)(2). (i) On January 6, 1997, X, a newly incorporated calendar year corporation, issues 100 shares of common stock to each of A and B and files an election to be treated as an S corporation for its 1997 taxable year. On July 24, 1997, B sells B's entire 100 shares of X corporation stock to C. During its 1997 taxable year, X has nonseparately computed income of \$720,000. X makes an election under section 1377(a)(2) and paragraph (b) of this section for the termination of B's entire interest arising from B's sale of 100 shares to C. As a result of the election, each shareholder's pro rata share is

determined as if X's taxable year consisted of two separate taxable years, the first of which ends on July 24, 1997, the date B's entire interest in X terminates.

(ii) Under X's normal method of accounting, \$200,000 of the \$720,000 of nonseparately computed income is allocable to the period of January 6, 1997, through July 24, 1997 (the first deemed taxable year), and the remaining \$520,000 is allocable to the period of July 25, 1997, through December 31, 1997 (the second deemed taxable year).

(iii) The pro rata share of the \$200,000 of nonseparately computed income for each of A and B for the first deemed taxable year is determined by assigning the \$200,000 of nonseparately computed income to each day of the first deemed taxable year ($\$200,000/200 \text{ days} = \$1,000 \text{ per day}$). Thus, for each day of the first deemed taxable year, \$1,000 is allocated between A and B based on their proportionate stock ownership. Because A and B each held 50% of X's authorized and issued shares on each day of the first deemed taxable year, the daily pro rata share for each of A and B for each day of the first deemed taxable year is \$500 ($\$1,000 \text{ per day} \times 50\%$). Thus, each shareholder's pro rata share of the \$200,000 of nonseparately computed income for the first deemed taxable year is \$100,000 ($\$500 \text{ per day} \times 200 \text{ days}$). A and B must report these amounts for their respective taxable years with or within which X's full taxable year ends (December 31, 1997).

(iv) The pro rata share of the \$520,000 of nonseparately computed income for each of A and C for the second deemed taxable year is determined by assigning the \$520,000 of nonseparately computed income to each day of the second deemed taxable year ($\$520,000/160 \text{ days} = \$3,250 \text{ per day}$). Thus, for each day of the second deemed taxable year, \$3,250 is allocated between A and C based on their proportionate ownership. Because A and C each held 50% of X's authorized and issued shares on each day of the second deemed taxable year, the daily pro rata shares for each of A and C for each day of the second deemed taxable year is \$1,625 ($\$3,250 \text{ per day} \times 50\%$). Therefore, each shareholder's pro rata share of the \$520,000 nonseparately computed income is \$260,000 ($\$1,625 \text{ per day} \times 160 \text{ days}$). A and C must report these amounts for their respective taxable years with or within which X's full taxable year ends (December 31, 1997).

Example 4. Interaction between the termination election under section 1377(a)(2) and section 1362(e). (i) On January 1, 1997, X, a calendar year S corporation, has two shareholders, A and B, owning 60 shares and 40 shares, respectively. On June 29, 1997, B sells B's 40 shares to C. On July 20, 1997, C sells C's 40 shares to P, a partnership, causing a termination under section 1362(d)(2) of X's election to be an S corporation. X makes an election under section 1377(a)(2) and paragraph (b) of this section with regard to the termination of B's entire interest on June 29, 1997. Because the termination on July 20, 1997, of C's entire interest results in a termination of X's election to be an S corporation, X cannot make a terminating election under section 1377(a)(2) and paragraph (b) of this section with regard to C's sale of 40 shares to P. However, X makes an election under section 1362(e)(3) to assign items to each short taxable year of the S termination year under X's normal method of accounting. X has nonseparately computed income of \$530,000 for its 1997 taxable year.

(ii) As a result of the election under section 1362(e)(3), the portion of X's taxable year ending at the close of the day prior to the termination of X's S corporation election (January 1, 1997, through July 19, 1997) is treated as a short taxable year for which X is an S corporation, and the portion of the year beginning on the day the termination is effective (July 20, 1997, through December 31, 1997) is treated as a short taxable year for which X is a C corporation. Under X's normal method of accounting, \$200,000 of the \$530,000 of X's taxable income is allocable to the S short year and the remaining \$330,000 is allocable to the C short year. Of the \$200,000 allocable to the S short year, \$90,000 is allocable to the first deemed taxable year (January 1, 1997, through June 29, 1997) (180 days), and \$110,000 is allocable to the second deemed taxable year (June 30, 1997, through July 19, 1997) (20 days) under X's normal method of accounting.

(iii) Each shareholder's pro rata share of X's income for the first deemed taxable year within the S short year is determined as follows. Because A owns 60% of the stock outstanding during the first deemed taxable year, A's pro rata share for that period is \$54,000 ($\$90,000/180 \text{ days in the period} \times 60\% \times 180 \text{ days}$). B's pro rata share for that period, reflecting B's 40% ownership, is \$36,000 ($\$90,000/180 \text{ days in the period} \times 40\% \times 180 \text{ days}$). A and B must report these amounts for their respective taxable years with or within which the S termination year ends (December 31, 1997).

(iv) Each shareholder's pro rata share of X's income for the second deemed taxable year within the S short year is determined as follows. Because A owns 60% of the stock outstanding during the second deemed taxable year, A's pro rata share for that period is \$66,000 ($\$110,000/20 \text{ days in the period} \times 60\% \times 20 \text{ days}$). C's pro rata share for that period, reflecting C's 40% ownership, is \$44,000 ($\$110,000/20 \text{ days in the period} \times 40\% \times 20 \text{ days}$). A and C must report these amounts for their respective taxable years with or within which the S termination year ends (December 31, 1997).

§1.1377-2 Post-termination transition period.

(a) *In general.* For purposes of subchapter S of chapter 1 of the Code and this section, the term post-termination transition period means—

(1) The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of—

(i) The day which is 1 year after such last day; or

(ii) The due date for filing the return for the last taxable year as an S corporation (including extensions); and

(2) The 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year.

(b) *When a post-termination transition period arises.* A post-termination

transition period arises following the termination under section 1362(d) of a corporation's S election. For example, a post-termination transition period arises if a C corporation acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies. However, if an S corporation acquires the assets of another S corporation in a transaction to which section 381(a)(2) applies, a post-termination transition period does not arise. (See §1.1368-2(d)(2) for the treatment of the acquisition of the assets of an S corporation by another S corporation in a transaction to which section 381(a)(2) applies.) The special treatment under section 1371(e)(1) of distributions of money by a corporation with respect to its stock during the post-termination transition period is available only to those shareholders who were shareholders in the S corporation at the time of the termination.

(c) *Last day of last taxable year.* For purposes of section 1377(b)(1)(A) and paragraph (a)(1) of this section, the last day of a corporation's last taxable year as an S corporation is—

(1) The last day of the short S taxable year under section 1362(e)-(1)(A); or

(2) The date of transfer (within the meaning of section 381(a)(2)) in the event that a C corporation acquires the assets of an S corporation in a transaction to which section 381(a)(2) applies.

(d) *Determination defined.* For purposes of section 1377(b)(1)(B) and paragraph (a)(2) of this section, the term determination means—

(1) A court decision rendered by a court of competent jurisdiction;

(2) A closing agreement entered into between the Secretary and the taxpayer pursuant to section 7121;

(3) A written agreement between the corporation and the Commissioner (including a statement acknowledging that the corporation's election to be an S corporation terminated under section 1362(d)) that the corporation failed to qualify as an S corporation;

(4) For a corporation subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A, the expiration of the period specified in section 6226 for filing a petition for readjustment of a final S corporation administrative adjustment finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period; and

Margaret Milner Richardson,
Commissioner of
Internal Revenue

(Filed by the Office of the Federal Register on July 11, 1995, 8:45 a.m., and published in the issue of the Federal Register for July 12, 1995, 60 F.R. 35882)

Notice of Proposed Rulemaking

Diversification of Common Trust Funds

PS-29-92

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of Proposed Rulemaking.

SUMMARY: This document proposes regulations relating to the diversification of common trust funds at the time of a combination or division. The proposed regulations will affect common trust funds and their participants.

DATES: Written comments and requests for a public hearing must be received by November 8, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-29-92), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS-29-92), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 584 of the Internal Revenue Code of 1986 relating to common trust funds.

A common trust fund is an investment vehicle set up by a bank in the form of a state-law trust. The investors in a common trust fund, referred to as participants, are trusts and certain other accounts for which the bank acts as a fiduciary.

Section 584(b) provides that a common trust fund is not subject to

taxation. Instead, each participant that invests in the common trust fund includes its proportionate share of the common trust fund's income or loss on its own return.

Under section 584(e), the contribution of property to a common trust fund is a taxable event to the contributing participant. This provision was added to section 584(e) by the Tax Reform Act of 1976 and was intended to prevent participants from using a common trust fund to diversify their portfolios tax-free. Accordingly, the legislative history to the 1976 amendment indicates that mergers or divisions of common trust funds will continue to be tax-free as long as the combining or dividing funds have portfolios that are diversified within the meaning of the corporate merger rules. S. Rep. No. 938, pt. 2, 94th Cong., 2d Sess. 48 (1976), 1976-3 (Vol. 3) C.B. 643, 690. The diversification test for corporate mergers, section 368(a)(2)(F)(ii), was enacted in 1976 as part of the same legislation.

Section 1.584-4(a), promulgated in 1984 and based on the 1976 amendment, provides that the transfer of a participating interest as a result of the combination of two or more common trust funds, or the division of a single common trust fund, is not considered an admission or a withdrawal if the combining, dividing, and resulting funds have diversified portfolios within the meaning of section 368(a)(2)(F)(ii).

Under section 368(a)(2)(F)(ii), a corporation has a diversified portfolio if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of five or fewer issuers. For purposes of the section 368(a)(2)(F)(ii) test, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. Also, a person holding stock in a regulated investment company, real estate investment trust, or other investment company (as defined by section 368(a)(2)-(F)(iii)) that meets the requirements of section 368(a)(2)(F)(ii) shall be treated as holding its proportionate share of the assets held by the company. Section 368(a)(2)(F)(iv) provides that in determining total assets, certain assets shall be excluded, including cash and cash items (including receivables), Government securities, and assets acquired to

(5) For a corporation not subject to the audit and assessment provisions of subchapter C of chapter 63 of subtitle A, the expiration of the period for filing a petition under section 6213 for the shareholder's taxable year for which the Commissioner has made a finding that the corporation failed to qualify as an S corporation, provided that no petition was timely filed before the expiration of the period.

(e) *Time of determination*—(1) *Court decision*. A court decision becomes a determination on the date the decision becomes final under rules applicable to the court rendering the decision.

(2) *Closing agreement*. A closing agreement becomes a determination on the date of its approval by the Commissioner.

(3) *Written agreement*. A written agreement described in paragraph (d)(3) of this section becomes a determination when it is signed by the district director having jurisdiction over the corporation (or by another Service official to whom authority to sign the agreement is delegated) and by an officer of the corporation authorized to sign on its behalf. Neither the request for a written agreement nor the terms of the written agreement suspend the running of any statute of limitations.

(4) *Implied agreement*. A determination under paragraph (d)(4) or (d)(5) of this section becomes effective on the day after the date of expiration of the period specified under section 6226 or 6213, respectively.

§1.1377-3 Effective date.

Sections 1.1377-1 and 1.1377-2 apply to taxable years of an S corporation beginning after [the date of publication as final regulations in the Federal Register].

PART 18—TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Par. 3. The authority citation for part 18 continues to read as follows:

Authority: 26 U.S.C. 7805 sec. (6)-(c)(3)(B)(iii) of the Subchapter S Revision Act of 1982.

Section 18.1377-1 [Removed]

Par. 4. Section 18.1377-1 is removed.

meet section 368(a)(2)(F)(ii) or to cease to be an investment company. Section 368(a)(2)(F)(v) provides that section 368(a)(2)(F) shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions. Section 368(a)(2)(F)(vii) defines securities for purposes of clauses (ii) and (iii) of section 368(a)(2)(F).

Reasons for Change

Excluding Government securities from a common trust fund's total assets pursuant to section 368(a)(2)(F)(iv) could inappropriately cause a fund with investments in Government securities to fail to be diversified under section 368(a)(2)(F)(ii). For example, if 95 percent of a common trust fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, only five percent of the fund's total assets (that is, only the X stock) would be included in total assets in applying section 368(a)(2)(F)(ii). As a result, the X stock would be treated as constituting 100 percent of the common trust fund's assets and the fund would not satisfy the 25 and 50 percent test of section 368(a)(2)(F)(ii). Because excluding Government securities from a common trust fund's total assets could cause a fund with investments in Government securities to fail to be diversified under section 368(a)(2)(F)(ii), common trust funds might be discouraged from investing in Government securities.

Explanation of Provisions

Under the proposed amendment to §1.584-4(a), the diversification test applied to a common trust fund at the time of a merger or division will continue to be section 368(a)(2)(F)(ii). However, the test is modified so that Government securities are now counted in determining a fund's total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

For purposes of §1.584-4(a), relevant provisions of section 368(a)(2)(F) will apply to the section 368(a)(2)(F)(ii) test. Those provisions include the controlled group and look-through rules found in clause (ii) (members of a controlled group of corporations are considered as one issuer and persons holding stock in certain investment

companies are treated as holding a proportionate share of the investment company's assets), the common ownership rule found in clause (v) (diversification will not be considered to occur if the interests in the common trust funds transferred are held substantially by the same persons in the same proportions), and the definition of securities found in clause (vii) (the term securities includes investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36))). The definition of total assets in section 368(a)(2)(F)(iv) will apply, except that, as stated above, Government securities will be included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

The proposed regulations contain the same diversification test as that in the proposed regulations under section 351(e) dealing with transfers to investment companies. Thus, these proposed regulations would ensure that a uniform diversification test is applied to common trust funds and similar investment entities.

The proposed regulations also update the regulations under section 584 to conform to changes in the law.

Proposed Effective Date

These regulations are proposed to apply to combinations and divisions of common trust funds consummated on or after the date of publication as final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1, is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

§1.584-2 [Amended]

Par. 2. Section 1.584-2 is amended by:

1. Removing paragraph (b)(1).
2. Redesignating paragraph (b)(2) as paragraph (b).

Par. 3. Section 1.584-4 is amended by:

1. Removing paragraphs (a)(1) and (2).
2. Revising the sixth sentence of paragraph (a).
3. Adding two sentences after the sixth sentence of paragraph (a).

The revision and additions read as follows:

§1.584-4 Admission and withdrawal of participants in the common trust fund.

(a) *** When a participating interest is transferred by a bank, or by two or more banks that are members of the

same affiliated group (within the meaning of section 1504), as a result of the combination of two or more common trust funds or the division of a single common trust fund, the transfer to the surviving or divided fund is not considered to be an admission or a withdrawal if the combining, dividing, and resulting common trust funds have diversified portfolios. For purposes of this paragraph, a common trust fund has a diversified portfolio if it satisfies section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F), except that, in applying section 368(a)(2)(F)(iv), Government securities are included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii). In addition, for a transfer of a participating interest in a division of a common trust fund not to be considered an admission or withdrawal, each participant's pro rata interest in each of the resulting common trust funds must be substantially the same as was the participant's pro rata interest in the dividing fund.

* * * * *

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on August 9, 1995, 8:45 a.m., and published in the issues of the Federal Register for August 10, 1995, 60 F.R. 40796)

Notice of Proposed Rulemaking

Selection of Tax Matters Partner for Limited Liability Companies

PS-34-92

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the designation or selection of a tax matters partner for limited liability companies classified as partnerships. This document also amends current proposed regulations to consolidate certain guidance necessary to determine the tax matters partner for partnerships.

DATES: Written comments and requests for a public hearing must be received by January 29, 1996.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-34-92), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to: CC:DOM:CORP:T:R (PS-34-92), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), adjustments attributable to the tax items of a partnership were made at the partner level. Section 402 of TEFRA added sections 6221 through 6231 to the Internal Revenue Code of 1986, as amended, to allow for consolidated administrative and judicial proceedings to determine the tax treatment of partnership items at the partnership level. Under this consolidated proceeding, the tax matters partner of a partnership represents the partnership before the IRS in all tax matters for a specific taxable year.

Section 6231(a)(7) provides that the tax matters partner of a partnership is the general partner designated as the tax matters partner as provided in regulations or, if no general partner is designated, the general partner having the largest profits interest in the partnership at the close of the taxable year involved (largest-profits-interest rule). Section 6231(a)(7) also provides that, if no general partner is designated and the Commissioner determines that it is impracticable to apply the largest-profits-interest rule, the partner selected by the Commissioner is treated as the tax matters partner.

Proposed regulations under sections 6221 through 6231 and section 6233 were published in the Federal Register (51 FR 13231 [LR-205-82, 1986-1 C.B. 782]) on April 18, 1986. Several comments on the proposed regulations were received, but no public hearing was requested and none was held. Temporary regulations identical to the proposed regulations were published in the Federal Register (52 FR 6779 [T.D. 8128, 1987-1 C.B. 325]) on March 5, 1987. The temporary and proposed regulations remain outstanding.

On February 29, 1988, the IRS published Rev. Proc. 88-16, 1988-1 C.B.

691. This revenue procedure describes circumstances under which the IRS will determine that it is impracticable to apply the largest-profits-interest rule and describes the criteria the IRS will consider in selecting a tax matters partner for the partnership.

Since the enactment of TEFRA, virtually all states and several foreign jurisdictions have enacted laws providing for the formation of limited liability companies (LLCs). Although local law varies as to the requirements for establishing an LLC, the common denominator is that none of the members are liable for the debts and obligations of the LLC beyond their contributions (absent an express assumption of liability by a member if authorized under the applicable LLC statute). In addition, under local law, LLCs may be generally managed by elected or designated "managers," who may be members of the LLC. In most jurisdictions, however, LLCs need not be managed by elected or designated managers. In those cases, all members of the LLC have management authority.

LLCs in most jurisdictions may be classified for Federal tax purposes either as partnerships or associations that are taxable as corporations, depending on the characteristics of the LLC. See, e.g., Rev. Rul. 88-76, 1988-2 C.B. 360; Rev. Rul. 93-38, 1993-1 C.B. 233. For LLCs that are classified as partnerships for Federal tax purposes, it is necessary to determine the tax matters partner for the LLC.

Explanation of Provisions

A. Tax Matters Partner for LLCs

The proposed regulations provide that a "member-manager" of an LLC will be treated as a general partner for purposes of determining the tax matters partner of the LLC. Any member of an LLC that is not a member-manager is treated as a partner other than a general partner. The proposed regulations define a member-manager as a member of the LLC who, alone or together with others, is vested with the continuing exclusive authority to make the management decisions necessary to conduct the business for which the organization was formed. This approach is adopted because, if a member of the LLC has such continuing exclusive management authority, the member should have the necessary authority and access to part-

nership records needed to function as a tax matters partner. The proposed regulations also provide that if there are no elected or designated member-managers (as described above), each member will be treated as a member-manager.

The proposed regulations define an LLC as an organization formed under a law that allows the limitation of the liability of all members for the organization's debts and other obligations and classified as a partnership for Federal tax purposes.

B. Amending proposed regulations to incorporate the provisions of Rev. Proc. 88-16

The current proposed regulations under §301.6231(a)(7)-1 provide certain guidance concerning the designation of a tax matters partner under the largest-profits-interest rule of section 6231(a)(7)(B). However, the current proposed regulations do not describe circumstances under which the Commissioner will determine that it is impracticable to apply the largest-profits-interest rule and do not describe how the Commissioner will select a tax matters partner when it is impracticable to apply the largest-profits-interest rule. This additional guidance is provided in Rev. Proc. 88-16.

For administrative simplicity, the provisions in this notice of proposed rulemaking amend the current proposed regulations to include the rules of Rev. Proc. 88-16. As a result, the complete guidance necessary for determining the tax matters partner for a partnership and an LLC will be contained in the proposed regulations under section 6231(a)(7).

As amended, the proposed regulations incorporate the provisions of Rev. Proc. 88-16 with one substantive change. Under sections 3.05 and 3.06 of Rev. Proc. 88-16, if each general partner is deemed to have no profits interest under section 3.03(2) or 3.03(3), the IRS will select a limited partner as the tax matters partner. Some partnerships, such as a general partnership or a foreign LLC in which all members are member-managers, do not have limited partners. To permit the Commissioner to select a tax matters partner in these situations, the proposed regulations allow the Commissioner to select any partner (including either a general or limited partner) as the tax matters partner.

Proposed Effective Date

Sections 301.6231(a)(7)-1 and 301.6231(a)(7)-2 are proposed to be effective for all designations, selections, and terminations of a tax matters partner occurring on or after the date final regulations are published in the Federal Register. Any other reasonable designation or selection of a tax matters partner of an LLC is binding for periods prior to the effective date of this regulation.

Effect on Other Documents

Rev. Proc. 88-16 is obsolete as of the date final regulations are published in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes,

Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.6231(a)(7)-1 also issued under 26 U.S.C. 6230 (i) and (k). * * *

Section 301.6231(a)(7)-2 also issued under 26 U.S.C. 6230 (i) and (k). * * *

Par. 2. Section 301.6231(a)(7)-1 (as proposed to be added in the Federal Register for April 18, 1986 (51 FR 13245)) is amended by:

1. Revising the section heading.
2. Adding a new sentence at the end of paragraph (a).
3. Removing the heading for paragraph (c)(1) and redesignating paragraph (c)(1) as paragraph (c).
4. Removing paragraph (c)(2).
5. Adding a sentence at the end of paragraph (m)(2).
6. Adding paragraphs (n), (o), (p), (q), (r), and (s).

The additions and revisions read as follows:

§301.6231(a)(7)-1 Designation or selection of tax matters partner.

(a) * * * If a partnership does not designate a general partner as the tax matters partner for a specific taxable year, or if the designation is terminated without the partnership designating another general partner as the tax matters partner, the tax matters partner is the partner determined under this section.

* * * * *

(m) * * *

(2) * * * For purposes of this paragraph (m)(2), the general partner with the largest profits interest is determined based on the year-end profits interests reported on the Schedules K-1 filed with the partnership income tax return for the taxable year for which the determination is being made.

(n) *Selection of tax matters partner by Commissioner when impracticable to apply the largest-profits-interest rule.* If the partnership has not designated a tax matters partner under this section for the taxable year and it is impracticable (as determined under paragraph (o) of this section) to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will select a tax matters partner as described in paragraph (p) of this section.

(o) *Impracticability of largest-profits-interest rule.* It is impracticable to apply the largest-profits-interest rule of paragraph (m)(2) of this section if, on the date the rule is applied, any one of the following three conditions is met:

(1) *General partner with the largest profits interest is not apparent.* The general partner with the largest profits interest is not apparent from the Schedules K-1 and is not otherwise readily determinable.

(2) *Each general partner is deemed to have no profits interest in the partnership.* Each general partner is deemed to have no profits interest in the partnership under paragraph (m)(3) of this section (concerning termination of a designation under the largest-profits-interest rule) because of the occurrence of one or more of the events described in paragraphs (1)(1) through (4) of this section (involving death, adjudication of incompetency, liquidation, and conversion of partnership items to nonpartnership items).

(3) *General partner with the largest profits interest is disqualified.* The general partner with the largest profits interest determined under paragraph (m)(2) of this section—

(i) Has been notified of suspension from practice before the Internal Revenue Service;

(ii) Is incarcerated;

(iii) Is residing outside the United States, its possessions, or territories; or

(iv) Cannot be located or cannot perform the functions of a tax matters partner for any reason, except that lack of cooperation with the Internal Revenue Service by the general partner with the largest profits interest is not a basis for finding that the partner cannot perform the functions of a tax matters partner.

(p) *Commissioner's selection of the tax matters partner—(1) When the*

general partner with the largest profits interest is not apparent. If it is impracticable under paragraph (o)(1) of this section to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will select (in accordance with the notification procedures set forth in paragraph (r) of this section) as the tax matters partner any person who was a general partner at any time during the taxable year under examination.

(2) *When each general partner is deemed to have no profits interest in the partnership.* If it is impracticable under paragraph (o)(2) of this section to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will select a partner (including a general or limited partner) as the tax matters partner in accordance with the criteria set forth in paragraph (q) of this section. The Commissioner will notify both the partner selected and the partnership of the selection, effective as of the date specified in the notice.

(3) *When the general partner with the largest profits interest is disqualified—(i) In general.* Except as otherwise provided in paragraph (p)(3)-(ii) of this section, if it is impracticable under paragraph (o)(3) of this section to apply the largest-profits-interest rule of paragraph (m)(2) of this section, the Commissioner will treat each general partner who fits the criteria contained in paragraph (o)(3) of this section as having no profits interest in the partnership for the taxable year and will select (in accordance with the notification procedures set forth in paragraph (r) of this section) a tax matters partner from the remaining persons who were general partners at any time during the taxable year.

(ii) *Partner selected if no general partner may be selected.* If all general partners during the taxable year either are treated as having no profits interest in the partnership for the taxable year under paragraph (m)(3) of this section (concerning termination of a designation under the largest-profits-interest rule) or are described in paragraph (o)(3) of this section (general partner with the largest profits interest is disqualified), the Commissioner will select a partner (including a general or limited partner) as the tax matters partner in accordance with the criteria set forth in paragraph (q) of this section. The Commissioner will notify both the partner selected and the

partnership of the selection, effective as of the date specified in the notice.

(q) *Criteria for selecting a partner as tax matters partner—(1) In general.* The Commissioner will select a partner as the tax matters partner under paragraph (p)(2) or (3)(ii) of this section only if the partner was a partner in the partnership at the close of the taxable year under examination.

(2) *Criteria to be considered.* The Commissioner may consider the following criteria in selecting a partner as the tax matters partner:

(i) The general knowledge of the partner in tax matters and the administrative operation of the partnership.

(ii) The partner's access to the books and records of the partnership.

(iii) The profits interest held by the partner.

(iv) The views of the partners having a majority interest in the partnership regarding the selection.

(v) Whether the partner is a partner of the partnership at the time the tax-matters-partner selection is made.

(vi) Whether the partner is a United States person (within the meaning of section 7701(a)(30)).

(3) *Limited restriction on subsequent designation of a tax matters partner by the partnership.* For purposes of paragraphs (p)(2) and (3)(ii) of this section, the partnership cannot designate a partner who is not a general partner to serve as tax matters partner in lieu of a partner selected by the Commissioner.

(r) *Notification of partnership—(1) In general.* If the Commissioner selects a tax matters partner under the provisions of paragraph (p)(1) or (3)(i) of this section, the Commissioner will notify both the partner selected and the partnership of the selection, effective as of the date specified in the notice.

(2) *Limited opportunity for partnership to designate the tax matters partner.* (i) Before the Commissioner selects a tax matters partner under paragraphs (p)(1) and (3)(i) of this section, the Commissioner will notify the partnership by mail that, after 30 days from the date of the notice, the Commissioner will make a determination that it is impracticable to apply the largest-profits-interest rule of paragraph (m)(2) of this section and will select the tax matters partner unless a prior designation is made by the partnership. This delay in making the determination will permit the partnership to designate

a tax matters partner under paragraph (e) (designation by general partners with a majority interest) or (f) of this section (designation by partners with a majority interest under certain circumstances), thereby avoiding a selection made by the Commissioner.

(ii) During the 30-day period and prior to a tax-matters-partner designation by the partnership, the Commissioner will communicate with the partnership by sending all correspondence or notices to "The Tax Matters Partner" in care of the partnership at the partnership's address.

(iii) Any subsequent designation of a tax matters partner by the partnership after the 30-day period will become effective as provided under paragraph (k)(2) of this section (concerning designations made after a notice of beginning of administrative proceeding is mailed).

(s) *Effective date.* This section applies to all designations, selections, and terminations of a tax matters partner occurring on or after the date final regulations are published in the Federal Register.

Par. 3. Section 301.6231(a)(7)-2 is added to read as follows:

§301.6231(a)(7)-2 Designation or selection of tax matters partner for a limited liability company (LLC).

(a) *In general.* Solely for purposes of applying section 6231(a)(7) and §301.6231(a)(7)-1 to an LLC, only a member-manager of an LLC is treated as a general partner, and a member of an LLC who is not a member-manager is treated as a partner other than a general partner.

(b) *Definitions*—(1) *LLC.* Solely for purposes of this section, *LLC* means an organization—

(i) Formed under a law that allows the limitation of the liability of all members for the organization's debts and other obligations within the meaning of §301.7701-2(d); and

(ii) Classified as a partnership for Federal tax purposes.

(2) *Member.* Solely for purposes of this section, *member* means any person who owns an interest in an LLC.

(3) *Member-manager.* Solely for purposes of this section, *member-manager* means a member of an LLC who, alone or together with others, is vested with the continuing exclusive

authority to make the management decisions necessary to conduct the business for which the organization was formed. Generally, an LLC statute may permit the LLC to choose management by one or more managers (whether or not members) or by all of the members. If there are no elected or designated member-managers (as so defined in this paragraph (b)(3)) of the LLC, each member will be treated as a member-manager for purposes of this section.

(c) *Effective date.* This section applies to all designations, selections, and terminations of a tax matters partner of an LLC occurring on or after the date final regulations are published in the Federal Register. Any other reasonable designation or selection of a tax matters partner of an LLC is binding for periods prior to the effective date of this section.

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on October 27, 1995, 8:45 a.m., and published in the issue of the Federal Register for October 30, 1995, 60 F.R. 55228)

**Notice of Proposed Rulemaking and
Notice of Public Hearing**

**Requirements to Ensure Collection of
Section 2056A Estate Tax**

PS-25-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In *** [T.D. 8613, page 216, this Bulletin], the IRS is issuing temporary regulations relating to the additional requirements necessary to ensure the collection of the estate tax imposed under section 2056A(b) with respect to taxable events involving qualified domestic trusts described in section 2056A(a). The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 20, 1995. Outlines of topics to be discussed at the public hearing scheduled for January 16, 1996, at 10 a.m., must be received by December 26, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-25-94), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered to: CC:DOM:CORP:T:R (PS-25-94), Internal Revenue Service, Room 5228, 1111 Constitution Avenue NW., Washington, DC. The public hearing will be held in the Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collections of information are in 20.2056A-2T(d). This information is required by the IRS in order to ensure the collectibility of the estate tax imposed under section 2056A(b) in cases (1) where a bond or letter of credit security arrangement alternative is adopted and (2) where the qualified domestic trust holds foreign real property or the principal residence exclusion applies. This information will be used to monitor compliance with the additional regulatory requirements contained in 20.2056A-2T(d)(1)(i) and (iv). The likely respondents will be trustees of qualified domestic trusts. Estimated total annual reporting burden: 6110 hours. The estimated annual burden per respondent varies from 30 minutes to 3 hours, depending upon individual circumstances, with an estimated average of 1.37 hours.

Estimated number of respondents: 4470.

Estimated annual frequency of responses: 1.

Background

Temporary regulations in *** [T.D. 8613, page 216, this Bulletin], amend Estate Tax Regulations (26 CFR part 20) relating to section 2056A. The temporary regulations contain rules relating to the additional requirements to ensure the collectibility of the estate tax imposed under section 2056A.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments that are submitted timely (preferably a signed original and eight copies) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 16, 1996, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral

comments at the hearing must submit written comments by November 20, 1995, and submit an outline of the topics to be discussed and the time to be devoted to each topic by December 26, 1995.

A period of 10 minutes will allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects in 26 CFR Part 20

Estate taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 20 is proposed to be amended as follows:

PART 20—ESTATE TAX; ESTATES OF DECEDENTS DYING AFTER AUGUST 16, 1954

Par. 1. The authority citation for part 20 continues to read in part as follows:

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

Par. 2. Section 20.2056A-2 is amended by adding paragraph (d) to read as follows:

20.2056A-2 Requirements for qualified domestic trust.

* * * * *

(d) [The text of this proposed regulation is the same as the text of 20.2056A-2T(d) published elsewhere in *** [T.D. 8613, page 216, this Bulletin].

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on August 21, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 22, 1995, 60 F.R. 43574)

Notice of Proposed Rulemaking and Notice of Public Hearing

Environmental Settlement Funds—Classification

PS-54-94

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the classification of certain organizations as trusts for federal tax purposes. The proposed regulations would provide guidance to taxpayers on the proper classification of trusts formed to collect and disburse amounts for environmental remediation of an existing waste site to discharge taxpayers' liability or potential liability under applicable environmental laws.

DATES: Written comments must be received by October 5, 1995. Requests to speak (with outlines of oral comments) at a public hearing scheduled for October 26, 1995, at 10 a.m. must be submitted by October 5, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-54-94), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS-54-94), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. The public hearing has been scheduled to be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Office of Management and Budget, Attention: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224.

The collection of information is required by §301.7701-4(e)(2). This information is required by the IRS to ensure the proper reporting of items of

income and expense of an environmental remediation trust in which a portion of the trust is treated as owned by a grantor. This information will be used to ensure compliance with the proposed regulation. The likely respondents are businesses and other for-profit institutions, including small businesses.

Estimated total annual reporting burden: 2,000 hours.

The estimated annual burden per respondent: 4 hours.

Estimated number of respondents: 500.

Estimated annual frequency of responses: 1.

Introduction

This document proposes to add §301.7701-4(e) to the Procedure and Administration Regulations (26 CFR Part 301) relating to the classification of certain environmental remediation trusts as trusts for federal tax purposes.

Background

Unincorporated organizations may be classified as associations (which are taxable as corporations), partnerships, or trusts for federal tax purposes. The criteria for determining when an organization will be classified as a trust are set forth in §301.7701-4. The proposed amendment to §301.7701-4 provides that an environmental remediation trust will be classified as a trust for federal tax purposes.

A trust is an environmental remediation trust if (1) the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws; (2) all contributors to the trust have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and (3) the trust is not a qualified settlement fund within the meaning of §1.468B-1(a). Environmental remediation trusts include trusts formed pursuant to an order of a governmental authority, as well as trusts formed by taxpayers to avoid future liability or potential liability under federal, state, or local environmental laws. An environmental remediation trust is classified as a trust,

even though it may differ from the traditional trust in which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts, because the purpose of an environmental remediation trust is to pay the costs of environmental remediation of an existing waste site as a result of liability or potential liability under federal, state, or local environmental laws, not to carry on a for-profit business.

The proposed regulations provide that each contributor to the trust will be treated as the owner of the portion of the trust contributed by that person, and, therefore, the trust is treated as a grantor trust under subpart E of subchapter J. The proposed regulations also require the trustee to provide information to the participants that will enable them to properly report their share of income, deductions, and credits, including information to properly determine whether a payment satisfies the economic performance rules of section 461(h).

The proposed regulations provide certain rules relating to participants (cash-out grantors) that contribute a fixed amount to the trust and are relieved from making further contributions to the trust, even though the participant still is liable or potentially liable under applicable environmental laws. Under the proposed regulations, all amounts contributed to an environmental remediation trust by a cash-out grantor are considered amounts contributed for remediation. In addition, the trust agreement may direct the trustee to expend amounts contributed by a cash-out grantor (and the earnings thereon) before expending amounts contributed by other grantors (and the earnings thereon). The proposed regulations also provide that a cash-out grantor will cease to be treated as an owner of a portion of the trust when the grantor's portion is treated as fully expended.

Effective Date

The regulations are proposed to apply to trusts that meet the requirements of paragraph (e)(1) of the regulations that are formed on or after the date of publication of these proposed regulations as final regulations in the Federal Register.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 26, 1995, at 10:00 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by October 5, 1995, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 5, 1995.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

List of Subjects in 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7701-4(e) is added to read as follows:

§301.7701-4 *Trusts.*

* * * * *

(e) *Environmental remediation trusts.* (1) An environmental remediation trust is considered a trust for purposes of the Internal Revenue Code. For purposes of this paragraph (e), an organization is an environmental remediation trust if the organization is organized under state law as a trust; the primary purpose of the trust is collecting and disbursing amounts for environmental remediation of an existing waste site to resolve, satisfy, mitigate, address, or prevent the liability or potential liability of persons imposed by federal, state, or local environmental laws; all contributors to the trust have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site; and the trust is not a qualified settlement fund within the meaning of §1.468B-1(a) of this chapter. An environmental remediation trust is classified as a trust because its primary purpose is environmental remediation of a waste site and not the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the remedial purpose is altered or becomes so obscured by business or investment activities that the declared remedial purpose is no longer controlling, the organization will no longer be classified as a trust. For purposes of this paragraph (e), environmental remediation includes the costs of assessing environmental conditions, remediating environmental contamination, monitoring remedial activities and the release of substances, preventing future releases of substances, and collecting

amounts from persons liable or potentially liable for the costs of these activities. For purposes of this paragraph (e), persons have potential liability or a reasonable expectation of liability under federal, state, or local environmental laws for environmental remediation of the waste site if there is authority under a federal, state, or local law that requires such persons to satisfy all or a portion of the costs of the environmental remediation.

(2) Each contributor (grantor) to the trust will be treated as the owner of the portion of the trust contributed by that grantor. See section 677 and §1.677(a)-1(d) of this chapter for rules regarding the treatment of a grantor as the owner of a portion of a trust applied in discharge of the grantor's legal obligation. Items of income, deduction, and credit attributable to any portion of an environmental remediation trust treated as owned by the grantor should not be reported by the trust on Form 1041, but should be shown on a separate statement to be attached to that form. See §1.671-4(a) of this chapter. The trustee must also furnish to each grantor a statement that shows all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by the grantor. The statement must provide the grantor with the information necessary to take the items into account in computing the grantor's taxable income, including information necessary to properly take into account items under the economic performance rules of section 461(h) and the regulations thereunder. See §1.461-4 of this chapter for rules relating to economic performance.

(3) All amounts contributed to an environmental remediation trust by a grantor (cash-out grantor) who, pursuant to an agreement with the other grantors, contributes a fixed amount to the trust and is relieved of any further obligation to make contributions to the trust, but remains liable or potentially liable under the applicable environmental laws, will be considered amounts contributed for remediation. An environmental remediation trust agreement may direct the trustee to expend amounts contributed by a cash-out grantor (and the earnings thereon) before expending amounts contributed by other grantors (and the earnings thereon). A cash-out grantor will cease to be treated as an owner of a portion of the trust when the grantor's portion is fully expended by the trust.

(4) The provisions of this paragraph (e) may be illustrated by the following example:

Example. (a) X, Y, and Z are calendar year corporations that are liable for the remediation of an existing waste site under applicable federal environmental laws. On June 1, 1996, pursuant to an agreement with the governing federal agency, X, Y, and Z create an environmental remediation trust within the meaning of paragraph (e)(1) to collect funds contributed to the trust by X, Y, and Z and to carry out the remediation of the waste site to the satisfaction of the federal agency. X, Y, and Z are jointly and severally liable under the federal environmental laws for the remediation of the waste site, and the federal agency will not release X, Y, or Z from liability until the waste site is remediated to the satisfaction of the agency.

(b) The estimated cost of the remediation is \$20,000,000. X, Y, and Z agree that, if Z contributes \$1,000,000 to the trust, Z will not be required to make any additional contributions to the trust, and X and Y will complete the remediation of the waste site and make additional contributions if necessary.

(c) On June 1, 1996, X, Y, and Z each contribute \$1,000,000 to the trust. The trust agreement directs the trustee to spend Z's contributions to the trust and the income allocable to Z's portion before spending X's and Y's portions. On November 30, 1996, the trustee pays \$2,000,000 for remediation work performed from June 1, 1996, through September 30, 1996. As of November 30, 1996, the trust had \$75,000 of interest income, which is allocated in equal shares of \$25,000 to X, Y, and Z's portions of the trust.

(d) Pursuant to the agreement between X, Y, and Z, Z made no further contributions to the trust. Pursuant to the trust agreement, the trustee expended Z's portion of the trust before expending X's and Y's portion. Therefore, Z's share of the remediation payment made in 1996 is \$1,025,000 (\$1,000,000 contribution by Z plus \$25,000 of income allocated to Z's portion of the trust). Z must take the \$1,025,000 payment into account under the appropriate federal tax accounting rules. In addition, X's share of the remediation payment made in 1996 is \$487,500, and Y's share of the remediation payment made in 1996 is \$487,500. X and Y must take their respective shares of the payment into account under the appropriate federal tax accounting rules.

(e) The trustee made no further remediation payments in 1996, and X and Y made no further contributions in 1996. From December 1, 1996, to December 31, 1996, the trust had \$5,000 of interest income, which is allocated \$2,500 to X's portion and \$2,500 to Y's portion. Accordingly, for 1996, X and Y each had income of \$27,500 from the trust.

(5) This paragraph (e) is applicable to trusts meeting the requirements of paragraph (e)(1) of this section that are formed on or after the date of publication of these proposed regulations as final regulations in the Federal Register.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 3, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 4, 1995, 60 F.R. 39903)

Notice of Proposed Rulemaking

Deposits of Excise Taxes

PS-8-95

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: In *** [T.D. 8616, page 263, this Bulletin], the IRS is issuing temporary regulations relating to deposits of excise taxes. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments and requests for a public hearing must be received by November 27, 1995.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (PS-8-95), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS-8-95), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations in *** [T.D. 8616, page 263, this Bulletin] amend

the Excise Tax Procedural Regulations (26 CFR part 40) relating to deposits of excise taxes under section 6302. The temporary regulations contain special safe harbor rules for the additional deposit of taxes due in September of each year.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these regulations, and, therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by any person that timely submits written comments. If a

public hearing is scheduled, notice of the date, time and place for the hearing will be published in the Federal Register.

List of Subjects in 26 CFR Part 40

Excise taxes, Reporting and record-keeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 40 is proposed to be amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 continues to read in part as follows:

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

Par. 2. Section 40.6302(c)-5 is added to read as follows:

*§40.6302(c)-5 Use of Government
depositories; rules under sections
6302(e) and (f).*

[The text of this proposed section is the same as the text of §40.6302(c)-5T published elsewhere in *** [T.D. 8616, this Bulletin].

Margaret Milner Richardson,
*Commissioner of
Internal Revenue.*

(Filed by the Office of the Federal Register on August 28, 1995, 8:45 a.m., and published in the issue of the Federal Register for August 29, 1995, 60 F.R. 44788)

Announcement of the Disbarment, Suspension, or Consent to Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents and enrolled actuaries are prohibited in any Internal

Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attor-

ney, certified public accountant, enrolled agent or enrolled actuary and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

| Name | Address | Designation | Date of Suspension |
|-------------------------|----------------------|----------------|--|
| Anderson, David J. | Minneapolis, MN | CPA | July 1, 1995 to September 30, 1995 |
| Broderick, William | Farmington Hills, MI | CPA | June 7, 1995 to December 6, 1995 |
| Chee, Warren W. | Honolulu, HI | CPA | October 1, 1995 to March 31, 1996 |
| Stenquist, Sigfred N. | Troy, MI | CPA | August 1, 1995 to July 31, 1996 |
| Cigainero, James M. | Houston, TX | CPA | Indefinite from June 13, 1995 |
| Tussey, Alva S. | Fayetteville, NC | CPA | June 16, 1995 to August 15, 1995 |
| Wright Jr., Edward | Matteson, IL | CPA | June 15, 1995 to June 14, 1996 |
| Genovese, Philip A. | Shrewsbury, NJ | CPA | Indefinite from June 26, 1995 |
| Jonaitis, George J. | Omaha, NE | CPA | Indefinite from June 29, 1995 |
| Birnbaum, Bernard | Larchmont, NY | CPA | July 20, 1995 to November 20, 1995 |
| Himmelmann III, William | Sacramento, CA | CPA | August 1, 1995 to October 1, 1995 |
| Milligan, Alex | Rockville, IN | CPA | July 26, 1995 to July 25, 1996 |
| Belfiore Jr., Paul J. | Simsbury, CT | CPA | Indefinite from August 7, 1995 |
| Crews, Robert J. | Florence, AL | CPA | September 1, 1995 to December 31, 1995 |
| Golden, Stephen | Imperial, MO | Enrolled Agent | September 7, 1995 to September 6, 1996 |
| Baldwin, Harrison S. | Richmond, VA | CPA | September 12, 1995 to March 11, 1996 |
| Hartman Jr., Charles | Dallas, TX | CPA | September 12, 1995 to September 11, 1997 |
| Hersh, Joel A. | Silver Spring, MD | CPA | September 12, 1995 to November 11, 1995 |
| Vines, Gerald L. | Birmingham, AL | Enrolled Agent | December 15, 1995 to December 14, 1997 |
| De Sonia, Richard H. | Burton, MI | Enrolled Agent | Indefinite from October 1, 1995 |
| Kendrick, Perry D. | Lodi, CA | CPA | Indefinite from October 1, 1995 |
| De Los Santos, Michael | Corpus Christi, TX | CPA | October 1, 1995 to September 30, 1996 |
| Monnett, Gary M. | Cloverdale, IN | CPA | October 1, 1995 to November 30, 1995 |
| Hanlin, William | Seattle, WA | CPA | Indefinite from October 6, 1995 |
| Smith Jr., Edward H. | S. Glastonbury, CT | CPA | Indefinite from October 18, 1995 |
| Moore, Michael C. | Huntsville, AL | Attorney | October 19, 1995 to October 18, 1996 |

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly

or indirectly employing, accepting assistance from, being employed by or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or as long as it is practicable for each attorney, certified public accountant, enrolled agent or enrolled actuary so suspended or disbarred and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

| Name | Address | Designation | Effective Date |
|--------------------|-----------------------|-------------|--------------------|
| Glennon, Martin K. | Bedford, NH | Attorney | June 15, 1995 |
| Kraemer, Steven | Minneapolis, MN | CPA | June 15, 1995 |
| Miglino, Nicholas | Whitetone, NY | Attorney | June 26, 1995 |
| Milone Jr., Louis | Rockville Center, NY | Attorney | June 26, 1995 |
| Roy, Lansing J. | Ponte Vedra Beach, FL | Attorney | June 26, 1995 |
| Rusk, James E. | Marlborough, CT | CPA | June 26, 1995 |
| Meyer, Robert | Hamden, CT | CPA | September 25, 1995 |
| Haskins, Wayne | Humble, TX | CPA | September 29, 1995 |
| Tritt, Raymond | Jackson, TN | CPA | October 6, 1995 |
| Perryman, James R. | Montgomery, AL | CPA | October 15, 1995 |

Announcement of the Expedited Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years, from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal

Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled

agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions of the applicable regulations:

| Name | Address | Designation | Date of Suspension |
|---------------------------|------------------|----------------|------------------------------------|
| McNamee Sr., Michael B. | W. Alton, MO | CPA | Indefinite from May 22, 1995 |
| Rice, Jerry V. | Albuquerque, NM | CPA | Indefinite from June 1, 1995 |
| Michel, Ralph | Huntingburg, IN | CPA | Indefinite from June 7, 1995 |
| Parkins Sr., Gerald B. | Moscow, ID | CPA | Indefinite from June 8, 1995 |
| Love, David M. | Hot Springs, AZ | Attorney | Indefinite from June 12, 1995 |
| Fitch II, Paul V. | Aiken, SC | CPA | Indefinite from June 20, 1995 |
| Rice, Jeffrey B. | Middleburg, VA | Attorney | Indefinite from June 22, 1995 |
| Henss, John L. | Des Moines, IA | CPA | Indefinite from June 30, 1995 |
| Bates, Donald K. | Wharton, TX | CPA | Indefinite from July 5, 1995 |
| Hofflin, Harold M. | Fort Lee, NJ | CPA | Indefinite from July 14, 1995 |
| Ramacciotti, Frank | Buffalo, MN | Attorney | Indefinite from July 17, 1995 |
| Craven, Patrick J. | Crete, NE | Attorney | Indefinite from July 24, 1995 |
| Burkholder Jr., Robert C. | Richmond, VA | Attorney | Indefinite from July 24, 1995 |
| Dubin, Robert P. | Palm Springs, CA | CPA | Indefinite from July 24, 1995 |
| Harrison, Lance | Livingston, NJ | CPA | Indefinite from August 3, 1995 |
| Piccola, Ronald J. | Lexington, KY | CPA | Indefinite from August 3, 1995 |
| Wachs, Melvin G. | Baltimore, MD | Attorney | Indefinite from August 3, 1995 |
| Crist, John A. | Middletown, OH | Attorney | Indefinite from August 21, 1995 |
| Marks, Richard E. | Redding, CA | Enrolled Agent | Indefinite from August 21, 1995 |
| Goldstein, Issac | Brooklyn, NY | CPA | Indefinite from September 1, 1995 |
| Pardue Jr., Hobart O. | Springfield, LA | Attorney | Indefinite from September 5, 1995 |
| Rodriguez, Manuel A. | Union City, NJ | Enrolled Agent | Indefinite from September 13, 1995 |
| Saylors, John R. | Denver, CO | CPA | Indefinite from September 18, 1995 |
| Remillard, John A. | Methuen, MA | Attorney | Indefinite from October 10, 1995 |
| Rotenberg, Gary A. | Westland, MI | CPA | Indefinite from October 10, 1995 |
| Phillips, Erwin W. | Scottsdale, AZ | CPA | Indefinite from October 10, 1995 |
| Joyce, Philip | Pittsburg, PA | CPA | Indefinite from October 10, 1995 |
| Jones, Wayne G. | Vidalia, GA | CPA | Indefinite from October 13, 1995 |

Scenarios of Disciplinary Actions from the Office of Director of Practice

The following scenarios are composites of matters that have come to the attention of the Office of Director of Practice. The scenarios are intended to inform tax practitioners of the types of activity that may result in disciplinary action under Treasury Department Circular No. 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents Enrolled Actuaries, and Appraisers Before the Internal Revenue Service (a republication of 31 C.F.R. Part 10). Because disciplinary matters are resolved on the basis of their particular facts and circumstances, these scenarios do not constitute precedent in any matter before the Director.

Comments concerning the scenarios should be sent to: Office of Director of Practice, C:AP:P, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, D.C. 20224.

Failure to file—For several years, the sole practitioner made estimated payments that exceeded his personal income tax liability. During those years he did not file Form 1040. When contacted by IRS Examination personnel, he stated that he always gave his many clients' first priority and, as a result, had no time to file his own returns. He claimed, moreover, that his estimated payments not only showed his good faith but, for all practical purposes, satisfied his income tax obligations.

The Director regarded the practitioner's conduct as a violation of Circular 230. Under section 10.51(d), a practitioner may be suspended or disbarred for willfully failing to make a Federal tax return in violation of the revenue laws of the United States. The willful failure to file tax returns is not a mere formality, even when the practitioner is due a refund. Rather, such failure is a violation of a known legal duty and constitutes disreputable conduct under section 10.51(d). Although the practitioner's estimated payments entitled him to some credit for good faith, this did not offset his failure to meet his responsibility to file.

Disreputable conduct—After the client's personal return was selected for audit, the client insisted to the practitioner that the matter be resolved as soon as possible. The practitioner immediately telephoned the revenue agent who was to conduct the audit, but

found that the agent was unavailable. When the agent returned the call, the practitioner was with a client. Over the next several days—through no fault of either party—they happened to miss each other's calls.

The practitioner placed another call and was informed that the revenue agent was in a meeting. The practitioner then said, "This is John Smith at City Hospital emergency room. I must speak to Agent Jones right now. It's matter of life or death."

The practitioner's message was relayed to the revenue agent, who became alarmed. When the revenue agent picked up the telephone, the practitioner identified himself and stated that he wanted to schedule the audit.

The Director contacted the practitioner concerning this incident, stating that the practitioner may have engaged in disreputable conduct in violation of section 10.51 of Circular 230. The practitioner responded that he had used a harmless ruse to bring the revenue agent to the telephone. However, the Director concluded that under any standard of reasonableness, the practitioner must have known that his conduct was unprofessional and hurtful. Therefore, the Director found the practitioner in violation of section 10.51.

Unreasonable delay—Within two months, the practitioner cancelled five conferences with the appeals officer. In each case, on the day of the conference, before normal business hours, the practitioner left a telephone message on the Appeals answering machine stating that he had to cancel due to "scheduling problems" or "prior commitments." Rescheduling was done at the initiative of the appeals officer, whose records revealed that three out of four telephone calls to the practitioner were not returned.

The Director regarded the practitioner's conduct as a possible violation of section 10.23 of Circular 230. That provision states that no practitioner shall unreasonably delay the prompt disposition of any matter before the IRS. Upon being contacted by the Director, the practitioner stated that he could not remember the specific reasons for his cancellations. Because the practitioner had given notice—albeit short notice—of his intention to cancel, he felt he had met his responsibilities.

The Director, however, concluded that the practitioner's conduct, taken as a whole, was unreasonable. Unreasonable delay covers a wide range of behavior. For example, it can take the form of several long delays or a pattern of short delays. In this case, the practitioner established a pattern of behavior that was objectionable for three reasons: he showed no consideration for the appeals officer's time; he had no objective reason for the delays, and he took no interest in rescheduling appointments to resolve a matter pending before the IRS. Consequently, the Director issued a private reprimand to the practitioner with a warning that repeated instances of such conduct could warrant a proceeding for suspension or disbarment.

Expedited Suspension—The practitioner pleaded guilty to making a false statement in securing a federally insured mortgage, which resulted in a felony conviction under 18 U.S.C. 1001. Within five years of the conviction, the Director of Practice served the practitioner with a complaint seeking his expedited suspension under section 10.76 of Circular 230. Section 10.76, which was added to Circular 230 in 1994, permits the expedited suspension of a practitioner convicted of a felony under title 18 of the United States Code involving "dishonesty" or "breach of trust." The practitioner filed an answer, claiming that breach of a fiduciary duty is a necessary element for a section 10.76 suspension that is based on a felony involving dishonesty.

Section 10.51(a) of Circular 230 provides that a practitioner who is convicted of an offense involving "dishonesty" or "breach of trust" is subject to suspension or disbarment in a non-expedited proceeding. The Director's long-standing interpretation of "dishonesty" in section 10.51(a) is that it means a knowing falsehood. Fiduciary duty has no relevance to an offense involving "dishonesty," although it may be relevant to an offense involving "breach of trust."

The Director's interpretation of "dishonesty" in section 10.76 was consistent with his interpretation of the term in section 10.51(a). Section 1001 of 18 U.S.C. imposes penalties for knowingly making false statements in any matter within the jurisdiction of any federal agency. Because the practitioner's felony involved a knowing falsehood, he was subject to an expedited suspension.

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The abbreviation and number in parentheses following the index entry refer to the specific item; numbers following the parentheses refer to page number on which it appears.

Key to Abbreviations:

| | |
|-----|----------------------------------|
| RR | Revenue Ruling |
| RP | Revenue Procedure |
| TD | Treasury Decision |
| CD | Court Decision |
| PL | Public Law |
| EO | Executive Order |
| DO | Delegation Order |
| TDO | Treasury Department Order |
| TC | Tax Convention |
| SPR | Statement of Procedural Rules |
| PTE | Prohibited Transaction Exemption |

EMPLOYMENT TAXES

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