HIGHLIGHTS OF THIS ISSUE
These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

T.D. 8941, page 977.
Final regulations under section 142(f)(4) of the Code provide rules for making the election to terminate tax-exempt bond financing for certain local furnishers. Temporary and proposed regulations under section 141 of the Code relate to special rules for output facilities. A public hearing on the proposed regulations is scheduled for July 24, 2001.

Proposed regulations under section 1092 of the Code concern qualified covered call treatment for equity options with flexible terms, equity options with standardized terms, and certain qualifying over-the-counter equity options. A public hearing is scheduled for May 9, 2001.

REG–101739–00, page 996.
Proposed regulations under section 7701 of the Code concern the check-the-box regulations that address the applicability of the elective federal tax classification regime to business entities wholly owned by a foreign government and to wholly owned nonbank entities of foreign banks. These regulations also provide that the term “entity” for purposes of section 892(a)(2)(B) of the Code includes a partnership. A public hearing is scheduled for May 16, 2001.

REG–104876–00, page 998.
Proposed regulations under section 706 of the Code provide guidance on determining the taxable year of a partnership with foreign partners. A public hearing is scheduled for June 6, 2001.

REG–107047–00, page 1002.
Proposed regulations under section 1221 of the Code relate to the determination of the character of gain or loss from hedging transactions. A public hearing is scheduled for May 16, 2001.

Research credit suspension period. This notice provides guidance to corporate taxpayers that file Form 7004 requesting an extension of time to file their income tax return for a taxable year that includes expired research credit suspension periods.

The Service announces that supplemental information on short-term Treasury bills for Publication 1212, List of Original Issue Discount Instruments (2000 edition), is available.

EMPLOYEE PLANS

REG–129608–00, page 1011.
Proposed regulations under section 7476 of the Code set forth new standards for satisfying the notice to interested parties requirement with respect to an application for a determination letter.

ADMINISTRATIVE

This notice provides tax relief under sections 6081, 6161, 6404(h), 6654(e)(3), and 7508A of the Code for taxpayers affected by the Cerro Grande Fire.
The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

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 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.

The Bulletin is divided into four parts as follows:

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).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

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

Section 141.—Private Activity Bond; Qualified Bond


T.D. 8941

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Obligations of States and Political Subdivisions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that provide guidance to issuers of tax-exempt bonds for output facilities. This document also contains final regulations that provide guidance to certain nongovernmental persons that are engaged in the local furnishing of electric energy or gas using facilities financed with state or local government bonds. These regulations will affect issuers of tax-exempt bonds and nongovernmental persons engaged in the local furnishing of electric energy or gas after the effective date.

The text of the temporary regulations also serves as the text of the proposed regulations (REG-114998-99) set forth in the notice of proposed rulemaking on this subject on page 992 of this Bulletin.

DATES: Effective Date: These regulations are effective January 19, 2001.

Applicability Date: For dates of applicability, see §§1.141–15T, 1.142(f)(4)–1(g), and 1.150–5(b).

FOR FURTHER INFORMATION CONTACT: Rose M. Weber (202) 622-3980 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information in this rule has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under 44 U.S.C. 3507 and assigned control number 1545-1730.

The collection of information in this regulation is in §1.142(f)(4)–1. This information is required to enable the IRS to identify persons engaged in the local furnishing of electric energy or gas that use facilities financed with exempt facility bonds under section 142(a)(8) and that expand their service area in a manner inconsistent with the requirements of sections 142(a)(8) and (f) who have made an election to ensure that those bonds will continue to be treated as exempt facility bonds. The data collected will be used by the IRS as the mechanism for identifying bonds that will remain tax-exempt notwithstanding a service area expansion that is inconsistent with the requirements of sections 142(a)(8) and (f). The collection of information is mandatory. The likely respondents are business institutions.

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, W:CAR:MP:FP:S:O Washington, DC 20224. Comments on the collection of information should be received by March 19, 2001. Comments are specifically requested concerning:

Whether the collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

Estimated total annual reporting burden is 15 hours.

Estimated average annual burden hours per respondent is 1 hour.

Estimated number of respondents is 15.

Estimated annual frequency of responses is on occasion.

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

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 amends the Income Tax Regulations (26 CFR part 1) under section 141 by providing special rules for tax-exempt bonds issued for output facilities. This document also amends the Income Tax Regulations under section 142(f)(4) by providing rules to make the election provided in that section for nongovernmental persons engaged in local furnishing of electric energy or gas using facilities financed with tax-exempt bonds.

On January 22, 1998, temporary regulations (T.D. 8757, 1998–1 C.B. 775) (the 1998 temporary regulations) were published in the Federal Register (63 FR 3256) to provide guidance under the Internal Revenue Code of 1986 regarding the application of the private activity bond tests under section 141(b)(1) and (2) to output contracts for output facilities; the application of the $15 million limit under section 141(b)(4) to output facility financings; the election provided in section 142(f)(4) for nongovernmental persons engaged in local furnishing of electric energy or gas using facilities financed with tax-exempt bonds; and the filing location for certain notices and elections. A notice of proposed rulemaking (REG–110965–97, 1998–1 C.B. 793) cross-referencing the temporary regulations was published in the Federal Register on the same day (63 FR 3296). On April 28, 1998, the IRS held a public hearing on the proposed regulations. Written comments responding to the notice of proposed rulemaking were also received. After consideration of all the comments, the 1998 temporary regulations are revised by this Treasury decision. The new tempo-
Explanatory regulations are referred to below as the “revised regulations.” The revisions are discussed below.

**Explanation of Provisions**

A. Section 1.141–7T Special Rules for Output Facilities

1. **Benefits and burdens test - transmission contracts**

Under the 1998 temporary regulations, an agreement to provide firm or priority transmission services is generally treated as a take or take or pay contract. Commentators suggested that firm or priority transmission contracts should not automatically be treated as take or take or pay contracts. They recommended that the same standards that apply to determine whether generation contracts result in private business use, including the requirements contract provisions, should also apply to transmission contracts. The revised regulations adopt this recommendation by deleting the provision that generally treats all contracts for firm or priority transmission service as take or take or pay contracts.

2. **Retail requirements contracts**

The 1998 temporary regulations provide that a retail requirements contract generally meets the benefits and burdens test to the extent it obligates the purchaser to make payments that are not contingent on the purchaser’s output requirements. Commentators requested clarification regarding the application of this rule to reasonable contract damages and termination provisions. The revised regulations clarify that a retail requirements contract does not meet the benefits and burdens test if the amount of the payment is reasonably related to the purchaser’s obligation to buy requirements.

3. **Output contract properly characterized as a lease**

Under the 1998 temporary regulations, output contracts that provide the purchaser with specific rights to control the output of a facility or with other specific performance rights to the use of output of the facility are generally taken into account under the private business tests, even if the benefits and burdens test is not met. Commentators requested clarification of the scope of this rule.

The revised regulations amend the rule and clarify its application by specifying that an output contract that is properly characterized as a lease for federal income tax purposes is tested under §§1.141–3 and 1.141–4 to determine whether it is taken into account under the private business tests.

4. **Special rule for facilities with significant unutilized capacity**

The 1998 temporary regulations provide that, if an issuer reasonably expects on the issue date that persons that are treated as private business users will purchase more than 30 percent of the actual output of the facility, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate capacity, such as the average expected annual output of the facility. The revised regulations change the 30 percent threshold to 20 percent.

5. **Special rule for facilities with a limited source of supply**

Under the 1998 temporary regulations, the available output of a facility that is constrained by a limited source of supply must be determined by reasonably taking those constraints into account. Commentators requested clarification of the meaning of limited source of supply. For example, they asked whether the term includes not only physical but also economic limitations.

The revised regulations clarify that a limited source of supply includes a physical limitation, such as the flow of water, but not an economic limitation, such as the cost of coal or gas.

6. **Measurement of private business use**

The 1998 temporary regulations provide that, if an output contract results in private business use, the amount of such use generally is the capacity that must be reserved for the nongovernmental person under prudent reliability standards. Commentators stated that this provision is difficult to apply and may overstate the amount of private business use. They suggested that the amount of private business use should be the amount of output actually purchased under the contract.

The revised regulations provide that, if an output contract results in private business use, the amount of private business use generally is the amount of output purchased under the contract.

7. **Exception for small purchases of output**

The 1998 temporary regulations provide that output contracts are not taken into account under the private business tests if the purchaser is not required to make a substantially certain payment in any year that is greater than 0.5 percent of the average annual debt service on an issue that finances the facility. Some commentators suggested that this provision should be amended to take into account average annual payments under a contract, rather than payments in any one year, and that the provision should apply based on all the outstanding bonds for the facility. Other commentators stated that the exception should be eliminated as inconsistent with a competitive electric industry.

The revised regulations provide that output contracts are not taken into account under the private business tests if the average annual payments under the contract that are substantially certain to be made do not exceed 0.5 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility.

8. **Exception for short-term sales of output**

The 1998 temporary regulations provide that the exceptions for short-term use that apply to other types of arrangements under the general private activity bond rules in §1.141–3 also apply to output contracts. Many commentators suggested that these exceptions may have limited practical application in the output context and recommended that they be expanded to permit contracts of a longer duration. These commentators stated that longer-term contracts are required in order to transfer substantial benefits of ownership and substantial burdens of debt service with respect to an output facility. Other commentators suggested that any sale of output by a municipal utility outside of its traditional service territory should result in private business use.
The revised regulations provide an exception under which an output contract with a nongovernmental person will not be taken into account under the private business tests if: (1) the term of the contract, including all renewal options, does not exceed one year; (2) the compensation under the contract is based on generally applicable and uniformly applied rates or represents a negotiated, fair market price; and (3) the facility is not financed for a principal purpose of serving that nongovernmental person.

9. Special exception for sales of output attributable to excess generating capacity resulting from open access

The 1998 temporary regulations contain an exception to private business use for certain output contracts if: (1) the contract term does not exceed three years; (2) the issuer does not utilize tax-exempt financing to increase the generating capacity of its system during the contract term; (3) the governmental owner offers non-discriminatory, open access transmission tariffs under certain rules of the Federal Energy Regulatory Commission (FERC) (or comparable provisions of state law pursuant to a plan approved by the FERC); (4) all of the output sold is attributable to excess capacity resulting from the offer of the open access tariffs; (5) the contract mitigates stranded costs attributable to the open access tariffs; and (6) any stranded costs recovered by the governmental owner are applied as promptly as is reasonably practical to redeem tax-exempt bonds in a manner consistent with §1.141–12.

Comments were received regarding many of the above requirements. In particular, many commentators suggested that the maximum contract term should be extended beyond three years. Some commentators recommended eliminating the prohibition on tax-exempt financing to increase capacity during the contract term. Others suggested that de minimis capacity increases should be permitted. Some commentators suggested that the requirement that a contract mitigate stranded costs should be eliminated because the purpose of that provision is accomplished by the requirement that all of the output sold be attributable to excess capacity from open access tariffs. Some commentators recommended deleting the reference to FERC approval of state open access plans because the FERC may not approve all such plans. Other commentators requested clarification regarding the amounts that an issuer must use to redeem bonds. Finally, some commentators recommended deleting the exception entirely.

The revised regulations retain the exception, with certain modifications. First, the revised exception permits tax-exempt financing during the contract term for property that does not increase the generating capacity of the issuer’s system by more than three percent. Second, the amended exception deletes the reference to FERC approval of state open access plans. Third, the revised regulations remove the reference to stranded costs. Finally, the revised exception clarifies that the amounts that an issuer must use to redeem bonds consist of all payments that it receives under the contract, other than the portion of such payments that is properly allocable to the payment of ordinary and necessary expenses directly attributable to the operation and maintenance of the facility (as described in §1.141–4(c)(2)(C)).

10. Special exceptions for transmission facilities

The 1998 temporary regulations do not treat all use of transmission facilities pursuant to standard tariffs as general public use, but contain certain special exceptions to private business use of transmission facilities. Some commentators suggested that use of transmission facilities under standard tariffs should be treated as general public use, and therefore should never result in private business use. The revised regulations do not treat all use of transmission facilities pursuant to standard tariffs as general public use, but retain and modify the special exceptions, as discussed below.

The 1998 temporary regulations contain two special exceptions under which certain actions with respect to transmission facilities financed by an issue are not treated as deliberate actions under §1.141–2(d). The first exception provides that the execution of a contract for the use of transmission facilities is not treated as a deliberate action if the contract is entered into in response to or in anticipation of a specific order by the FERC to wheel power under sections 211 and 212 of the Federal Power Act (16 U.S.C. 824j and 824k) (or a state regulatory authority under comparable provisions of state law pursuant to a plan approved by the FERC); the terms of the contract are bona fide and arm’s-length; and the consideration paid is consistent with section 212(a) of the Federal Power Act.

Commentators suggested eliminating the requirement that orders of state regulatory authorities be undertaken pursuant to a FERC-approved state open access plan because FERC approval may not be required for all such plans. The revised regulations adopt this suggested change.

The second exception in the 1998 temporary regulations provides that an action is not treated as a deliberate action if it is taken to implement the offering of non-discriminatory, open access tariffs for the use of financed transmission facilities in a manner consistent with FERC rules, including the reciprocity conditions of FERC Order No. 888 (61 FR 21540, May 10, 1996). The exception also applies to orders and rules of state regulatory authorities pursuant to a plan approved by the FERC that are comparable to certain FERC orders and rules. The exception does not apply, however, to the sale, exchange, or other disposition of bond-financed transmission facilities to a nongovernmental person.

Commentators recommended that the exception be expanded to apply to open access tariffs that are offered under state law provisions that are comparable to FERC rules, regardless of whether those provisions are promulgated by a state regulatory authority or approved by the FERC. The revised regulations adopt this suggested change.

Commentators also requested clarification regarding the circumstances in which an independent system operator (ISO) may be treated as a private business user of transmission facilities. Some commentators suggested that the operation of transmission facilities by an ISO is a quasi-governmental function and thus should never constitute private business use. Some commentators requested clarification of whether the existing rules for management contracts under section 141 may be applied to arrangements for the operation of transmission facilities by an ISO.

The revised regulations do not provide that the operation of bond-financed transmission facilities by an ISO or other regional transmission organization (RTO) is disregarded under section 141. However, the existing rules for management contracts under section 141, including Revenue Pro-
The 1998 temporary regulations provide a special transition rule for bonds (other than advance refunding bonds) that refund bonds issued prior to July 9, 1996 (the effective date of FERC Order No. 888). Under this rule, an action taken or to be taken with respect to transmission facilities is not taken into account under the reasonable expectations test of §1.141–2(d) if the action is described in one of the two special exceptions discussed above and the weighted average maturity of the refunding bonds does not exceed the remaining weighted average maturity of the prior bonds.

Commentators recommended that the July 9, 1996, date be changed to a date on or after February 23, 1998 (the effective date of the 1998 temporary regulations). The revised regulations change the cut-off date to February 23, 1998.

Under the 1998 temporary regulations, issuers may apply the special exceptions for transmission facilities to any bonds issued before the effective date of those regulations. However, issuers may not apply the exceptions to refunding bonds issued on or after the effective date, unless the refunding bonds are subject to the 1998 temporary regulations in their entirety. Commentators suggested that, in order to encourage open access, issuers should be permitted to apply the exceptions to refunding bonds that are not otherwise subject to the regulations. The revised regulations adopt this change.

11. Definition of transmission facilities

The 1998 temporary regulations define transmission facilities to include facilities that are necessary to provide ancillary services required to be offered as part of open access transmission tariffs under FERC rules. Commentators stated that the inclusion of ancillary services within the general definition of transmission facilities creates unwarranted complexity. They recommended that facilities used for ancillary services be treated as transmission facilities only for purposes of the special exceptions for transmission facilities in the regulations. The revised regulations adopt this approach.

B. Section 1.141–8T $15 Million Limitation for Output Facilities

Under the 1998 temporary regulations, property that replaces existing property is treated as part of the same project as the replaced property unless, among other things, the bonds that finance the replaced property have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the replaced property.

One commentator noted that it is not common to allocate bonds that finance output facilities to the specific assets that comprise those facilities, and thus it may be difficult to determine whether this 120 percent requirement is met. The revised regulations amend this rule so that it applies to the entire output facility of which the replaced property is a part, rather than the specific asset being replaced.

C. Need for Temporary Regulations and Request for Public Comments

Congress passed the Energy Policy Act of 1992 to encourage restructuring of the electric power industry. Since that time, the FERC and many states have adopted policies to open up access to transmission facilities. Treasury and the IRS are aware that these initiatives are causing rapid changes in the electric power industry.

The 1998 temporary regulations were published in order to provide immediate guidance under section 141 regarding the effect on the tax-exempt status of bonds of certain restructuring transactions necessary for utilities to participate in a restructured electric utility industry. Treasury and the IRS are aware, however, that restructuring efforts are evolving and uncertain, and that new types of arrangements may be developed to implement restructuring.

Accordingly, the revised regulations are published in both temporary and proposed form in order to continue to provide guidance on which issuers can rely in evaluating their participation in open access regimes, while providing the opportunity for public comment with respect to developments in the electric power industry that have occurred since the publication of the 1998 temporary regulations. The revised regulations are published in temporary form with the expectation that the Treasury and the IRS will reexamine them in light of new developments within the next three years.

Comments are invited on whether further guidance is needed to address the new types of contractual arrangements that are arising in the electric power industry. In particular, comments are invited on whether additional guidance is needed to address the proper treatment under section 141 of output contracts for the use of transmission and distribution facilities under open access, and output contracts for ancillary services that are necessary to maintain the reliability of a transmission grid. Comments are also requested on the impact of FERC Order No. 2000 (65 FR 810, January 6, 2000) on tax-exempt bonds issued by public power systems, including whether additional guidance is needed regarding the proper treatment under section 141 of arrangements for the operation of bond-financed transmission facilities by an ISO or other RTO that satisfies the requirements of Order 2000.

Effective Dates


Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations.

It is hereby certified that the collection of information in these regulations will not have a significant impact on a substantial number of small entities. This certification is based upon the fact that in the years 1987 through 1997 a total of only 80 different state or local government issuers of exempt facility bonds issued under section 142(f)
for facilities for the local furnishing of electric energy or gas filed information returns with the IRS under section 149(e). Further, an election under section 142(f)(4) is in no event required to be filed with the Internal Revenue Service more than once. 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, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Bruce M. Serchuk, and Rose M. Weber, Office of Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service, and Stephen J. Watson, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in their development.

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 1.141–0 is amended by revising the entries for §§1.141–7T, 1.141–8T and 1.141–15T to read as follows:

§1.141–0 Table of contents.

* * * * *

§1.141–7T Special rules for output facilities (temporary).

(a) Overview.
(b) Definitions.
(1) Available output.
(2) Measurement period.
(3) Sale at wholesale.
(4) Take contract and take or pay contract.
(5) Transmission facilities.
(6) Nonqualified amount.
(c) Output contracts.
(1) General rule.
(2) Benefits and burdens test.
(3) Take contract or take or pay contract.
(4) Requirements contracts.
(5) Output contract properly characterized as a lease.
(d) Measurement of private business use.
(e) Measurement of private security or payment.
(f) Exceptions for certain contracts.
(1) Small purchases of output.
(2) Swapping and pooling arrangements.
(3) Short-term output contracts.
(4) Special 3-year exception for sales of output attributable to excess generating capacity resulting from participation in open access.
(5) Special exceptions for transmission facilities.
(6) Certain conduit parties disregarded.
(g) Allocations of output facilities and systems.
(1) Facts and circumstances analysis.
(2) Illustrations.
(3) Transmission contracts.
(4) Allocation of payments.
(h) Examples.

§1.141–8T $15 million limitation for output facilities (temporary).

(a) In general.
(1) General rule.
(2) Reduction in $15 million output limitation for outstanding issues.
(3) Benefits and burdens test applicable.
(b) Definition of project.
(1) General rule.
(2) Separate ownership.
(3) Generating property.
(4) Transmission.
(5) Subsequent improvements.
(6) Replacement property.
(c) Examples.

§1.141–15T Effective dates (temporary).

(a) through (e) [Reserved].
(f) Effective dates for certain regulations relating to output facilities.
(1) General rule.
(2) Transition rule for requirement contracts.
(3) Elective application of 1998 temporary regulations.
(g) Refunding bonds.
(h) Permissive retroactive application.
(i) Permissive retroactive application of certain regulations pertaining to output contracts.

* * * * *
Par. 3. Section 1.141–7T is revised to read as follows:

§1.141–7T Special rules for output facilities (temporary).

(a) Overview. This section provides special rules to determine whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. For this purpose, unless otherwise stated, water facilities are treated as output facilities. Sections 1.141–3 and 1.141–4 generally apply to determine whether other types of arrangements for use of an output facility cause an issue to meet the private business tests.

(b) Definitions. For purposes of this section and §1.141–8T, the following definitions and rules apply:

(1) Available output. The available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for that issue.

(ii) Generating facilities. The number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or the equivalent (or where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserves, maintenance or other unutilized capacity.

(ii) Transmission and other output facilities—(A) In general. For transmission, cogeneration, and other output facilities, available output must be measured in a reasonable manner to reflect capacity.

(B) Electric transmission facilities. Measurement of the available output of all or a portion of electric transmission facilities may be determined in a manner consistent with the reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC). For example, for a transmission network, the use of aggregate load and load share ratios in a manner consistent with the requirements of the FERC may be reasonable. In addition, depending on the facts and circumstances, measurement of the available output of transmission facilities using thermal capacity or transfer capacity may be reasonable.
(iii) Special rule for facilities with significant unutilized capacity. If an issuer reasonably expects on the issue date that persons that are treated as private business users will purchase more than 20 percent of the actual output of the facility financed with the issue, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate capacity, such as the average expected annual output of the facility. For example, the Commissioner may determine the available output of a financed peaking electric generating unit by reference to the reasonably expected annual output of that unit if the issuer reasonably expects, on the issue date of bonds that finance the unit, that an investor-owned utility will purchase more than 20 percent of the actual output of the facility during the measurement period under a take or pay contract, even if the amount of output purchased is less than 10 percent of the available output determined by reference to nameplate capacity. The reasonably expected annual output of the generating facility must be consistent with the capacity reported for prudent reliability purposes.

(iv) Special rule for facilities with a limited source of supply. If a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by reasonably taking into account those constraints. For this purpose, a limited source of supply shall include a physical limitation (for example, flow of water), but not an economic limitation (for example, cost of coal or gas). For example, the available output of a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

(2) Measurement period. The measurement period of an output facility financed by an issue is determined under §1.141–3(g).

(3) Sale at wholesale. For purposes of this section, a sale at wholesale means a sale of output to any person for resale.

(4) Take contract and take or pay contract. A take contract is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output. A take or pay contract is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output.

(5) Transmission facilities.—(i) In general. Transmission facilities are facilities for the transmission or distribution of output.

(ii) Special rule for ancillary services. For purposes of paragraph (f)(5), transmission facilities include facilities necessary to provide ancillary services required to be offered as part of open access transmission tariffs under rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e). Thus, if a facility also serves another function (for example, a facility that provides for operating reserves for transmission and also provides generation) an allocable portion of the facility is treated as a transmission facility for purposes of paragraph (f)(5) of this section.

(6) Nonqualified amount. The nonqualified amount with respect to an issue is determined under section 141(b)(8).

(c) Output contracts.—(1) General rule. The purchase by a nongovernmental person of available output of an output facility (output contract) financed with the proceeds of an issue is taken into account under the private business tests if the purchase has the effect of transferring substantial benefits of owning the facility and substantial burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the benefits and burdens test). See paragraph (c)(5) of this section for the treatment of an output contract that is properly characterized as a lease for Federal income tax purposes. See paragraphs (d) and (e) of this section for rules regarding the use of, and payments of debt service for, an output facility for determining whether the private business tests are met. See also §1.141–8T for rules for when an issue that finances an output facility (other than a water facility) meets the private business tests because the nonqualified amount of the issue exceeds $15 million.

(2) Benefits and burdens test.—(i) Benefits of ownership. An output contract transfers substantial benefits of owning a facility if the contract gives the purchaser (directly or indirectly) rights to capacity of the facility on a basis that is preferential to the rights of the general public.

(ii) Burdens of paying debt service. An output contract transfers substantial burdens of paying debt service on an issue to the extent that the issuer reasonably expects that it is substantially certain that payments will be made under the terms of the contract (disregarding default, insolvency, or other similar circumstances). For example, an output contract is treated as transferring burdens of paying debt service on an issue if payments must be made upon contract termination.

(iii) Payments pursuant to pledged contract. Payments made or to be made under the terms of an output contract that is pledged as security for an issue are taken into account under the private business tests even if the issuer reasonably expects that it is not substantially certain that payments will be made under the contract (disregarding default, insolvency, or other similar circumstances). For this purpose, an output contract is pledged as security only if the bond documents provide that the pledged contract cannot be substantially amended without the consent of bondholders or a trustee for the bondholders. This paragraph (c)(2)(iii) applies to pledges made on or after February 23, 1998, with respect to bonds that are subject to this section.

(3) Take contract or take or pay contract. The benefits and burdens test is met if a nongovernmental person agrees pursuant to a take contract or a take or pay contract to purchase available output of a facility.

(4) Requirements contracts.—(i) In general. A requirements contract under which a nongovernmental person agrees to purchase all or part of its output requirements is taken into account under the private business tests only to the extent that, based on all the facts and circumstances, the contract meets the benefits and burdens test. See §1.141–15T(f)(2) for special effective dates for the application of this paragraph (c)(4) to issues financing facilities subject to requirements contracts.

(ii) Significant factors. Significant factors that tend to establish that the benefits and burdens test is met under the rule set forth in paragraph (c)(4)(ii) of this section include, but are not limited to—

(A) The purchaser’s customer base has significant indicators of stability, such as large size, diverse composition, and a substantial residential component;

(B) The contract covers historical requirements of the purchaser, rather than only projected requirements that are in addition to historical requirements; and
(C) The purchaser agrees not to construct or acquire other power resources to meet the requirements covered by the contract.

(iii) Special rule for retail requirements contracts. In general, a requirements contract that is not a sale at wholesale (a retail requirements contract) does not meet the benefits and burdens test because the obligation to make payments on the contract is contingent on the output requirements of a single user. Such a requirements contract in general meets the benefits and burdens test, however, to the extent that it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser or that obligate the purchaser to have output requirements. For example, a requirements contract with an industrial purchaser meets the benefits and burdens test if the purchaser enters into additional contractual obligations with the issuer or another governmental unit not to cease operations. A retail requirements contract does not meet the benefits and burdens test by reason of a provision that requires the purchaser to pay reasonable and customary damages (including liquidated damages) in the event of a default, or a provision that permits the purchaser to pay a specified amount to terminate the contract while the purchaser has requirements, in each case if the amount of the payment is reasonably related to the purchaser’s obligation to buy requirements that is discharged by the payment.

(5) Output contract properly characterized as a lease. Notwithstanding any other provision of this section, an output contract that is properly characterized as a lease for Federal income tax purposes shall be tested under the rules contained in §§1.141–3 and 1.141–4 to determine whether it is taken into account under the private business tests.

(d) Measurement of private business use. If an output contract results in private business use under this section, the amount of private business use generally is the amount of output purchased under the contract.

(e) Measurement of private security or payment. The measurement of payments made or to be made by nongovernmental persons under output contracts as a percent of the debt service of an issue is determined under the rules provided in §1.141–4.

(f) Exceptions for certain contracts—(1) Small purchases of output. An output contract is not taken into account under the private business tests if the average annual payments under the contract that are substantially certain to be made under paragraph (c)(2)(i) of this section do not exceed 0.5 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

(2) Swapping and pooling arrangements. An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the output facility owned by the governmental person to the extent that—

(i) The swapped output is reasonably expected to be approximately equal in value (determined over periods of one year or less); and

(ii) The purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.

(3) Short-term output contracts. An output contract with a nongovernmental person is not taken into account under the private business tests if—

(i) The term of the contract, including all renewal options, is not longer than 1 year;

(ii) The contract either is a negotiated, arm’s-length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and

(iii) The output facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(4) Special 3-year exception for sales of output attributable to excess generating capacity resulting from participation in open access. The purchase of output of an electric generating facility by a nongovernmental person is not treated as private business use if all of the following requirements are met:

(i) The term of the contract is not longer than 3 years, including all renewal options.

(ii) The issuer does not make expenditures to increase the generating capacity of its system during the term of the contract that are, or will be, financed with proceeds of tax-exempt bonds (other than expenditures for property that does not increase the generating capacity of the system by more than 3 percent).

(iii) The governmental owner offers nondiscriminatory, open access transmission tariffs for use of its transmission system pursuant to rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e) (or comparable provisions of state law).

(iv) All of the output sold under the contract is attributable to excess capacity resulting from the offer of the non-discriminatory, open access transmission tariffs referred to in paragraph (f)(5)(iii) of this section.

(v) All payments received by the governmental owner under the contract (other than the portion of such payments described in §1.141–4(c)(2)(C)) are applied as promptly as is reasonably practical to redeem tax-exempt bonds that financed the output facility in a manner consistent with §1.141–12.

(5) Special exceptions for transmission facilities—(i) Mandated wheeling. Entering into a contract for the use of transmission facilities financed by an issue is not treated as a deliberate action under §1.141–2(d) if—

(A) The contract is entered into in response to (or in anticipation of) an order by the United States under sections 211 and 212 of the Federal Power Act (16 U.S.C. 824j and 824k) (or a state regulatory authority under comparable provisions of state law); and

(B) The terms of the contract are bona fide and arm’s length, and the consideration paid is consistent with the provisions of section 212(a) of the Federal Power Act.

(ii) Actions taken to implement non-discriminatory, open access. An action is not treated as a deliberate action under §1.141–2(d) if it is taken to implement the offering of non-discriminatory, open access tariffs for the use of transmission facilities financed by an issue in a manner consistent with rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e) (or comparable provisions of state law). This paragraph (f)(5)(ii) does not apply, however, to the sale, exchange, or other disposition of transmission facilities to a nongovernmental person.

(iii) Application of reasonable expectations test to certain current refunding bonds. An action taken or to be taken with
respect to transmission facilities refinanced by an issue is not taken into account under the reasonable expectations test of §1.141–2(d) if—

(A) The action is described in paragraph (f)(5)(i) or (ii) of this section;

(B) The bonds of the issue are current refunding bonds that, directly or indirectly, refund bonds originally issued before February 23, 1998; and

(C) The weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of those prior bonds.

(6) Certain conduit parties disregarded. A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person. Use of property by a power marketer in the trade or business of purchasing and reselling power, however, is taken into account under the private business tests.

(g) Allocations of output facilities and systems—(1) Facts and circumstances analysis. Whether output sold under an output contract is allocated to a particular facility (for example, a generating unit), to the entire system of the seller of that output (net of any uses of that system output allocated to a particular facility), or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to financed property are the following:

(i) The extent to which it is physically possible to deliver output to or from a particular facility or system.

(ii) The terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources).

(iii) Whether a contract is entered into as part of a common plan of financing for a facility.

(iv) The method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

(2) Illustrations. The following illustrate the factors set forth in paragraph (g)(1) of this section:

(i) Physical possibility. Output from a generating unit that is fed directly into a low voltage distribution system of the owner of that unit and that cannot physically leave that distribution system generally must be allocated to those receiving electricity through that distribution system. Output may be allocated without regard to physical limitations, however, if exchange or similar agreements provide output to a purchaser where, but for the exchange agreements, it would not be possible for the seller to provide output to that purchaser.

(ii) Contract terms relating to performance. A contract to provide a specified amount of electricity from a system, but only when at least that amount of electricity is being generated by a particular unit, is allocated to that unit. For example, a contract to buy 20 MW of system power with a right to take up to 40 percent of the actual output of a specific 50 MW facility whenever total system output is insufficient to meet all of the seller’s obligations generally is allocated to the specific facility rather than to the system.

(iii) Common plan of financing. A contract entered into as part of a common plan of financing for a facility generally is allocated to the facility if debt service for the issue of bonds is reasonably expected to be paid, directly or indirectly, from payments substantially certain to be made under the contract (disregarding default, insolvency, or other similar circumstances).

(iv) Pricing method. Pricing based on the capital and generating costs of a particular turbine tends to indicate that output under the contract is properly allocated to that turbine.

(3) Transmission contracts. Whether use under an output contract for transmission is allocated to a particular facility or to a transmission network is based on all the facts and circumstances, in a manner similar to paragraphs (g)(1) and (2) of this section. In general, the method used to determine payments under a contract is a more significant contract term for this purpose than nominal contract path. In general, if reasonable and consistently applied, the determination of use of transmission facilities under an output contract may be based on a method used by third parties, such as reliability councils.

(4) Allocation of payments. Payments for output provided by an output facility financed with two or more sources of funding are generally allocated under the rules in §1.141–4(c).

(h) Examples. The following examples illustrate the application of this section:

Example 1. Joint ownership. Z, an investor-owned electric utility, and City H agree to construct an electric generating facility of a size sufficient to take advantage of the economies of scale. H will issue $50 million of its 24-year bonds, and Z will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. If H’s bonds will be secured by H’s ownership interest in the facility and by revenues to be derived from its share of the annual output of the facility. H will need only 50 percent of its share of the annual output of the facility during the first 20 years of operations. It agrees to sell 10 percent of its share of the annual output to Z for a period of 20 years pursuant to a contract under which Z agrees to take that power if available. The facility will begin operation, and Z will begin to receive power, 4 years after the H bonds are issued. The measurement period for the property financed by the issue is 20 years. H also will sell the remaining 40 percent of its share of the annual output to numerous other private utilities under contracts of one year or less that satisfy the exception under paragraph (f)(3) of this section. No other contracts will be executed obligating any person to purchase any specified amount of the power for any specified period of time. No person (other than Z) will make payments substantially certain to be made (disregarding default, insolvency, or other similar circumstances) under paragraph (c)(2) of this section that will result in a transfer of substantial burdens of paying debt service on bonds used directly or indirectly to provide H’s share of the facilities. The bonds are not private activity bonds, because H’s one-third interest in the facility is not treated as used by the other owners of the facility. Although 10 percent of H’s share of the annual output of the facility will be used in the trade or business of Z, a nongovernmental person, under this section, that portion constitutes not more than 10 percent of the available output of H’s ownership interest in the facility.

Example 2. Requirements contract treated as take contract. (i) City J issues 20-year bonds to acquire an electric generating facility having a reasonably expected economic life substantially greater than 20 years and a nameplate capacity of 100 MW. The available output of the facility under paragraph (b)(1) of this section is approximately 17,520,000 MWh (100 MW X 24 hours X 365 days X 20 years). On the issue date, J enters into a contract with T, an investor-owned utility, to provide T with all of its power requirements for a period of 10 years, commencing on the issue date. J reasonably expects that T will actually purchase an average of 30 MW over the 10-year period. Based on all of the facts and circumstances, including the size, diversity, and composition of T’s customer base, J reasonably expects that it is substantially certain (disregarding default, insolvency, or other similar circumstances) that T will actually purchase only an average of 26 MW over the 10-year period. The contract is a requirements contract that must be taken into account under the private business tests pursuant to paragraph (c)(4) of this section because it provides T with substantial benefits of ownership (rights to capacity) and obligates T with substantial
burdens of making payments that the issuer reasonably expects are substantially certain.

(ii) Under paragraph (d) of this section, the amount of reasonably expected private business use under this contract is approximately 15 percent (30 MW X 24 hours X 365 days X 10 years, or 2,628,000 MWh) of the available output. Accordingly, the issue meets the private business use test. J reasonably expects that the amount to be paid for an average of 26 MW of power (less the operation and maintenance costs directly attributable to generating that 26 MW of power), will be more than 10 percent of debt service on the issue on a present-value basis. The payment for 26 MW of power is an amount that J reasonably expects is substantially certain to be made under paragraph (c)(2) of this section. Accordingly, the issue meets the private security or payment test because J reasonably expects that it is substantially certain that payment of more than 10 percent of the debt service will be indirectly derived from payments by T. The bonds are private activity bonds under paragraph (c) of this section. Further, if 15 percent of the sale proceeds of the issue is greater than $15 million and the issue meets the private security or payment test with respect to the $15 million output limitation, the bonds are also private activity bonds under section 141(b)(4). See §1.141–8T.

Example 3. Allocation of existing contracts to new facilities. Power Authority K, a political subdivision created by the legislature in State X to own and operate certain private generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in 1999, under which the four systems are required to take or pay for specified portions of the total power output until the year 2029. Existing facilities supply all of the present needs of the four utility systems, but their future power requirements are expected to increase substantially beyond the capacity of K’s current generating system. K issues 20-year bonds in 2004 to construct a large generating facility. As part of the financing plan for the bonds, a fifth private utility system contracts with K to take or pay for 15 percent of the available output of the new facility. The balance of the output of the new facility will be available for sale as required, but initially it is not anticipated that there will be any need for that power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 10 percent of the debt service on the bonds (determined on a present value basis). The balance, which will exceed 10 percent of the debt service on the bonds, will be paid from revenues derived from the contracts with the four systems initially from sale of power produced by the old facilities. The output contracts with all the private utilities are allocated to K’s entire generating system. See paragraphs (g)(1) and (2) of this section. Thus, the bonds meet the private business use test because more than 10 percent of the proceeds will be used in the trade or business of a non-governmental person that will operate those combined assets as a single, state-wide system. Municipally-owned utilities are eligible for, but are not required to participate in, the open access system implemented by the RTO. The functions of the RTO include control of transmission access and pricing, scheduling transmission, control area operations, and settlements and billing. The RTO’s compensation under its operating agreement with transmission owners is based on a share of net revenue from operating the facilities. The restructuring plan is approved by the FERC pursuant to sections 205 and 206 of the Federal Power Act.

(ii) In 1994, City D had issued bonds to finance improvements to its transmission system. In 2001, D transfers operating control of its transmission system to the RTO pursuant to the restructuring plan. At the same time, D chooses to apply the private activity bond regulations of §§1.141–1 through 1.141–15 to the 1994 bonds. The operation of the financed facilities by the RTO results in private business use under §1.141–3. Under the special exception in paragraph (f)(5) of this section, however, the transfer of control is not treated as a deliberate action. Accordingly, the transfer of control does not cause the 1994 bonds to meet the private activity bond tests.

Example 6. Current refunding. The facts are the same as in Example 5 of this paragraph (h), and in addition D issues bonds in 2003 to currently refund the 1994 bonds. The maximum average maturity of the 2003 bonds is not greater than the remaining weighted average maturity of the 1994 bonds. D chooses to apply the private activity bond regulations of §§1.141–1 through 1.141–15 to the refunding bonds. In general, reasonable expectations must be separately tested on the date that refunding bonds are issued to meet the private activity bond tests.

Par. 4. Section 1.141–8T is revised to read as follows:

§1.141–8T $15 million limitation for output facilities (temporary).

(a) In general—(1) General rule. Section 141(b)(4) provides a special private activity bond limitation (the $15 million output limitation) for issues 5 percent or more of the proceeds of which are to be used to finance output facilities (other than a facility for the furnishing of water). Under this rule, an issue consists of private activity bonds under the private business tests of section 141(b)(1) and (2) if the nonqualified amount with respect to output facilities financed by the proceeds of the issue exceeds $15 million. The $15 million output limitation applies in addition to the private business tests of section 141(b)(1) and (2).

Under section 141(b)(4) and paragraph (a)(2) of this section, the $15 million output limitation is reduced in certain cases. Specifically, an issue meets the test in section 141(b)(4) if both of the following tests are met:

(i) More than $15 million of the proceeds of the issue to be used with respect to an output facility are to be used for a private business use. Investment proceeds are disregarded for this purpose if they are not allocated disproportionately to the private business use portion of the issue.

(ii) The payment of the principal of, or the interest on, more than $15 million of the sales proceeds of the portion of the issue used with respect to an output facility is (under the terms of the issue or any underlying arrangement) directly or indirectly—

(A) Secured by any interest in an output facility used or to be used for a private business use (or payments in respect of such an output facility); or

(B) To be derived from payments (whether or not to the issuer) in respect of an output facility used or to be used for a private business use.

(2) Reduction in $15 million output limitation for outstanding issues—(i) General rule. In determining whether an issue 5 percent or more of the proceeds of which are to be used with respect to an output facility consists of private activity bonds under the $15 million output limitation, the $15 million limitation on private business
use and private security or payments is applied by taking into account the aggregate nonqualified amounts of any outstanding bonds of other issues 5 percent or more of the proceeds of which are or will be used with respect to that output facility or any other output facility that is part of the same project.

(ii) Bonds taken into account. For purposes of this paragraph (a)(2), in applying the $15 million output limitation to an issue (the later issue), a tax-exempt bond of another issue (the earlier issue) is taken into account if—

(A) That bond is outstanding on the issue date of the later issue;

(B) That bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of that bond by the later issue; and

(C) 5 percent or more of the sale proceeds of the earlier issue financed an output facility that is part of the same project as the output facility that is financed by 5 percent or more of the sale proceeds of the later issue.

(3) Benefits and burdens test applicable—(i) In general. In applying the $15 million output limitation, the benefits and burdens test of §1.141–7T applies, except that “$15 million” is substituted for “10 percent”, or “5 percent” as appropriate.

(ii) Earlier issues for the project. If bonds of an earlier issue are outstanding and must be taken into account under paragraph (a)(2) of this section, the nonqualified amount for that earlier issue is multiplied by a fraction, the numerator of which is the adjusted issue price of the earlier issue as of the issue date of the later issue, and the denominator of which is the issue price of the earlier issue. Pre-issuance accrued interest as defined in §1.148–1(b) is disregarded for this purpose.

(b) Definition of project—(1) General rule. For purposes of paragraph (a)(2) of this section, project has the meaning provided in this paragraph. Facilities that are functionally related and subordinate to a project are treated as part of that same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. For example, the following are generally not part of the same project—

(i) Generation and transmission facilities;

(ii) Separate facilities designed to serve wholesale customers and retail customers; and

(iii) A peaking unit and a baseload unit.

(2) Separate ownership. Except as otherwise provided in this paragraph (b)(2), facilities that are not owned by the same person are not part of the same project. If different governmental persons act in concert to finance a project, however (for example as participants in a joint powers authority), their interests are aggregated with respect to that project to determine whether the $15 million output limitation is met. In the case of undivided ownership interests in a single output facility, property that is not owned by different persons is treated as separate projects only if the separate interests are financed—

(i) With bonds of different issuers; and

(ii) Without a principal purpose of avoiding the limitation in this section.

(3) Generating property—(i) Property on same site. In the case of generation and related facilities, project means property located at the same site.

(ii) Special rule for generating units. Separate generating units are not part of the same project if one unit is reasonably expected, on the issue date of each issue that finances the units, to be placed in service more than 3 years before the other. Common facilities or property that will be functionally related to more than one generating unit must be allocated on a reasonable basis. If a generating unit already is constructed or is under construction (the first unit) and bonds are to be issued to finance an additional generating unit (the second unit), all costs for any common facilities paid or incurred before the earlier of the issue date of bonds to finance the second unit or the commencement of construction of the second unit are allocated to the first unit. At the time that bonds are issued to finance the second unit (or, if earlier, upon commencement of construction of that unit), any remaining costs of the common facilities may be allocated between the first and second units so that in the aggregate the allocation is reasonable.

(4) Transmission. In the case of transmission facilities, project means functionally related or contiguous property. Separate transmission facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the facilities, to be placed in service more than 2 years before the other.

(5) Subsequent improvements—(i) In general. An improvement to generating or transmission facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service.

(ii) Special rule for transmission facilities. An improvement to transmission facilities that is not part of the original design of that property is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction, or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

(6) Replacement property. For purposes of this section, property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless—

(i) The need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property; and

(ii) The bonds that finance (and refinance) the output facility have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the facility.

(c) Example. The application of the provisions of this section is illustrated by the following example:

Example. (i) Power Authority K, a political subdivision, intends to issue a single issue of tax-exempt bonds at par with a stated principal amount and sale proceeds of $500 million to finance the acquisition of an electric generating facility. No portion of the facility will be used for a private business use, except that L, an investor-owned utility, will purchase 10 percent of the output of the facility under a take contract and will pay 10 percent of the debt service on the bonds. The nonqualified amount with respect to the bonds is $50 million.

(ii) The maximum amount of tax-exempt bonds that may be issued for the acquisition of an interest in
the facility in paragraph (i) of this Example is $465 million (that is, $450 million for the 90 percent of the facility that is governmentally owned and used plus a nonqualified amount of $15 million).

Par. 5. Section 1.141–15 is amended by revising paragraphs (c), (d) and (e) to read as follows:

§1.141–15 Effective dates.

* * * * *

(c) Refunding bonds. Sections 1.141–1 through 1.141–6(a), 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in §1.150–1(b) do not apply to any bonds issued on or after May 16, 1997, to refund a bond to which those sections do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds; or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(d) Permissive application of regulations. Except as provided in paragraph (e) of this section, §§1.141–1 through 1.141–6(a), 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in §1.150–1(b) may be applied in whole, but not in part, to actions taken before February 23, 1998, with respect to—

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997, that are subject to section 141.

(e) Permissive application of certain sections. The following sections may each be applied to any bonds—

(1) Section 1.141–3(b)(4);

(2) Section 1.141–3(b)(6); and

(3) Section 1.141–12.

Par. 6. Section 1.141–15T is revised to read as follows:

§1.141–15T Effective dates (temporary).

(a) through (e) [Reserved]. For further guidance see §1.141–15.

(f) Effective dates for certain regulations relating to output facilities—(1) General rule. Except as otherwise provided in this section, §§1.141–7T and 1.141–8T apply to bonds sold on or after January 19, 2001, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(2) Transition rule for requirements contracts. For bonds otherwise subject to §§1.141–7T and 1.141–8T, §1.141–7T(c)(4) applies to output contracts entered into on or after February 23, 1998. An output contract is treated as entered into on or after that date if its term is extended, the parties to the contract change, or other material terms are amended on or after that date. For purposes of this paragraph (f)(2)—

(i) The extension of the term of a contract causes the contract to be treated as entered into on the first day of the additional term;

(ii) The exercise by a party of a legally enforceable right that was provided under a contract before February 23, 1998, on terms that were fixed and determinable before such date, is not treated as an amendment of the contract. For example, the exercise by a purchaser after February 23, 1998, of a renewal option that was provided under a contract before that date, on terms identical to the original contract, is not treated as an amendment of the contract;

(iii) An amendment that reduces the term of a contract, or the amount of requirements covered by a contract, is not, in and of itself, material.


(g) Refunding bonds in general. Except as otherwise provided in paragraph (h) or (i) of this section, §§1.141–7T and 1.141–8T do not apply to any bonds sold on or after January 19, 2001, to refund a bond to which §§1.141–7T and 1.141–8T do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds;

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(h) Permissive retroactive application. Except as provided in §1.141–15(d) or (e) or paragraph (i) of this section, §§1.141–1 through 1.141–6, 1.141–7T through 1.141–8T, 1.141–9 through 1.141–14, 1.145–1 through 1.145–2, 1.150–1(a)(3) and the definition of bond documents contained in §1.150–1(b) may be applied in whole, but not in part to—

(1) Outstanding bonds that are sold before January 19, 2001, and subject to section 141; or

(2) Refunding bonds sold on or after January 19, 2001, that are subject to section 141.

(i) Permissive application of certain regulations pertaining to output contracts. Section 1.141–7T(f)(4) and (5) may be applied to any bonds.

Par. 7. Section 1.142(f)(4)–1 is added to read as follows:

§1.142(f)(4)–1 Manner of making election to terminate tax-exempt bond financing.

(a) Overview. Section 142(f)(4) permits a person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and that expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and (f) to make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must meet the requirements of paragraphs (b) and (c) of this section.

(b) Time for making election—(1) In general. An election under section 142(f)(4)(B) must be filed with the Internal Revenue Service on or before 90 days after the date of the service area expansion that causes bonds to cease to meet the requirements of sections 142(a)(8) and (f).
(2) Date of service area expansion. For the purposes of this section, the date of the service area expansion is the first date on which the local furnisher is authorized to collect revenue for the provision of service in the expanded area.

(c) Manner of making election. An election under section 142(f)(4)(B) must be captioned “ELECTION TO TERMINATE TAX-EXEMPT BOND FINANCING”, must be signed under penalties of perjury by a person who has authority to sign on behalf of the local furnisher, and must contain the following information—

1. The name of the local furnisher;
2. The tax identification number of the local furnisher;
3. The complete address of the local furnisher;
4. The date of the service area expansion;
5. Identification of each bond issue subject to the election, including the complete name of each issue, the tax identification number of each issuer, the CUSIP number (if any) of the bond with the latest maturity of each issue, the issue price of each issue, the adjusted issue price of each issue as of the date of the election, the earliest date on which the bonds of each issue may be redeemed, and the principal amount of bonds of each issue to be redeemed on the earliest redemption date;
6. A statement that the local furnisher making the election agrees to the conditions stated in section 142(f)(4)(B); and
7. A statement that each issuer of the bonds subject to the election has received written notice of the election.

(d) Effect on section 150(b). Except as provided in paragraph (e) of this section, section 150(b) does not apply to bonds identified in the election during and after that period.

(e) Effect of failure to meet agreements. If a local furnisher fails to meet any of the conditions stated in an election pursuant to paragraph (c)(6) of this section, the election is invalid.

(f) Corresponding provisions of the Internal Revenue Code of 1954. Section 103(b)(4)(E) of the Internal Revenue Code of 1954 set forth corresponding requirements for the exclusion from gross income of the interest on bonds issued for facilities for the local furnishing of electric energy or gas. For the purposes of this section any reference to sections 142(a)(8) and (f) of the Internal Revenue Code of 1986 includes a reference to the corresponding portion of section 103(b)(4)(E) of the Internal Revenue Code of 1954.

(g) Effective dates. This section applies to elections made on or after January 19, 2001.

§1.142(f)(4)–1T [Removed]
Par. 8. Section 1.142(f)(4)–1T is removed.

§1.142[f](4)–1T [Removed]
Par. 9. Section 1.142–2(c)(2).

§1.150–5T [Removed]
Par. 10. Section 1.150–5T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority for part 602 continues to read as follows:
Par. 12. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:
§602.101 OMB Control numbers.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.


Jonathan Talisman,
Assistant Secretary of the Treasury.

(Revised by the Office of the Federal Register on January 17, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 18, 2001, 66 F.R. 4661)
Part III. Administrative, Procedural, and Miscellaneous

Form 7004—Research Credit Suspension Period

Notice 2001–29

In Notice 2001–2, 2001–2 I.R.B. 265, the Internal Revenue Service provided guidance to help taxpayers compute and report their credit for increasing research activities (research credit) under § 41 of the Internal Revenue Code for taxable years that include the research credit suspension periods described in § 502(d)(2) of the Tax Relief Extension Act of 1999, Pub. L. No. 106-170 (the Act). This notice provides additional guidance to corporate taxpayers that may request extensions of time to file their income tax returns for taxable years that include expired research credit suspension periods.

Section 502(d) of the Act provides that, for purposes of the Code, any research credit attributable to the period beginning on July 1, 1999, and ending on September 30, 2000, that is otherwise allowable under the Code, may not be taken into account prior to October 1, 2000. Further, any research credit attributable to the period beginning on October 1, 2000, and ending on September 30, 2001, that is otherwise allowable under the Code, may not be taken into account prior to October 1, 2001.

Notice 2001–2 provides that, for the Service to administer § 502(d) of the Act properly, research credits attributable to a research credit suspension period may not be used as a credit against tax on a timely filed or late filed original return for a taxable year that includes any part of that suspension period even if that original return is filed after the expiration of the suspension period. The research credit attributable to a suspension period may be taken into account after the close of that period as a credit against tax for a taxable year that includes any part of that suspension period after filing a Form 1045, Application for Tentative Refund, or a Form 1139, Corporation Application for Tentative Refund, or by filing an amended income tax return (Form 1040X, Form 1120X, or other amended return) on or after the date the taxpayer files an original return for the applicable tax year. Further, after the close of the applicable research credit suspension period, taxpayers may use research credits attributable to a suspension period as an adjustment to estimated taxes.

Under § 1.6081–3 of the Income Tax Regulations, a 6-month extension of time to file a corporate income tax return is granted automatically, if a corporation properly files a completed Form 7004, Application for Automatic Extension of Time to File Corporation Income Tax Return, and pays the balance due on line six of the form by the due date of the return for which the extension applies. Because Notice 2001–2 provides that research credits attributable to a research credit suspension period may not be used as a credit against tax on a timely filed or late filed original return for a taxable year that includes any part of the suspension period, a taxpayer seeking to obtain an extension of time for filing a corporate income tax return by filing Form 7004 may indicate a balance due on that form. Any balance due that is attributable to a research credit suspension period that ended on or before the close of the taxable year will be eliminated when the taxpayer files its Form 1139 or its amended income tax return to claim its research credit for the suspension period that ended on or before the close of the taxable year. Therefore, if a taxpayer is otherwise eligible for an extension of time to file its return and shows a balance due that relates to the research credit attributable to a suspension period that ended before the close of the applicable taxable year, the taxpayer may file a Form 7004 without paying that balance. Taxpayers should file the Form 7004, with the statement “Research Credit Suspension Period” indicated at the top of the form.

For example, assume that a calendar-year corporation expects that it will have at least 800x dollars of research credit for the taxable year ending December 31, 2000. The amount of research credit attributable to the period from January 1 through September 30, 2000, would be 600x dollars (9/12 x 800x dollars). Taxpayer’s 600x dollars of research credit attributable to the period January 1 through September 30, 2000, may not be taken into account in determining any of the estimated tax payments that are due before October 1, 2000. The taxpayer’s first estimated tax payment due on or after October 1, 2000, is the payment due on December 15, 2000. Taxpayer reduced the amount of its estimated tax payments otherwise required to be paid on December 15, 2000, by 600x dollars, the amount equal to its 600x dollars of research credit attributable to the period January 1 through September 30, 2000, and available for use on October 1, 2000.

For its taxable year ending December 31, 2000, taxpayer wants an extension of time to file its corporation income tax return. Taxpayer’s Form 7004 shows a balance due of 600x dollars, the amount of its research credit attributable to the first suspension period that ended on September 30, 2000. Taxpayer files the Form 7004 on March 15, 2001, showing a balance due of 600x dollars and indicating at the top “Research Credit Suspension Period.” Because taxpayer’s 600x dollar balance due for the taxable year ending December 31, 2000, results from research credits for the taxable year that are attributable to the first suspension period that ended on September 30, 2000, the extension will be granted automatically.

DRAFTING INFORMATION

The principal author of this notice is Lisa J. Shuman of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Shuman at (202) 622-3120 (not a toll-free call).

Disaster Relief for Taxpayers Affected by the Cerro Grande Fire

Notice 2001–30

Purpose

This notice provides tax relief under sections 6081, 6161, 6404(h), 6465(e)(3), and 7508A of the Internal Revenue Code for taxpayers affected by the Cerro Grande Fire, which burned more than 40,000 acres in New Mexico in 2000. This fire started on May 4, 2000, when the National Park Service initiated a pre-
scribed burn at Bandelier National Monument in New Mexico. The President issued a federal disaster declaration on May 13, 2000. The declaration covers 21 New Mexico counties: Los Alamos, Rio Arriba, Sandoval, Santa Fe, Bernalillo, Cibola, McKinley, Mora, San Juan, San Miguel, Taos, Chaves, DeBaca, Dona Ana, Eddy, Guadalupe, Lincoln, Otero, Sierra, Socorro, and Torrance ("affected counties"). These counties constitute a "covered disaster area" within the meaning of section 301.7508A–1(d)(2) of the Procedure and Administration Regulations.

SUMMARY OF RELIEF

(1) Individuals located in the affected counties and other individuals who are "affected taxpayers" as defined by section 301.7508A–1(d)(1) of the regulations will have a postponement to January 16, 2002, to file certain federal tax returns for calendar year 2000 that would otherwise be due on April 16, 2001 (April 15, 2001, is a Sunday). A postponement to January 16, 2002, is also granted to pay the amount of tax (or any installment of tax) shown or required to be shown on those returns. These returns include individual income tax returns (Forms 1040, 1040A, 1040EZ, 1040NR, or 1040NR-EZ) and gift tax returns (Forms 709 and 709-A). See section 301.7508A–1(c)(1) for a list of affected returns.

(2) Interest (and penalties relating to a failure to timely file or pay) will be abated through January 16, 2002, with respect to individual income tax returns for calendar year 2000 originally due on April 16, 2001, for individuals located in the affected counties and other individuals who are "affected taxpayers" as defined by section 301.7508A–1(d)(1).

(3) Affected taxpayers as defined by section 301.7508A–1(d)(1) of the regulations are granted both a 90 day postponement under section 7508A and a six month extension under sections 6081 and 6161 to file certain federal tax returns otherwise due on or after May 4, 2000, and on or before April 16, 2001, and to pay the tax shown or required to be shown on those returns. These returns include partnership returns, corporate income tax returns, estate and trust income tax returns, estate tax returns, annual returns filed by tax-exempt organizations, certain excise tax returns and employment tax returns. See section 301.7508A–1(c)(1) for a list of affected returns.

(4) The due date of any estimated tax payment originally due on or after May 4, 2000, and on or before April 16, 2001, for taxpayers located in the affected counties, and other affected taxpayers, is postponed by 90 days and extended by an additional six months. This applies to estimated tax payments made by individuals, corporations, estates, and trusts. Individuals, trusts, and calendar year corporations will not be subject to penalties for failure to pay estimated tax installments for 2000 with respect to installments that were originally due on or after May 4, 2000. Individuals, estates, trusts, and calendar year corporations will not be subject to penalties with respect to the estimated tax installment due for 2001 that was originally due on or before April 16, 2001, as long as the installment is paid by January 16, 2002. Fiscal year corporations and estates will not be subject to penalties for failure to pay estimated tax installments due on or after May 4, 2000, and on or before April 16, 2001, as long as such installments are paid by the extended and postponed due date.

(5) In addition the Internal Revenue Service has granted a 90 day postponement of time to the "affected taxpayers" to perform the other acts described in section 301.7508A–1(c)(1) of the regulations, including the making of contributions to certain pension plans and individual retirement accounts. The postponement applies to acts required to be performed within the period beginning on the date of the fire (May 4, 2000) and ending on April 16, 2001.

BACKGROUND

Section 6081 of the Code provides that if the Secretary grants a reasonable extension of time (generally not to exceed 6 months) for filing any return, declaration, statement, or other document required by the Internal Revenue Code or by regulations thereunder. Section 6161 of the Code provides that the Secretary may grant a reasonable extension of time (generally not to exceed 6 months) for paying the amount (or any installments) of tax shown or required to be shown on any return or declaration required by the Code or by regulations thereunder.

Section 7508A of the Code provides the Secretary with authority to postpone the time for performing certain acts under the internal revenue laws for a taxpayer affected by a Presidentially declared disaster as defined in section 103(h)(3). Pursuant to section 7508A(a) and section 301.7508A–1 of the regulations, a period of up to 90 days may be disregarded in determining whether the performance of certain acts is timely under the internal revenue laws. Section 301.7508A–1(c)(1) lists seven acts performed by taxpayers for which section 7508A relief may apply. Among these acts are the filing of certain tax returns; the payment of certain taxes; the making of contributions to certain pension plans and individual retirement accounts; the filing of a Tax Court petition; the filing of a claim for credit or refund of tax; and the bringing of a lawsuit upon a claim for credit or refund of tax. Section 301.7508A–1(c)(1) describes the seven types of "affected taxpayers" eligible for the 90 day postponement. These taxpayers include, among others, any individual whose principal residence, and any business entity whose principal place of business, is located in the covered disaster area.

Section 6404(h) of the Code provides that if the Secretary extends for any period the time for filing income tax returns under section 6081 and the time for paying income tax with respect to such returns under section 6161 for taxpayers located in a Presidentially declared disaster area, the Secretary shall abate for such period the assessment of any interest prescribed under section 6601 on such income tax. Section 301.7508A–1(f) provides that if there is both a postponement under section 7508A and extensions of time to file the return and pay the tax under sections 6081 and 6161, interest will be abated under section 6404(h) for the period of time disregarded under section 7508A in addition to the period of time covered by the filing and payment extensions.

GRANT OF RELIEF

The Internal Revenue Service, by the exercise of its authority under section 7508A of the Code, has granted a 90 day postponement of time to taxpayers af-
fected by the Cerro Grande Fire to per-
form the acts specified in section
301.7508A–1(c)(1) of the regulations.
The postponement applies to acts required
to be performed within the period begin-
ning on the date of the fire (May 4, 2000)
and ending on April 16, 2001.

In addition, the Internal Revenue Ser-
vice has granted an extension of time to
file returns under section 6081 of the
Code and to pay tax under section 6161.
In particular, individual income tax re-
turns for calendar year 2000 originally
due on April 16, 2001, are postponed and
extended until January 16, 2002 (90 days
plus six months from April 16, 2001).
Further, payments of tax (or any install-
ments of tax) shown or required to be
shown on those returns are correspond-
ingly postponed and extended until Janu-
ary 16, 2002. Income tax returns of tax-
payers other than individuals, and returns
other than income tax returns, originally
due on or after May 4, 2000, and on or be-
fore April 16, 2001, are also postponed
and extended for a period of 90 days plus
six months.

Further, pursuant to sections 6404(h)
and 7508A of the Code and section
301.7508A–1(f) of the regulations, the In-
ternal Revenue Service will abate the as-
sessment of any interest on income tax li-
abilities due under section 6601 for the
period of time disregarded under section
7508A and the period of time covered by
the filing and payment extensions under
sections 6081 and 6161. Also, penalties
relating to a failure to timely file or pay
will be waived for the period of time dis-
regarded under section 7508A and the pe-
riod of time covered by the filing and pay-
ment extensions.

Taxpayers filing for relief under this
notice should mark “Cerro Grande Fire”
in red ink on the top of their return.

DRAFTING INFORMATION

The principal author of this notice is
Charles Hall of the Office of Associate
Chief Counsel, Procedure and Adminis-
tration (Administrative Provisions and Ju-
dicial Practice Division). For further in-
formation regarding this notice, contact
Charles Hall at (202) 622-4940 (not a toll-
free call).
**Part IV. Items of General Interest**

**Partial Withdrawal of Notice of Proposed Rulemaking; Notice of Proposed Rulemaking by CrossReference to Temporary Regulations; and Notice of Public Hearing**

**Obligations of States and Political Subdivisions**

**REG–114998–99**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking; notice of proposed rulemaking by cross-reference to temporary regulations; and notice of public hearing.

SUMMARY: This document withdraws portions of the notice of proposed rulemaking published in the Federal Register on January 22, 1998. In T.D. 8941 on page 977 of this Bulletin, the IRS is issuing temporary regulations that provide guidance to state and local governments that issue bonds for output facilities. The text of those temporary regulations also serves as the text of these proposed regulations. This document provides a notice of public hearing on these proposed regulations.

DATES: Written comments must be received by July 18, 2001. Outlines of topics to be discussed at the public hearing scheduled for July 24, 2001, at 10 a.m. must be received by July 3, 2001.

ADDRESSSES: Send submissions to: CC:M&SP:RU (REG–114998–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–114998–99), courier’s desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslist.html. The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Rose M. Weber, (202) 622-3980; concerning submissions and the hearing, Treena Garrett, (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

Proposed regulations (REG–110965–97, 1998–1 C.B. 793) §§1.141–7, 1.141–8 and 1.141–15(f) through (i), published on January 22, 1998 (63 FR 3296), addressed the application of the private activity bond tests of section 141(b) (1) and (2) to output contracts for output facilities and the application of the $15 million limitation under section 141(b)(4) to output facility financings. These proposed sections are withdrawn.

Sections 1.141–7T, 1.141–8T and 1.141–15T published in T.D. 8941 are issued to provide guidance on certain aspects of the private activity bond restrictions under section 141 of the Internal Revenue Code.

The text of the 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 Executive Order 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) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. 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 July 24, 2001, 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 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 July 18, 2001, and submit an outline of the topics to be discussed and the time to be devoted to each topic by July 3, 2001.

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.

**Drafting Information**

The principal authors of these regulations are Bruce M. Serchuk, and Rose M. Weber, Office of Chief Counsel (Tax Exempt and Government Entities), Internal Revenue Service, and Stephen J. Watson, Office of Tax Legislative Counsel, Department of the Treasury. However, other personnel from the IRS and Treasury Department participated in their development.

**Partial Withdrawal of Notice of Proposed Rulemaking**

Under the authority of 26 U.S.C. 7805, §§1.141–7, 1.141–8 and 1.141–15(f) through (i) in the notice of proposed rulemaking that was published on January 22, 1998 (63 FR 3256) are withdrawn.

**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:
posed regulations would provide qualified covered call rules. The proposed regulations provide guidance to taxpayers writing equity call options. This document also provides notice of public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to appear and outlines of topics to be discussed at the public hearing scheduled for May 9, 2001, at 10 a.m., must be submitted by April 18, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–115560–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–115560–99), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “TaxRegs” option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regulist.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Pamela Lew, (202) 622-3950; concerning submissions and the hearing, Guy Traynor, (202) 622-7180, (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On June 25, 1998, the IRS published in the Federal Register proposed regulations (REG–104641–97, 1998–2 C.B. 75 [63 FR 34616]) addressing whether strike prices available for equity options with flexible terms affect the definition of a qualified covered call (QCC) under section 1092(c)(4) for equity options with standardized terms. No requests to speak at a public hearing were received, and no public hearing was held.

The proposed regulations provided that strike prices available for equity options with flexible terms do not affect the benchmark marks used to determine whether equity options with standardized terms are eligible for QCC treatment. That provision was adopted as §1.1092(c)–1 of the final regulations (T.D. 8866, 2000–6 I.R.B. 495), published in the Federal Register for January 25, 2000 (65 F.R. 3812).

The regulatory text of REG–104641–97 did not address whether an equity option with flexible terms is itself eligible for QCC treatment. The preamble to the proposed regulations, however, did request comments about whether equity options with flexible terms should be eligible for QCC treatment and, if eligible, what benchmark should apply. In light of the comments received, consideration was also given to the treatment of over-the-counter options and standardized options with terms of more than one year. After consideration of the written comments, this NPRM proposes regulations addressing the eligibility for QCC treatment of equity options with flexible terms, over-the-counter options and standardized options with terms longer than one year.
Section 1092(c)(4)(H) grants the Secretary of the Treasury the authority to prescribe regulations to carry out the purposes of the QCC exception, including regulations modifying the provisions of the exception as appropriate to take account of changes in the practices of options exchanges.

The introduction of exchange-traded equity options with flexible terms is one such change. Unlike equity options with standardized terms, equity options with flexible terms can have strike prices at other than fixed intervals and have other than standardized expiration dates. Options exchanges have also introduced standardized options with longer terms.

In response to the request for comments, two comments were received. One commentator argued that equity options with flexible terms should not be eligible for QCC treatment. This commentator noted that in 1984, when section 1092(c)(4) was enacted, only equity options with standardized terms were traded on the national exchanges and that it is likely that Congress did not intend to include customizable options within the definition of a QCC. This commentator also pointed out that equity options with flexible terms were developed to compete with over-the-counter (OTC) options, which are not eligible for QCC treatment. The commentator suggested that excluding equity options with flexible terms from QCC treatment would avoid a competitive imbalance from different tax treatment for competing products.

The second commentator stated that, as a matter of statutory analysis, equity options with flexible terms are already eligible for QCC treatment. This commentator argued that QCC treatment is appropriate if the taxpayer is using the option to increase the yield on its stock investment and not to reduce the risk of loss on its stock. In support of this point, the commentator noted that nothing in the applicable legislative history suggests that Congress intended to limit the QCC option exception to standardized options. Alternatively, this commentator argued that because equity options with flexible terms were designed to compete with OTC options, regulations should be promulgated allowing OTC options to qualify for QCC treatment on the same terms as exchange-traded equity options with flexible terms.

**Explanation of Provisions**

**Equity Options with Flexible Terms and Qualifying OTC Options**

After consideration of the comments received, the proposed regulations provide that equity options with flexible terms may be QCC options as long as they satisfy the general rules for QCC treatment described in section 1092(c)(4), are not for a term of longer than one year, and meet other specified requirements. In addition, an equity option with standardized terms must be outstanding for the underlying equity. For purposes of applying the general rules, the bench marks will be the same as those for an equity option with standardized terms on the same stock having the same applicable stock price.

The proposed regulations also provide that certain OTC options may be QCC options so that OTC options that are economically similar to equity options with flexible terms may enjoy the same tax benefits as equity options with flexible terms. Specifically, the proposed regulations provide that an OTC option is eligible for QCC treatment if it is entered into with a person registered with the Securities and Exchange Commission as a broker-dealer or alternative trading system and meets the same requirements for QCC treatment that apply to equity options with flexible terms.

**QCC Status for Equity Options with Standardized Terms**

In the process of considering the proper treatment for equity options with flexible terms, the IRS examined QCC status in general. At the time that Congress enacted section 1092(c)(4), options available on the national securities exchanges had a term of nine months or less. Congress did not include in the legislative history any guidance on the effect of the time value of money upon the strike price.

Subsequent to the enactment of section 1092(c)(4), the national securities exchanges began offering certain standardized options with expiration dates that are 12 or more months after the date entered into. The longer term of these options may reduce the taxpayer’s risk of loss on its stock position because of the time period involved.

Increased risk reduction through the use of long term options applies equally to equity options with flexible terms, OTC options, and equity options with standardized terms. The proposed regulations therefore provide that a one-year term limit also applies to equity options with standardized terms. Comments are requested on this issue, including a discussion of time limitations in general, as well as the appropriateness of a one-year cutoff.

If QCC treatment should apply to longer-term options, it may be appropriate to change the deep-in-the-money standard to prevent the increase in risk reduction. A comment recommending a time limitation greater than one year or recommending that there be no time limitation should also provide detailed, comprehensive descriptions of possible solutions to the problem of increased risk reduction. Comments should also address the administrability of any proposed solutions.

**Proposed Effective Date**

These regulations would apply to options entered into on or after 30 days after the date that the Treasury decision adopting these rules as final regulations is published in the Federal Register. Regulations concerning time limitations for equity options with standardized terms would be prospective in nature and would apply to transactions entered into on or after 90 days from the date of publication of the final regulation promulgating such rules.

**Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 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 upon the fact that these regulations do not impose any recordkeeping or reporting requirements and therefore impose minimal compliance costs, if any, upon any small entities that may be affected. Because equity options with standardized terms will not be eligible for QCC treatment if such options have a duration of more than one year, some
taxpayers may lose substantive tax benefits. This certification is further based upon the understanding that such taxpayers will not include a substantial number of small entities. Comments are specifically requested on the question of whether a substantial number of small entities (as opposed to large entities or individual investors) will suffer a significant economic impact under these regulations. 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, 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 or electronic comments (a signed original and eight (8) copies, if written) that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. The IRS and Treasury request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 9, 2001, at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington DC. Due to building security procedures, visitors must enter at the 10th Street entrance located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identifications to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

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 and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 18, 2001. 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.

Drafting Information

The principal author of these regulations is Pamela Lew, Office of Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

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 1.1092(c)–2 also issued under 26 U.S.C. 1092(c)(4)(H)

Section 1.1092(c)–3 also issued under 26 U.S.C. 1092(c)(4)(H).* * *

Par. 2. Section 1.1092(c)–1 is amended as follows:

1. Paragraphs (b) and (d)(1)(i) introductory text are revised.
2. Paragraphs (c) and (d)(3) are added.
3. Paragraph (e) is revised.

The revisions and addition read as follows:

§1.1092(c)–1 Equity options with flexible terms.

* * * * *

(b) No effect on lowest qualified bench mark for standardized options. The availability of strike prices for equity options with flexible terms does not affect the determination of the lowest qualified bench mark, as defined in section 1092(c)(4)(D), for an equity option with standardized terms.

(c) Qualified covered call option status—(1) Requirements. An equity option with flexible terms is a qualified covered call option only if—

(i) The option meets the requirements of section 1092(c)(4)(B) (taking into account paragraph (c)(2) of this section);

(ii) The only payments permitted with respect to the option are a single fixed premium paid not later than 5 business days after the day on which the option is granted, and a single fixed strike price stated as a dollar amount that is payable entirely at (or within 5 business days of) exercise;

(iii) The option is granted not more than 1 year before the day on which the option expires; and

(iv) An equity option with standardized terms is outstanding for the underlying equity.

(2) Lowest qualified bench mark—(i) In general. For purposes of determining whether an equity option with flexible terms is deep in the money within the meaning of section 1092(c)(4)(C), the lowest qualified bench mark under section 1092(c)(4)(D) is the same for an equity option with flexible terms as the lowest qualified bench mark for an equity option with standardized terms on the same stock having the same applicable stock price.

(ii) Example. The following example illustrates the rules set out in paragraph (c)(2)(i) of this section:

Example. Taxpayer owns stock in Corporation X. Taxpayer writes an equity call option with flexible terms on Corporation X stock through a national securities exchange. The applicable stock price for Corporation X stock is $73.75. Using the benchmark marks for an equity option with standardized terms with an applicable stock price of $73.75, the highest available benchmark mark less than the applicable stock price is $70, and the second highest benchmark mark is $65. Therefore, an equity call option with flexible terms on Corporation X with a term of 90 days or less will not be deep in the money if the strike price is not less than $70. If the term is greater than 90 days, an equity call option with flexible terms on Corporation X will not be deep in the money if the strike price is not less than $65.

(d) * * *

(1) * * *

(ii) That is traded on any national securities exchange which is registered with the Securities and Exchange Commission (other than those described in the SEC Releases set forth in paragraph (d)(1)(i) of this section) and is—

* * * * *

(3) Equity option with standardized terms means an equity option that is traded on a national securities exchange registered with the Securities and Ex-
change Commission and that is not an equity option with flexible terms.

(e) Effective date—(1) In general. Except as provided in paragraph (e)(2) of this section, this section applies to equity options with flexible terms entered into on or after January 25, 2000.

(2) Special effective date for paragraph (c). Paragraph (c) of this section applies to equity options with flexible terms entered into on or after 30 days after the date that the Treasury decision adopting these regulations is published in the Federal Register.

Par. 3. Section 1.1092(c)-2 is added to read as follows:

§1.1092(c)-2 Equity options with standardized terms.

(a) One-year limitation. An equity option with standardized terms (as defined in §1.1092(c)-1(d)(3)) is a qualified covered call only if—

(1) The option meets the requirements of section 1092(c)(4)(B); and

(2) The option is granted not more than 1 year before the day on which the option expires.

(b) Effective date. This section applies to equity options with standardized terms entered into on or after 90 days after the date that the Treasury decision adopting these regulations is published in the Federal Register.

Par. 4. Section 1.1092(c)-3 is added.

§1.1092(c)-3 Qualifying over-the-counter options.

(a) In general. Under section 1092(c)(4)(B)(i), an equity option is not a qualified covered call option unless it is traded on a national securities exchange registered with the Securities and Exchange Commission or other market which the Secretary determines has rules adequate to carry out the purposes of section 1092(c)(4). In accordance with section 1092(c)(4)(H), this requirement is modified as provided in paragraph (b) of this section.

(b) Qualified covered call option status. A qualifying over-the-counter option is a qualified covered call option if it meets the requirements of §1.1092(c)-1(c) after substituting “qualifying over-the-counter option” for “equity option with flexible terms”. For the purposes of this paragraph (b), a qualifying over the counter option is deemed to satisfy the requirements of section 1092(c)(4)(B)(i).

(c) Qualifying over-the-counter option. For the purposes of this section, qualifying over-the-counter option means an equity option that—

(1) Is not traded on a national securities exchange registered with the Securities and Exchange Commission; and

(2) Is entered into with a person registered with the Securities and Exchange Commission as—

(i) A broker-dealer under section 15 of the Securities Act of 1934 and the regulations thereunder; or

(ii) An alternative trading system under 17 CFR 242.300 et seq.

(d) Effective date. This section applies to qualifying over-the-counter options entered into on or after 90 days after the date that the Treasury decision adopting these regulations is published in the Federal Register.

Robert E. Wenzel, Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on January 17, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 18, 2001, 66 F.R. 4751)

Notice of Proposed Rulemaking and Notice of Public Hearing

Clariﬁcation of Entity Classiﬁcation Rules

REG-101739-00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document proposes regulations under section 7701 that address the Federal tax classification of a business entity wholly owned by a foreign government and provide that a nonbank entity that is wholly owned by a foreign bank cannot be disregarded as an entity separate from its owner (disregarded entity) for purposes of applying the special rules of the Internal Revenue Code applicable to banks. This document also proposes regulations under section 892 that provide that a partnership can be a controlled commercial entity for purposes of section 892(a)(2)(B). In addition, this document provides notice of a public hearing on the proposed regulations.

DATES: Written comments and outline of topics to be discussed at the public hearing scheduled for May 16, 2001, must be received by April 25, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–101739–00), room 5226, 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:M&SP:RU (REG–101739–00), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.gov/tax_regs/regslist.html. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Camille B. Evans, (202) 622-3860 (not a toll-free number); concerning submissions and the hearing, Sonya M. Cruse, (202) 622-7180 (not a toll-free number).

SUPPLEMENTAL INFORMATION:

Background and Purpose

On December 18, 1996, the IRS and the Treasury Department published the elective regime under section 7701 known as the check-the-box regulations (T.D. 8697, 1997–1 C.B. 215 [61 FR 66584]). Generally, the check-the-box regulations allow any business entity to elect to be treated for Federal tax purposes as a corporation, a partnership (if it has two or more members), or a disregarded entity (if it has a single owner). This document proposes to amend the current Procedure and Administration Regulations (26 CFR Part 301) to address the treatment of an entity wholly owned by a foreign government (as defined in §1.892–2T) and a nonbank entity wholly owned by a foreign bank.

This document also proposes to provide that a partnership can be a controlled commercial entity under section 892.
Explanation of Provisions

A. §301.7701–2

Section 301.7701–2(b) of the check-the-box regulations specifies that certain business entities are classified as per se corporations for Federal tax purposes (i.e., those business entities that are not permitted to elect a noncorporate Federal tax classification). Section 301.7701–2(b)(6) classifies a business entity wholly owned by a State or any of its political subdivisions as a per se corporation. However, the regulations do not specify that the phrase State or any political subdivision thereof includes a foreign government.

The IRS and Treasury believe that it is appropriate to treat a foreign government similarly to a State in this context. Thus, to achieve parallel tax treatment under the check-the-box regulations of a business entity wholly owned by a State or any of its political subdivisions and a business entity wholly owned by a foreign government, these proposed regulations provide that a business entity wholly owned by a foreign government cannot elect to be treated as a disregarded entity.

The check-the-box regulations also provide a special rule for the treatment of nonbank entities that are wholly owned by banks. In particular, §301.7701–2(c)(2)(ii) provides that a bank cannot treat a wholly owned nonbank entity as a disregarded entity for purposes of applying the special rules of the Internal Revenue Code (Code) applicable to banks. The term bank for this purpose is defined in section 581 to include only domestic entities. Section 301.7701–2(c)(2)(ii) does not explicitly restrict foreign banks from treating their wholly owned nonbank entities as disregarded entities for all tax purposes (because foreign banks are not defined as banks under section 581).

As with the rule described for foreign governments, the IRS and Treasury believe that nonbank entities wholly owned by domestic banks and foreign banks should be treated similarly in this context. These regulations incorporate a reference to section 585(a)(2)(B) (which includes certain foreign banks that are engaged in a U.S. trade or business in the definition of the term bank) in §301.7701–2(c)(2)(ii). As a result, neither domestic banks nor foreign banks engaged in a U.S. trade or business can treat wholly owned nonbank entities as disregarded entities for purposes of applying the special rules of the Code applicable to banks.

B. §1.892–5(a)

Section 1.892–5T(a) currently provides that for purposes of defining the term controlled commercial entity, the term entity encompasses corporations and trusts (including pension trusts described in §1.892–2T(c)) and estates. To ensure that investments in the United States by a foreign government through separate juridical entities are treated similarly, these proposed regulations under §1.892–5(a) provide that, for purposes of section 892(a)(2)(B), the term entity also includes a partnership.

Proposed Effective Dates

The regulations that address the Federal tax classification of business entities wholly owned by a foreign government under §301.7701–2 are proposed to be applied on or after the earlier of January 14, 2002, or the date these regulations are published as final regulations in the FEDERAL REGISTER to such business entities regardless of any prior entity classification, and the regulations that address the definition of the term entity for purposes of section 892(a)(2)(B) are proposed to apply on or after the earlier of January 14, 2002, or the date these regulations are published as final regulations in the FEDERAL REGISTER. The regulations relating to a nonbank entity that is wholly owned by a foreign bank are proposed to apply to taxable years beginning after January 12, 2001.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their 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 (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 16, 2001, beginning at 10 a.m., in room 6718, 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 fifteen (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 timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by April 25, 2001.

A period of ten (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.

Drafting Information

The principal author of these regulations is Camille B. Evans of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:
PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for “Sections 1.892–1T through 1.892–7T” and adding the following entries in numerical order:

Authority: 26 U.S.C. 7805 * * *
   Section 1.892–1T also issued under 26 U.S.C. 892(c).
   Section 1.892–2T also issued under 26 U.S.C. 892(c).
   Section 1.892–3T also issued under 26 U.S.C. 892(c).
   Section 1.892–4T also issued under 26 U.S.C. 892(c).
   Section 1.892–5 also issued under 26 U.S.C. 892(c).
   Section 1.892–5T also issued under 26 U.S.C. 892(c).
   Section 1.892–6T also issued under 26 U.S.C. 892(c).
   Section 1.892–7T also issued under 26 U.S.C. 892(c). * * *

Par. 2. Section 1.892–5 is added to read as follows:

§1.892–5 Controlled commercial entity.

(a) through (a)(2) [Reserved]. For further information, see §1.892–5T(a) through (a)(2).

(3) For purposes of section 892(a)(2)(B), the term entity means and includes a corporation, a partnership, a trust (including a pension trust described in §1.892–2T), and an estate.

(b) through (d) [Reserved]. For further information, see §§1.892–5T(b) through (d).

Par. 3. Section 1.892–5 is amended by:

1. Removing the flush language immediately following paragraph (a)(2).

2. Adding paragraph (a)(3).

The addition reads as follows:

§1.892–5T Controlled commercial entity (temporary regulations).

(a) * * *

(3) [Reserved]. For further information, see §1.892–5(a)(3).

* * * * *
Background

Section 706 governs the taxable years for a partnership and its partners. The partners and the partnership each have their own taxable years, which may or may not coincide. Under section 706(a), for a partner’s taxable year, the partner must include in taxable income the partner’s share of any income, gain, loss, deduction, or credit of the partnership for the partnership’s taxable year that ends within or with the partner’s taxable year. Section 706(b) provides rules for determining a partnership’s taxable year.

Prior to the Tax Reform Act of 1986, it was possible for partners to create income deferral opportunities through arranging divergent taxable years for a partnership and its partners. For example, under certain circumstances, a partnership could elect a June 30 taxable year while its partners were calendar year taxpayers. Under such an arrangement, the partners would include partnership income earned from July 1, Year 1, to June 30, Year 2, in Year 2, when the partnership’s taxable year ended, even though six months of income was generated during Year 1. To prevent this potential for income deferral, Congress amended section 706(b). See generally Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, 533-39 (1986).

Section 706(b) provides that, unless the partnership establishes a business purpose for a different taxable year, a partnership cannot have a taxable year other than: (i) the majority interest taxable year; (ii) if there is no majority interest taxable year, the taxable year of all the principal partners of the partnership; or (iii) if there is no taxable year described in (i) or (ii), the calendar year unless the Secretary by regulation prescribes another period. Section 1.706–1T(a)(1) and (2) provides that if neither (i) nor (ii) is applicable, the partnership’s taxable year will be the taxable year that results in the least aggregate deferral of partnership income. Additionally, §1.706–3T(a) provides that under certain circumstances, a tax-exempt partner will be disregarded for purposes of section 706(b).

Explaination of Provisions

I. Treatment of Foreign Partners

Currently, foreign partners are taken into consideration when determining a partnership’s taxable year under section 706(b). In some circumstances, this could allow the taxable year of a partnership to be determined for Federal tax purposes by reference to the taxable year of one or more partners who may not be subject to U.S. taxation on income earned through the partnership. For instance, assume that a foreign partner owns a majority interest in a partnership that generates only foreign source income that is not effectively connected with a trade or business conducted within the United States. The minority partners are domestic persons subject to tax in the United States on income earned through the partnership. If the taxable year or years of the domestic partners are different from that of the majority partner, the majority partner’s taxable year would determine the partnership’s taxable year, which would affect the timing of the domestic partners’ inclusion of partnership income. Thus, by conforming the partnership’s taxable year to the taxable year of foreign partners, the mechanical application of section 706(b) can create deferral for those partners who are subject to tax in the United States on income earned through the partnership, while having no impact on the majority foreign partners who are not subject to tax in the United States on such income. The IRS and the Treasury do not believe that such a result is consistent with the intent of the statute.

A. Disregard certain foreign partners

The proposed regulations generally require foreign partners who are not subject to U.S. taxation on a net basis on income earned through the partnership to be disregarded for purposes of applying section 706(b). For these purposes a foreign partner will be considered subject to Federal income tax only if the partner is allocated gross income of the partnership that is effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States (effectively connected income or ECI). In the case of a foreign partner claiming benefits under a U.S. income tax treaty, a foreign partner will be disregarded unless it is allocated gross income that is attributable to a permanent establishment in the United States.

A foreign partner also may be subject to U.S. Federal income tax on its distributive share of fixed or determinable annual or periodic income (FDAP income) from U.S. sources. In certain circumstances, the timing for imposing United States withholding tax on FDAP income earned through a partnership may be affected by the partnership’s taxable year. See, e.g., §1.1441–5(b)(2)(i) (providing the timing for withholding under section 1441 in the case of a domestic partnership that has received, but not distributed, FDAP income that is includible in the distributive share of a foreign partner). The IRS and Treasury believe that the withholding provisions of section 1441 provide a more appropriate mechanism than section 706 for addressing timing issues for these partners. Additionally, the IRS and Treasury are concerned that the ability of a partnership to earn small amounts of FDAP income, and thereby alter the determination of its taxable year, may permit inappropriate manipulation of the rule under section 706(b) for the domestic partners. Accordingly, under these proposed regulations, the taxable year of a foreign partner would be disregarded for purposes of section 706(b) if that partner is subject to Federal income tax solely due to the presence of U.S. source income earned through the partnership that is not ECI. In addition, it is irrelevant, for purposes of the proposed regulations, whether the foreign partner is subject to tax in the United States with respect to income other than income earned by the partnership.

The rule for foreign partners provided in these proposed regulations generally is consistent with the present rule under §1.706–3T for the treatment of partners that are exempt from taxation under section 501(a). The taxable years of tax-exempt partners are not considered for purposes of section 706(b) unless those partners are subject to tax on income from the partnership. One difference between the rules for foreign partners and the rules for tax-exempt partners is that foreign partners will be included in determining a partnership’s taxable year where the foreign partner is allocated gross income that is effectively connected with a U.S. trade or business, but actually has a net loss.
from the partnership for the taxable year (i.e., the foreign partners are not actually subject to tax on their allocable portion of the partnership’s income). By contrast, a tax-exempt partner is disregarded where its allocable share of the partnership’s tax items produces a net loss for the taxable year even though, if the foreign partner were allocated net income for the taxable year, the tax-exempt entity would have been subject to tax on such income. The IRS and Treasury are considering modifying the tax-exempt rule to conform with the proposed rule for foreign partners and request comments in this regard.

Finally, for purposes of these rules, the proposed regulations generally define a foreign partner as a partner that is not a U.S. person (as defined in section 7701(a)(30)), but provide that controlled foreign corporations (CFCs) and foreign personal holding companies (FPHCs) are not treated as foreign partners. These entities are not treated as foreign for purposes of determining a partnership’s taxable year under section 706 because the U.S. owners of such entities may be subject to Federal income taxation on a current basis with respect to income earned by the entities.

The IRS and Treasury also considered, but did not include, a similar rule for passive foreign investment companies (PFICs). The proposed regulations do not include a similar rule for PFICs because, unlike the rules for CFCs and FPHCs, which require that a majority of the ownership be concentrated in a small group of U.S. persons, the PFIC rules apply without regard to the level of ownership of the individual, or of all U.S. owners in the aggregate. Additionally, in most instances where a PFIC does have substantial U.S. ownership, it will also be a CFC or a FPHC.

B. Minority interest rule

The IRS and Treasury recognize that requiring a partnership taxable year to be determined without regard to certain foreign partners may present difficulties for minority partners in some cases. If the taxable years of certain foreign partners are disregarded for purposes of section 706(b), it is possible that the taxable year of a partnership may be determined solely by reference to the taxable year of one or more small minority domestic partners. This could create significant administrative burdens for minority partners if the partnership maintains its books and records on a taxable year selected by significant foreign partners that is different from the taxable year of the minority partner or partners.

In order to provide relief in this situation, the proposed regulations contain an exception providing that foreign partners will not be disregarded for purposes of section 706(b) if the partnership’s taxable year would be determined by reference to partners that individually hold less than a 10-percent interest, and in the aggregate hold less than a 20-percent interest, in the capital and profits of the partnership. For purposes of this rule, a partner’s interest will include interests held directly and interests held by related partners. In determining whether the minority interest rule applies, the proposed regulations take into account the ownership of tax-exempt entities that are disregarded under §1.706–3T(a).

Where a domestic tax-exempt entity (or entities) owns a relatively small interest in the partnership, but enough to cause the minority interest rule not to apply, the result may be anomalous, given that the tax-exempt entity has no real interest in a particular taxable year and thus has no incentive to convince significant foreign partners to cause the partnership to determine its taxable year by reference to the domestic partners. However, where such a tax-exempt entity (or entities) owns a majority interest in the partnership, the result may be more appropriate because the domestic partners are more likely to have significant bargaining power regarding the taxable year vis-a-vis the foreign partners. An appropriate solution may be to exclude tax-exempt entities from both the numerator and denominator in applying the de minimis rule. The IRS and Treasury request comments regarding how tax-exempt entities should be treated for purposes of the minority interest rule.

C. Transitional relief

Under current law, a partnership may have adopted a taxable year that creates deferral by reference to the taxable year of a foreign partner not subject to U.S. net income taxation. In such instances, compliance with these regulations could result in a change in the partnership taxable year which would cause a “bunching” of more than 12 months of partnership income into a single taxable year of the partners subject to Federal income tax.

For example, consider a partnership that has a June 30 taxable year because of the presence of a 60-percent foreign partner that is not subject to U.S. net income taxation on income earned through the partnership. This taxable year creates six months of deferral for the 40-percent domestic partner, who is on the calendar year. In the year that these proposed regulations become effective, two partnership taxable years (the taxable year concluding on June 30 and the initial short calendar year concluding December 31) would close during the domestic partner’s taxable year. Thus, section 706(a) would require the domestic partner to recognize its distributive share of 18 months of partnership income during a single taxable year. While the historic taxable year of the partnership in this example is inconsistent with the intent of section 706(b), the IRS and Treasury recognize that the potential bunching of income caused by changing to an appropriate taxable year might present an undue hardship for some taxpayers.

In order to alleviate such a hardship, the proposed regulations would permit adversely affected taxpayers to apply the four-year spread provisions of §1.702–3T. This transitional rule will have limited application; it is intended only to provide relief for bunching of income that occurs in the first taxable year beginning on or after the effective date of these proposed regulations.

II. Application of §1.701–2

The mechanical rules of section 706(b) operate to limit partners’ opportunities to defer the recognition of partnership income. Where partners have different taxable years, eliminating or limiting deferral for one partner may result in increasing deferral for another partner. Such deferral is an anticipated result of section 706(b). However, an application of the mechanical rules of section 706(b) and these proposed regulations remains subject to the anti-abuse rule of §1.701–2.

For example, assume that these proposed regulations would disregard the taxable year of a 76-percent foreign partner and require the partnership (which only has for-
eign operations, and therefore does not earn ECI to adopt the taxable year of the 24-percent domestic partner. Conceivably the partners could attempt to avoid this result by forming a tiered structure where the foreign partner would own a 95-percent interest in an upper-tier domestic partnership that would hold, as its only asset, an 80 percent interest in the lower-tier operating partnership (the domestic partner would own the remaining 5 percent of the upper-tier partnership and the remaining 20 percent of the lower-tier partnership). In substance, this is the same arrangement as the single partnership except that the minority interest rule would generally require the upper-tier partnership to adopt the taxable year of the foreign partner (because the domestic partner owns less than a 10-percent interest in the upper-tier partnership). The upper-tier domestic partnership’s taxable year would then be considered the majority interest taxable year of the lower-tier partnership under section 706(b)(1)(B)(i). In these circumstances, the Commissioner may determine that in order to achieve a tax result that is consistent with the intent of section 706, §1.701–2 should apply. In such event, the Commissioner may disregard the upper-tier partnership and treat the assets thereof (in this case, the interest in the lower-tier partnership) as being owned directly by its partners, with the result that the foreign partner would be disregarded in determining the taxable year of the lower-tier partnership under section 706(b) and these proposed regulations.

III. Finalization of Prior Proposed Regulations

The current temporary regulations under section 706 are the product of three separate Treasury decisions. The text of these Treasury decisions, T.D. 7991 (1985–1 C.B. 71) (adopted November 29, 1984), T.D. 8169 (1988–1 C.B. 259) (adopted December 23, 1987), and T.D. 8205 (1988–1 C.B. 156) (adopted May 24, 1988), were also contemporaneously promulgated as proposed regulations, LR–183–84 (1985–1 C.B. 653) (published in the Federal Register on November 30, 1984), LR–101–86 (1988–1 C.B. 924) (published in the Federal Register on December 29, 1987), and LR–53–88 (1988–1 C.B. 935) (published in the Federal Register on May 27, 1988). These proposed regulations have not been withdrawn, and it is likely that they will be finalized in conjunction with the finalization of the regulations proposed by this document. The IRS and Treasury expect that the finalization of these previously proposed regulations will be accompanied by the withdrawal of the existing temporary regulations. Comments previously received in connection with the prior proposed regulations will be considered as well as new or additional comments with respect to such regulations.

IV. Effective Date

These regulations are proposed to apply to partnership taxable years beginning on or after the date final regulations are published in the Federal Register. For example, if the final regulations were published on November 1, 2001, a partnership that historically has determined its taxable year by reference to a 75-percent foreign partner with a March 31 taxable year end rather than by reference to a 25-percent domestic partner that uses the calendar year would be required to change to the calendar year as of April 1, 2002 (the partnership year beginning after the date final regulations were published). This would result in a short taxable year from April 1, 2002, to December 31, 2002.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations, and because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. 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 (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 6, 2001, beginning at 10 a.m., in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER INFORMATION CONTACT” section of this preamble.

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 timely written comments and must submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by May 16, 2001. 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.

Drafting Information

The principal author of these regulations is Dan Carmody, Office of Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART I—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 1.706–4 is added to read as follows:
§1.706–4 Certain foreign partners disregarded

(a) General rule.—(1) Foreign partners not claiming benefits under a U.S. income tax treaty. In determining the taxable year (the current taxable year) of a partnership under section 706(b) and the regulations thereunder, a foreign partner shall be disregarded unless such partner is allocated any gross income of the partnership that was effectively connected (or treated as effectively connected) with the conduct of a trade or business within the United States during the partnership’s taxable year immediately preceding the current taxable year.

However, if a foreign partner was not a partner during the partnership’s immediately preceding taxable year, such partner will be disregarded for the current taxable year if the partnership reasonably believes that the partner will not be allocated any gross income generated by the partnership during the current taxable year that is effectively connected with the conduct of a trade or business within the United States.

(2) Foreign partners claiming benefits under a U.S. income tax treaty. In the case of a foreign partner claiming benefits under an income tax treaty between the United States and another jurisdiction, a foreign partner will be disregarded under this paragraph (a) unless such partner was allocated any gross income that was attributable to a permanent establishment in the United States during the partnership’s taxable year immediately preceding the current taxable year (or, if such partner was not a partner during the immediately preceding taxable year, the partnership reasonably believes that such partner will be allocated such income during the current taxable year).

(b) Minority interest rule. If the partners that are not disregarded by paragraph (a) of this section (absent the application of this paragraph (b)) individually hold less than a 10-percent interest, and in the aggregate hold less than a 20-percent interest, in the capital and profits of the partnership, paragraph (a) of this section will not apply. For purposes of determining ownership in the partnership after application of paragraph (a) of this section, 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. However, “10 percent” shall be substituted for “50 percent” in section 318(a)(2)(C) and (3)(C).

For purposes of determining if partners hold less than a 20-percent interest in the aggregate, the same interests will not be considered as being owned by more than one partner.

(c) Definition of foreign partner. For purposes of this section, a foreign partner is any partner that is not a U.S. person (as defined in section 7701(a)(30)), except that a partner that is a controlled foreign corporation (as defined in section 957(a)) or a foreign personal holding company (as defined in section 552) shall not be treated as a foreign partner.

(d) Example. The provisions of this section may be illustrated by the following example:

Example. Partnership B is owned by two partners, F, a foreign corporation that owns a 95-percent interest in the capital and profits of partnership B, and D, a domestic corporation that owns the remaining 5-percent interest in the capital and profits of partnership B. Partnership B is not engaged in the conduct of a trade or business within the United States, and, accordingly, partnership B does not earn any income that is effectively connected with a U.S. trade or business. F uses a March 31 fiscal year, and causes partnership B to maintain its books and records on a March 31 fiscal year as well. D is a calendar year taxpayer. Under paragraph (a) of this section, F would be disregarded and partnership B’s taxable year would be determined by reference to D. However, because D owns less than a 10-percent interest in the capital and profits of partnership B, the minority interest rule of paragraph (b) of this section applies, and partnership B must adopt the March 31 fiscal year.

(e) Effective date.—(1) Generally. The provisions of this section are applicable for partnership taxable years that begin on or after the date final regulations are published in the Federal Register.

(2) Transition rule. Partners of a partnership that is required to change its taxable year as of the beginning of its first taxable year after the date final regulations are published in the Federal Register may apply the provisions of §1.702–3T if the change in taxable year occurs in the first taxable year following the date final regulations are published in the Federal Register.

* * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

("Filed by the Office of the Federal Register on January 16, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2001, 66 F.R. 3920")

Notice of Proposed Rulemaking and Notice of Public Hearing

Hedging Transactions

REG–107047–00

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 character of hedging transactions. These proposed regulations reflect changes to the law made by the Ticket to Work and Work Incentives Improvement Act of 1999. The proposed regulations affect businesses entering into hedging transactions. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronically generated comments must be received by April 25, 2001. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for May 16, 2001, at 10 a.m., must be submitted by April 25, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–107047–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–107047–00), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page, or by sub-
mitting comments directly to the IRS internet site at http://www.irs.gov/tax_regs/reglist.html. The public hearing will be held in the IRS auditorium, 1111 Constitution Ave., NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Jo Lynn Ricks, (202) 622-3920; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, contact Lanita Vandyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control numbers 1545-1403 and 1545-1480.

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

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 proposed amendments to 26 CFR part 1 under section 1221 of the Internal Revenue Code (Code). Prior to amendment in 1999, section 1221 generally defined a capital asset as property held by the taxpayer other than: (1) stock in trade or other types of assets includible in inventory; (2) property used in a trade or business that is real property or property subject to depreciation; (3) certain copyrights (or similar property); (4) accounts or notes receivable acquired in the ordinary course of a trade or business; and (5) U.S. government publications.

In 1994, the IRS published in the Federal Register (59 FR 36360) final Treasury regulations under section 1221 providing for ordinary character treatment for most business hedges. The regulations generally apply to hedges that reduce risk with respect to ordinary property, ordinary obligations, and borrowings of the taxpayer and that meet certain identification requirements. (§1.1221–2). In 1996, the IRS published in the Federal Register (61 FR 517) final regulations on the character and timing of gain or loss from hedging transactions entered into by members of a consolidated group. The final regulations published in 1994 and 1996 are collectively referred to as the Treasury regulations in this preamble.

On December 17, 1999, section 1221 was amended by section 532 of the Ticket to Work and Work Incentives Improvement Act of 1999 (113 Stat 1860) to provide ordinary gain or loss treatment for hedging transactions and consumable supplies. Section 1221(a)(7) provides ordinary treatment for hedging transactions that are clearly identified as such before the close of the day on which they were acquired, originated, or entered into.

The statute defines a hedging transaction generally to include a transaction entered into by the taxpayer in the normal course of business primarily to manage risk of interest rate, price changes, or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer. §1221(b)(2)(A)(i) and (ii). The statutory definition of hedging transaction also includes transactions to manage such other risks as the Secretary may prescribe in regulations. Section 1221(b)(2)(A)(iii). Further, the statute grants the Secretary the authority to provide regulations to address the treatment of nonidentified or improperly identified hedging transactions, and hedging transactions involving related parties (sections 1221(b)(2)(B) and (b)(3), respectively). The statutory hedging provisions are effective for transactions entered into on or after December 17, 1999.

Section 1221(a)(8) provides that supplies of a type regularly consumed by the taxpayer in the ordinary course of a taxpayer’s trade or business are not capital assets. That provision is effective for supplies held or acquired on or after December 17, 1999.

The legislative history to the hedging provisions states that Congress intended that the approach taken in the Treasury regulations with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of present law. S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999). These proposed regulations conform the Treasury regulations to these statutory provisions.

Explanation of Provisions

Paragraph (a) of the proposed regulations provides basic rules for the treatment of hedging transactions. The substance of these rules is the same as the rules under §1.1221–2(a).

Accordingly, paragraph (a)(1) of the proposed regulations generally provides that property that is part of a hedging transaction, as defined in section 1221(b)(2)(A) and paragraph (b) of the proposed regulations, is not a capital asset. Paragraph (a)(2) of the proposed regulations provides a similar rule for short sales and options. Where a short sale or option is part of a hedging transaction, as defined, any gain or loss on the short sale or option is ordinary. Under paragraph (a)(3), if a transaction falls outside the regulations, gain or loss from the transaction is not made ordinary by the fact that property is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose. As under the Treasury regulations, Congress intended that the hedging rules be the exclusive means through which the gains and losses on hedging transactions are treated as ordinary. S. Rep. No. 201, 106th Cong., 1st Sess. 25 (1999).

The provisions of the proposed regulations generally apply to determine the character of gain or loss from transactions that are subject to various international provisions of the Code. Paragraph (a)(4) of the proposed regulations, however, provides that section 988 transactions are excluded from these regulations because gain or loss on those transactions is ordinary under section 988(a)(1). Paragraph (a)(4) of the proposed regulations also provides that the definition of a hedging transaction under §1.1221–2(b) of the proposed regulations does not apply for purposes of the hedging exceptions to the subpart F rules of section 954(c) and cer-
tains hedging rules in the interest allocation regulations under section 864(e).

Regulations under §1.482–8 will address risk management activities in the context of a global dealing operation. Thus, except to the extent provided in §§1.475(g)–2, 1.482–8, and 1.863–3(h), these regulations do not apply in determining the allocation and source of income for a participant in a global dealing operation or whether a risk management function related to the activities of a regular dealer in securities has been conducted.

Proposed regulations under §§1.882–5 and 1.884–1 also refer to hedging under §1.1221–2 for purposes of determining assets and liabilities of a foreign corporation for interest allocation and branch tax purposes. The IRS and Treasury are evaluating the appropriate requirements necessary to implement cross-border and worldwide hedging rules for these purposes and seek comments in this regard. Therefore, paragraph (a)(4) of the proposed regulations provides that the definition of hedging transaction in paragraph (b) of the proposed regulations is inapplicable in determining the hedging requirements under sections 882(c) and 884, except to the extent provided in regulations under those sections.

Paragraph (b) of the proposed regulations restates the definition of hedging transaction in section 1221(b)(2)(A). Under this rule, a hedging transaction is generally a transaction that a taxpayer enters into in the normal course of its business primarily to manage the risk of interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings of the taxpayer.

Paragraph (c) of the proposed regulations provides rules of application designed to ensure that the definition of hedging transaction is applied reasonably to include most common types of business hedges. Congress intended that the approach taken in the Treasury regulations with respect to the character of hedging transactions generally should be codified as an appropriate interpretation of present law. S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999). The Senate Finance Committee believed that the Treasury regulations interpret risk reduction flexibly to provide hedging transaction treatment for fixed to floating hedges, certain written call options, dynamic hedges, partial hedges, recycled hedges, and hedges of aggregate risk (see §1.1221–2(c)). Id. at n.12. The Committee believed that (depending on the facts) the treatment of those transactions as hedging transactions is appropriate and that it is also appropriate to modernize the definition of hedging transaction by providing risk management as the standard. Id. These proposed regulations revise the Treasury regulations to reflect the risk management standard.

Paragraph (c)(1) of the proposed regulations deals with the meaning of risk management. It provides that, except as otherwise provided in paragraph (c), a transaction satisfies the risk management standard if it reduces risk. To enter into a hedging transaction, the taxpayer must have risk when all of its operations are considered—that is, there must be risk on a “macro” basis. Nonetheless, a hedge of a single asset or liability, or pool of assets or liabilities, will be respected as managing risk if the hedge reduces the risk attributable to the item or items being hedged and if the hedge is reasonably calculated to reduce the overall risk of the taxpayer’s operations. In addition, if a taxpayer hedges a particular asset or liability, or a pool of assets or liabilities, and the hedge is undertaken as part of a program to reduce the overall risk of the taxpayer’s operations, the taxpayer need not show that the hedge reduces its overall risk.

Paragraph (c)(2) of the proposed regulations also recognizes that fixed to floating hedges and certain types of written options may manage risk and may be hedging transactions in appropriate situations. For example, a covered call with respect to assets held or a written put option with respect to assets to be acquired may be a hedging transaction.

In addition, paragraph (c)(1) of the proposed regulations provides that a hedging transaction includes a transaction that reverses or counteracts a hedging transaction. This rule recognizes that some transactions are used to eliminate some or all of the risk reduction accomplished through another hedging transaction. Although the transactions are not risk reducing if viewed independently, they are considered to be part of the larger hedging transaction.

Paragraph (c)(1) of the proposed regulations further provides that a taxpayer may hedge any part or all of its risk for any part of the period during which it has risk. The proposed regulations also provide that the fact that a taxpayer frequently enters into and terminates hedging positions is not relevant to whether transactions are hedging transactions.

Except as otherwise provided in paragraph (c) of the proposed regulations, a transaction that is not entered into primarily to reduce risk is not a hedging transaction. For example, the so-called “store-on-the-board” transaction, in which a taxpayer disposes of its production output and enters into a long futures contract with respect to the same product, is not a hedging transaction. In this example, the long futures contract could be viewed as a surrogate for the storage of the commodity. The net proceeds from the sale of the production output and the gain or loss on the long futures contract simulates the price at which the production output would have sold if it had been physically stored and sold at a later time. However, because the production output to which the futures contract relates has been sold, there is no underlying position (with respect to ordinary property held or to be held) that exposes the taxpayer to price risk. Thus, the long position does not reduce risk. Moreover, gain or loss on the contract is not treated as ordinary on the grounds that it is a surrogate for inventory.

Paragraph (c)(2) of the proposed regulations provides that a hedging transaction may be entered into by using a position that was a hedge of one asset or liability to hedge another asset or liability.

Paragraph (c)(3) of the proposed regulations provides that the acquisition of certain assets, such as investments, may not be a hedging transaction. Even though acquisition of these assets may involve some risk reduction, they typically are not acquired primarily to manage risk. For example, a taxpayer’s interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate. The proposed regulations provide that the acquisition of the debt instruments, however, is not made primarily to reduce risk and, therefore, is not a hedging transaction. Similarly, borrowings generally are not
made primarily to manage risk. The IRS and Treasury request comments on the circumstances in which the acquisition of debt instruments or borrowings are made primarily to manage risk.

Paragraph (c)(4) defines the normal course requirement of paragraph (b) to include any transaction entered into in furtherance of a taxpayer’s trade or business. Thus, for example, a liability hedge meets this requirement regardless of whether the liability is undertaken to fund current operations, an acquisition, or an expansion of a taxpayer’s business. This definition does not apply to other uses of the term “normal course” in the Code or regulations.

Paragraph (c)(5) of the proposed regulations provides that a hedge of property or of an obligation is a hedging transaction only if a sale or exchange of the property, or performance or termination of the obligation, could not produce capital gain or loss. The special rule in the Treasury regulations for noninventory supplies (§1.1221–2(c)(5)(ii)), however, is not contained in these proposed regulations. Under the noninventory supply rule, if a taxpayer sells only a negligible amount of a noninventory supply, then, only for purposes of determining whether a hedge of the purchase of that noninventory supply is a hedging transaction, that noninventory supply is treated as ordinary property. This rule is not being proposed because section 1221(a)(8) generally provides ordinary gain or loss treatment for consumable supplies held or acquired on or after December 17, 1999.

Paragraph (c)(6) of the proposed regulations provides that the status of liability hedges as hedging transactions is determined without regard to the use that is made of the proceeds of a borrowing so long as the transaction is entered into in furtherance of the taxpayer’s trade or business. The Service and Treasury believe that a liability hedge should not fail to qualify as a hedging transaction because the proceeds of the borrowing being hedged are used to purchase a capital asset.

Paragraph (c)(7) of the proposed regulations provides that, in the case of hedges of aggregate risk, all but a de minimis amount of the risk being hedged must be attributable to ordinary property, ordinary obligations, or borrowings.

Although the purpose of the rules in paragraph (c) is to ensure that the definition of hedging transaction will be interpreted reasonably to cover most common business hedges, not all hedges are intended to be covered. For example, the regulations do not apply where a taxpayer hedges a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations with respect to ordinary property, ordinary obligations, or borrowings. Moreover, the regulations do not provide ordinary treatment for gain or loss from the disposition of stock where, for example, the stock is acquired to protect the goodwill or business reputation of the acquirer or to ensure the availability of goods.

Paragraph (c)(8) of the proposed regulations provides that a hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations, unless a regulation, revenue ruling, or revenue procedure provides otherwise. Thus, until such guidance is published, a hedge of volume or revenue fluctuations is not a hedging transaction. One example of this type of hedge is a weather derivative used by an energy producer to hedge against the decrease in volume of sales from variations in weather patterns.

The IRS is considering whether to expand the definition of hedging transaction to include transactions that manage risks other than interest rate or price changes, or currency fluctuations with respect to ordinary property, ordinary obligations or borrowings of the taxpayer. The Service solicits comments on the types of risks that should be covered, including specific examples of derivative transactions that may be incorporated into future guidance.

The status of so-called “gap” hedges is not separately addressed in paragraph (c) of the proposed regulations. Insurance companies, for example, sometimes hedge the “gap” between their liabilities and the assets that fund them. Under the proposed regulations, a hedge of those assets does not qualify as a hedging transaction if the assets are capital assets. Whether a gap hedge qualifies as a liability hedge is a question of fact and depends on whether it is more closely associated with the liabilities than with the assets. For example, a contract to purchase assets is generally not a liability hedge even if the assets are being purchased to fund the liability. Other gap hedges may be appropriately treated as liability hedges and, therefore, may qualify as hedging transactions.

The rules in paragraphs (d), (e) and (f) of the proposed regulations, covering consolidated group hedging, identification and recordkeeping rules, and the effect of identification and non-identification, respectively, are generally unchanged from the corresponding rules in the Treasury regulations. This is because Congress generally intended to codify the approach to hedging transactions that was taken in the Treasury regulations. S. Rep. No. 201, 106th Cong., 1st Sess. 24 (1999).

Paragraph (d) of the proposed regulations provides rules applicable to hedging by members of a consolidated group. The proposed regulations retain the single-entity approach of the Treasury regulations. That is, they treat the risk of one member of the group as the risk of the other members, as if all the members were divisions of a single corporation. Thus, a member of a consolidated group that hedges the risk of another member by entering into a transaction with a third party may receive ordinary gain or loss treatment on that transaction if the transaction otherwise qualifies as a hedging transaction.

Under this single-entity approach, intercompany transactions are neither hedging transactions nor hedged items. Because they are treated as transactions between divisions of a single corporation, intercompany transactions do not manage the risk of that single corporation and, therefore, fail to qualify as hedging transactions.

The proposed regulations also retain the separate-entity election of the Treasury regulations, permitting a consolidated group to treat its members as separate entities when applying the hedging rules. The election is made by attaching a statement to the group’s federal income tax return.

For a group that elects separate-entity treatment, an intercompany transaction is treated as a hedging transaction if and only if: (1) it would qualify as a hedging transaction if entered into with an unrelated party; and (2) it is entered into with
a member that, under its method of accounting, marks its position in the intercompany transaction to market. If these requirements are satisfied, the member with respect to which it is an intercompany hedging transaction must account for its position in the transaction under §1.1446–4, and, if that member properly identifies the transaction as a hedging transaction, each member treats the gain or loss from its position in the transaction as ordinary.

The proposed regulations provide that, even when these two requirements are met, these regulations supplant only the character and timing rules of §1.1502–13. Other aspects of the transaction, such as the source of the gain or loss, are unaffected by these regulations and thus may be governed by other portions of §1.1502–13.

Pursuant to section 1221(a)(7), paragraph (e)(1) of the proposed regulations provides that hedging transactions must be identified before the close of the day on which they are entered into. Paragraph (e)(2) of the proposed regulations requires that the item, items, or aggregate risk being hedged be identified substantially contemporaneously with entering into the hedging transaction. The identification must be made no more than 35 days after entering into the hedging transaction.

Paragraph (e)(3) of the proposed regulations contains a series of special rules for identifying certain types of hedging transactions. In the case of inventory, the identification must specify the type or class of inventory to which the hedge relates. If particular inventory purchases or sales transactions are being hedged, the taxpayer must also identify the expected date and the amount to be acquired or sold. In the case of hedges of aggregate risk, the identification requirement is satisfied if a taxpayer’s records contain a description of the hedging program and if there is a system for identifying transactions as entered into as part of that program. The intent underlying this rule is to provide verifiable information with respect to the item being hedged without requiring the taxpayer to identify individually any of the aggregate risk being hedged.

Paragraph (e)(4) of the proposed regulations provides rules with respect to how an identification is made. It must be clear that the identification is being made for tax purposes. In lieu of separately identifying each transaction, however, a taxpayer may establish a system in which identification is indicated by the type of transaction or the manner in which the transaction is consummated or recorded.

Paragraph (e)(5) of the proposed regulations deals with the required identification where the taxpayer is a member of a consolidated group, and paragraph (e)(6) of the proposed regulations provides that an identification for purposes of section 1256(e)(2) is also an identification for purposes of §1.1221–2(e)(1).

Pursuant to section 1221(b)(2)(B), paragraph (f) of the proposed regulations deals with the effect of identification and non-identification. The rules in this paragraph are the same as the rules in paragraph (f) of the Treasury regulations.

The proposed regulations under section 1256 generally restate the rules of §1.1256(e)–1 that coordinate the identification of hedges for purposes of section 1256(e). The citations to section 1256(e)(2)(C) in the Treasury regulations have been replaced with citations to section 1256(e)(2) in the proposed regulations.

Proposed Effective Date

The proposed regulations are proposed to be effective for transactions entered into on or after January 18, 2001. However, the IRS will not challenge any transaction entered into on or after December 17, 1999, and before January 18, 2001, that satisfies the provisions of these proposed regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that very few small businesses enter into hedging transactions due to their cost and complexity. Further, those small businesses that hedge enter into very few hedging transactions because hedging transactions are costly, complex, and require constant monitoring and a sophisticated understanding of the capital markets. 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, 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 electronic or written comments (a signed original and eight (8) copies of written comments) that are submitted timely (in the manner described in “ADDRESSES”) to the IRS. The IRS and Treasury request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for May 16, 2001, beginning at 10 a.m., in the IRS auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see “FOR FURTHER INFORMATION CONTACT.”

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 and an outline of topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by April 25, 2001. A period of 10 minutes will be allotted to each person 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.
Drafting Information

The principal author of these regulations is Jo Lynn Ricks, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

** 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 revising the entry for §1.1221–2 to read as follows:

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

§1.1221–2 also issued under 26 U.S.C. 1221(b)(2)(A)(iii), (b)(2)(B), and (b)(3),***

Par. 2. Section 1.1221–2 is revised to read as follows:

§1.1221–2 Hedging transactions.

(a) Treatment of hedging transactions—

(1) In general. This section governs the treatment of hedging transactions under section 1221(a)(7). Except as provided in paragraph (f)(2) of this section, the term capital asset does not include property that is part of a hedging transaction (as defined in paragraph (b) of this section).

(2) Short sales and options. This section also governs the character of gain or loss from a short sale or option that is part of a hedging transaction. Except as provided in paragraph (f)(2) of this section, gain or loss on a short sale or option that is part of a hedging transaction (as defined in paragraph (b) of this section) is ordinary income or loss.

(3) Exclusivity. If a transaction is not a hedging transaction as defined in paragraph (b) of this section, gain or loss from the transaction is not made ordinary on the grounds that property involved in the transaction is a surrogate for a noncapital asset, that the transaction serves as insurance against a business risk, that the transaction serves a hedging function, or that the transaction serves a similar function or purpose.

(4) Coordination with other sections—

(i) Section 988. This section does not apply to determine the character of gain or loss realized on a section 988 transaction as defined in section 988(c)(1) or realized with respect to any qualified fund as defined in section 988(c)(1)(E)(iii).

(ii) Sections 864(e) and 954(c). Except as otherwise provided in regulations issued pursuant to sections 864(e) and 954(c), the definition of hedging transaction in paragraph (b) of this section does not apply for purposes of sections 864(e) and 954(c).

(iii) Global dealing operation. Except as otherwise provided in §§1.475(g)–2, 1.482–8, and 1.863–3(h), the rules of application for purposes of the definition of a hedging transaction in paragraph (c) of this section do not apply in determining the allocation and source of income with respect to a participant in a global dealing operation or in determining whether a risk management function related to the activities of a regular dealer in securities has been conducted. See §1.1842–8(a) for the definitions of global dealing operation, regular dealer in securities, and participant.

(iv) Sections 882(c) and 884. Except as otherwise provided in regulations issued under sections 882(c) and 884, the definition of hedging transaction in paragraph (b) of this section does not apply for purposes of those sections.

(b) Hedging transaction defined. Section 1221(b)(2)(A) provides that a hedging transaction is any transaction that a taxpayer enters into in the normal course of the taxpayer’s trade or business primarily—

(1) To manage risk of price changes or currency fluctuations with respect to ordinary property (as defined in paragraph (c)(5) of this section) that is held or to be held by the taxpayer;

(2) To manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer; or

(3) To manage such other risks as the Secretary may prescribe in regulations (see paragraph (c)(8) of this section).

(c) Rules of application. The rules of this paragraph (c) apply for purposes of the definition of the term hedging transaction in section 1221(b)(2)(A) and paragraph (b) of this section. These rules must be interpreted reasonably and consistently with the purposes of this section. Where no specific rules of application control, the definition of hedging transaction must be interpreted reasonably and consistently with the purposes of section 1221(b)(2)(A) and this section.

(1) Managing risk—(i) Transactions that manage risk. Whether a transaction manages a taxpayer’s risk is determined based on all of the facts and circumstances surrounding the taxpayer’s business and the transaction. In general, a taxpayer’s hedging strategies and policies as reflected in the taxpayer’s minutes or other records are evidence of whether particular transactions were entered into primarily to manage the taxpayer’s risk.

(ii) Micro and macro hedges—(A) In general. A taxpayer has risk of a particular type only if it is at risk when all of its operations are considered. Nonetheless, a hedge of a particular asset or liability generally will be respected as managing risk if it reduces the risk attributable to the asset or liability and if it is reasonably expected to reduce the overall risk of the taxpayer’s operations. If a taxpayer hedges particular assets or liabilities, or groups of assets or liabilities, and the hedges are undertaken as part of a program that, as a whole, is reasonably expected to reduce the overall risk of the taxpayer’s operations, the taxpayer generally does not have to demonstrate that each hedge that was entered into pursuant to the program reduces its overall risk.

(B) Fixed-to-floating hedges. Under the principles of paragraph (c)(1)(i)(A) of this section, a transaction that economically converts an interest rate or price from a fixed rate or price to a floating rate or price may manage risk. For example, if a taxpayer’s income varies with interest rates, the taxpayer may be at risk if it has a fixed rate liability. Similarly, a taxpayer with a fixed cost for its inventory may be at risk if the price at which the inventory can be sold varies with a particular factor. Thus, a transaction that converts an interest rate or price from fixed to floating may be a hedging transaction.

(iii) Written options. A written option may manage risk. For example, in appropriate circumstances, a written call option with respect to assets held by a taxpayer or a written put option with respect to assets to be acquired by a taxpayer may be a hedging transaction. See also paragraph (c)(1)(v) of this section.
(iv) **Extent of risk management.** A taxpayer may hedge all or any portion of its risk for all or any part of the period during which it is exposed to the risk.

(v) **Transactions that counteract hedging transactions.** If a transaction is entered into primarily to counteract all or any part of the risk reduction effected by one or more hedging transactions, the transaction is a hedging transaction. For example, if a written option is used to reduce or eliminate the risk reduction obtained from another position such as a purchased option, then it may be a hedging transaction.

(vi) **Number of transactions.** The fact that a taxpayer frequently enters into and terminates positions (even if done on a daily or more frequent basis) is not relevant to whether these transactions are hedging transactions. Thus, for example, a taxpayer hedging the risk associated with an asset or liability may frequently establish and terminate positions that hedge that risk, depending on the extent the taxpayer wishes to be hedged. Similarly, if a taxpayer maintains its level of risk exposure by entering into and terminating a large number of transactions in a single day, its transactions may nonetheless qualify as hedging transactions.

(vii) **Transactions that do not manage risk.** A transaction that is not entered into to reduce a taxpayer’s risk does not manage risk. For example, assume that a taxpayer produces a commodity for sale, sells the commodity, and enters into a long futures or forward contract in that commodity in the hope that the price will increase. Because the long position does not reduce risk, and is not otherwise treated as a hedging transaction in this paragraph (c), the transaction is not a hedging transaction. Moreover, gain or loss on the contract is not made ordinary on the grounds that it is a surrogate for inventory. See paragraph (a)(3) of this section.

(2) **Entering into a hedging transaction.** A taxpayer may enter into a hedging transaction by using a position that was a hedge of one asset or liability as a hedge of another asset or liability (recycling).

(3) **No investments as hedging transactions.** If an asset (such as an investment) is not acquired primarily to manage risk, the purchase or sale of that asset is not a hedging transaction even if the terms of the asset limit or reduce the taxpayer’s risk with respect to other assets or liabilities. For example, a taxpayer’s interest rate risk from a floating rate borrowing may be reduced by the purchase of debt instruments that bear a comparable floating rate. The acquisition of the debt instruments, however, is not a hedging transaction because the transaction is not entered into primarily to reduce the taxpayer’s risk. Similarly, borrowings generally are not made primarily to manage risk.

(4) **Normal course.** Solely for purposes of paragraph (b) of this section, if a transaction is entered into in furtherance of a taxpayer’s trade or business, the transaction is entered into in the normal course of the taxpayer’s trade or business. This rule applies even if the risk to be managed relates to the expansion of an existing business or the acquisition of a new trade or business.

(5) **Ordinary property and obligations.** Property is ordinary property to a taxpayer only if a sale or exchange of the property by the taxpayer could not produce capital gain or loss regardless of the taxpayer’s holding period when the sale or exchange occurs. Thus, for example, property used in a trade or business within the meaning of section 1231(b) (determined without regard to the holding period specified in that section) is not ordinary property. An obligation is an ordinary obligation if performance or termination of the obligation by the taxpayer could not produce capital gain or loss. For purposes of the preceding sentence, termination has the same meaning as in section 1234A.

(6) **Borrowings.** Whether hedges of a taxpayer’s debt issuances (borrowings) are hedging transactions is determined without regard to the use of the proceeds of the borrowing.

(7) **Hedging an aggregate risk.** The term hedging transaction includes a transaction that manages an aggregate risk of interest rate changes, price changes, and/or currency fluctuations only if all of the risk, or all but a de minimis amount of the risk, is with respect to ordinary property, ordinary obligations, or borrowings.

(8) **Hedges of other risks.** Except as otherwise determined in a regulation, revenue ruling, or revenue procedure, a hedging transaction does not include a transaction entered into to manage risks other than interest rate or price changes, or currency fluctuations.

(d) **Hedging by members of a consolidated group—**

(1) **General rule: single-entity approach.** For purposes of this section, the risk of one member of a consolidated group is treated as the risk of the other members as if all of the members of the group were divisions of a single corporation. For example, if any member of a consolidated group hedges the risk of another member of the group by entering into a transaction with a third party, that transaction may potentially qualify as a hedging transaction. Conversely, intercompany transactions are not hedging transactions because, when considered as transactions between divisions of a single corporation, they do not manage the risk of that single corporation.

(2) **Separate-entity election.** In lieu of the single-entity approach specified in paragraph (d)(1) of this section, a consolidated group may elect separate-entity treatment of its hedging transactions. If a group makes this separate-entity election, the following rules apply.

(i) **Risk of one member not risk of other members.** Notwithstanding paragraph (d)(1) of this section, the risk of one member is not treated as the risk of other members.

(ii) **Intercompany transactions.** An intercompany transaction is a hedging transaction (an intercompany hedging transaction) with respect to a member of a consolidated group if and only if it meets the following requirements—

(A) The position of the member in the intercompany transaction would qualify as a hedging transaction with respect to the member (taking into account paragraph (d)(2)(i) of this section) if the member had entered into the transaction with an unrelated party; and

(B) The position of the other member (the marking member) in the transaction is marked to market under the marking member’s method of accounting.

(iii) **Treatment of intercompany hedging transactions.** An intercompany hedging transaction (that is, a transaction that meets the requirements of paragraphs (d)(2)(ii)(A) and (B) of this section) is subject to the following rules—
(A) The character and timing rules of §1.1502–13 do not apply to the income, deduction, gain, or loss from the intercompany hedging transaction; and

(B) Except as provided in paragraph (f)(3) of this section, the character of the marking member’s gain or loss from the transaction is ordinary.

(iv) Making and revoking the election. Unless the Commissioner otherwise prescribes, the election described in this paragraph (d)(2) must be made in a separate statement saying “[Insert Name and Employer Identification Number of Common Parent] HEREBY ELECTS THE APPLICATION OF SECTION 1.1221–2(d)(2) (THE SEPARATE-ENTITY APPROACH).” The statement must also indicate the date as of which the election is to be effective. The election must be signed by the common parent and filed with the group’s federal income tax return for the taxable year that includes the first date for which the election is to apply. The election applies to all transactions entered into on or after the date so indicated. The election may be revoked only with the consent of the Commissioner.

(3) Definitions. For definitions of consolidated group, divisions of a single corporation, group, intercompany transactions, and member, see section 1502 and the regulations thereunder.

(4) Examples. The following examples illustrate this paragraph (d):

General Facts. In these examples, O and A are members of the same consolidated group. O’s business operations give rise to interest rate risk “A,” which O wishes to hedge. O enters into an intercompany transaction with H that transfers the risk to H. O’s position in the intercompany transaction is “B,” and H’s position in the transaction is “C.” H enters into position “D” with a third party to reduce the interest rate risk it has with respect to its position C. D would be a hedging transaction with respect to risk if O’s risk were H’s risk.

Example 1. Single-entity treatment.—(i) General rule. Under paragraph (d)(1) of this section, O’s risk A is treated as H’s risk, and therefore D is a hedging transaction with respect to risk A. Thus, the character of D is determined under the rules of this section, and the income, deduction, gain, or loss from D must be accounted for under a method of accounting that satisfies §1.446–4. The intercompany transaction B-C is not a hedging transaction and is taken into account under §1.1502–13.

(ii) Identification. D must be identified as a hedging transaction under paragraph (e)(1) of this section, and A must be identified as the hedged item under paragraph (e)(2) of this section. Under paragraph (e)(5) of this section, the identification of A as the hedged item can be accomplished by identifying the positions in the intercompany transaction as hedged or items, as appropriate. Thus, substantially contemporaneous with entering into D, H may identify C as the hedged item and O may identify B as a hedge and A as the hedged item. Example 2. Separate-entity election; counterparty that does not mark to market. In addition to the General Facts stated above, assume that the group makes a separate-entity election under paragraph (d)(2) of this section. If H does not mark C to market under its method of accounting, then D is not a hedging transaction, and the B-C intercompany transaction is taken into account under the rules of section 1502. D is not a hedging transaction with respect to A, but D may be a hedging transaction with respect to C if C is ordinary property or an ordinary obligation and if the other requirements of paragraph (b) of this section are met. If D is not part of a hedging transaction, then D may be part of a straddle for purposes of section 1092.

Example 3. Separate-entity election; counterparty that marks to market. The facts are the same as in Example 2 above, except that H marks C to market under its method of accounting. Also assume that B would be a hedging transaction with respect to risk A if O had entered into that transaction with an unrelated party. Thus, for O, the B-C transaction is an intercompany hedging transaction with respect to O’s risk A, the character and timing rules of §1.1502–13 do not apply to the B-C transaction, and O’s income, deduction, gain, or loss from C is ordinary. However, other attributes of the items from the B-C transaction are determined under §1.1502–13. D is a hedging transaction with respect to C if it meets the requirements of paragraph (b) of this section.

(e) Identification and recordkeeping—
(1) Same-day identification of hedging transactions. Under section 1221(a)(7), a taxpayer that enters into a hedging transaction (including recycling an existing hedging transaction) must clearly identify it as a hedging transaction before the close of the day on which the transaction is acquired, originated, or entered into the transaction (or recycled the existing hedging transaction).

(2) Substantially contemporaneous identification of hedged item.—(i) Content of the identification. A taxpayer that enters into a hedging transaction must identify the item, items, or aggregate risk being hedged. Identification of an item being hedged generally involves identifying a transaction that creates risk, and the type of risk that the transaction creates. For example, if a taxpayer is hedging the price risk with respect to its June purchases of corn, the hedging transaction is the June purchase of corn and the risk is price movements in the market where the taxpayer buys its corn. For additional rules concerning the content of this identification, see paragraph (e)(3) of this section.

(ii) Timing of the identification. The identification required by this paragraph (e)(2) must be made substantially contemporaneously with entering into the hedging transaction. An identification is not substantially contemporaneous if it is made more than 35 days after entering into the hedging transaction.

(3) Identification requirements for certain hedging transactions. In the case of the hedging transactions described in paragraph (b)(3), the identification under paragraph (e)(2) of this section must include the information specified.

(i) Anticipatory asset hedges. If the hedging transaction relates to the anticipated acquisition of assets by the taxpayer, the identification must include the expected date or dates of acquisition and the amounts expected to be acquired.

(ii) Inventory hedges. If the hedging transaction relates to the purchase or sale of inventory by the taxpayer, the identification is made by specifying the type or class of inventory to which the transaction relates. If the hedging transaction relates to specific purchases or sales, the identification must also include the expected dates of the purchases or sales and the amounts to be purchased or sold.

(iii) Hedges of debt of the taxpayer.—(A) Existing debt. If the hedging transaction relates to accruals or payments under an issue of existing debt of the taxpayer, the identification must specify the issue and, if the hedge is for less than the full issue price or the full term of the debt, the amount of the issue price and the term covered by the hedge.

(B) Debt to be issued. If the hedging transaction relates to the expected issuance of debt by the taxpayer or to accruals or payments under debt that is expected to be issued by the taxpayer, the identification must specify the following information: the expected date of issuance of the debt; the expected maturity or maturities; the total expected issue price; and the expected interest provisions. If the hedge is for less than the entire expected issue price of the debt or the full expected term of the debt, the identification must also include the amount or the term being hedged. The identification may indicate a range of dates, terms, and amounts, rather than specific dates, terms.
or amounts. For example, a taxpayer might identify a transaction as hedging the yield on an anticipated issuance of fixed rate debt during the second half of its fiscal year, with the anticipated amount of the debt between $75 million and $125 million, and an anticipated term of approximately 20 to 30 years.

(iv) Hedges of aggregate risk—(A) Required identification. If a transaction hedges aggregate risk as described in paragraph (c)(7) of this section, the identification under paragraph (e)(2) of this section must include a description of the risk being hedged and of the hedging program under which the hedging transaction was entered. This requirement may be met by placing in the taxpayer’s books a description of the hedging program and by establishing a system under which individual transactions can be identified as being entered into pursuant to the program.

(B) Description of hedging program. A description of a hedging program must include an identification of the type of risk being hedged, a description of the type of items giving rise to the risk being aggregated, and sufficient additional information to demonstrate that the program is designed to reduce aggregate risk of the type identified. If the program contains controls on speculation (for example, position limits), the description of the hedging program must also explain how the controls are established, communicated, and implemented.

(4) Manner of identification and records to be retained—(i) Inclusion of identification in tax records. The identification required by this paragraph (e) must be made on, and retained as part of, the taxpayer’s books and records.

(ii) Presence of identification must be unambiguous. The presence of an identification for purposes of this paragraph (e) must be unambiguous. The identification of a hedging transaction for financial accounting or regulatory purposes does not satisfy this requirement unless the taxpayer’s books and records indicate that the identification is also being made for tax purposes. The taxpayer may indicate that individual hedging transactions, or a class or classes of hedging transactions, that are identified for financial accounting or regulatory purposes are also being identified as hedging transactions for purposes of this section.

(iii) Manner of identification. The taxpayer may separately and explicitly make each identification, or, so long as paragraph (e)(4)(ii) of this section is satisfied, the taxpayer may establish a system pursuant to which the identification is indicated by the type of transaction or by the manner in which the transaction is consummated or recorded. An identification under this system is made at the later of the time that the system is established or the time that the transaction satisfies the terms of the system by being entered, or by being consummated or recorded, in the designated fashion.

(iv) Examples. The following examples illustrate the principles of paragraph (e)(4)(iii) of this section and assume that the other requirements of paragraph (e) are satisfied.

(A) A taxpayer can make an identification by designating a hedging transaction for (or placing it in) an account that has been identified as containing only hedges of a specified item (or of specified items or specified aggregate risk).

(B) A taxpayer can make an identification by including and retaining in its books and records a statement that designates all future transactions in a specified derivative product as hedges of a specified item, items, or aggregate risk.

(C) A taxpayer can make an identification by designating a certain mark, a certain form, or a certain legend as meaning that a transaction is a hedge of a specified item (or of specified items or a specified aggregate risk). Identification can be made by placing the designated mark on a record of the transaction (for example, trading ticket, purchase order, or trade confirmation) or by using the designated form or a record that contains the designated legend.

(5) Identification of hedgers involving members of the same consolidated group—(i) General rule: single-entity approach. A member of a consolidated group must satisfy the requirements of this paragraph (e) as if all of the members of the group were divisions of a single corporation. Thus, the member entering into the hedging transaction with a third party must identify the hedging transaction under paragraph (e)(1) of this section. Under paragraph (e)(2) of this section, that member must also identify the item, items, or aggregate risk that is being hedged, even if the item, items, or aggregate risk relates primarily or entirely to other members of the group. If the members of a group use intercompany transactions to transfer risk within the group, the requirements of paragraph (e)(2) of this section may be met by identifying the intercompany transactions, and the risks hedged by the intercompany transactions, as hedges or hedged items, as appropriate. Because identification of the intercompany transaction as a hedge serves solely to identify the hedged item, the identification is timely if made within the period required by paragraph (e)(2) of this section. For example, if a member transfers risk in an intercompany transaction, it may identify under the rules of this paragraph (e) both its position in that transaction and the item, items, or aggregate risk being hedged. The member that hedges the risk outside the group may identify under the rules of this paragraph (e) both its position with the third party and its position in the intercompany transaction. Paragraph (d)(4) Example 1 of this section illustrates this identification.

(ii) Rule for consolidated groups making the separate-entity election. If a consolidated group makes the separate-entity election under paragraph (d)(2) of this section, each member of the group must satisfy the requirements of this paragraph (e) as though it were not a member of a consolidated group.

(6) Consistency with section 1256(e)(2). Any identification for purposes of section 1256(e)(2) is also an identification for purposes of paragraph (e)(1) of this section.

(1) Effect of identification and non-identification—(i) In general. If a taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e)(1) of this section, the identification is binding with respect to gain, whether or not all of the requirements of paragraph (e) are satisfied. Thus, gain from that transaction is ordinary income. If the transaction is not in fact a hedging transaction described in paragraph (b) of this section, however, paragraphs (a)(1) and (2) of this section do not apply and the character of loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or
purpose. Thus, the taxpayer’s identification of the transaction as a hedging transaction does not itself make loss from the transaction ordinary.

(ii) Inadvertent identification. Notwithstanding paragraph (f)(1)(i) of this section, if the taxpayer identifies a transaction as a hedging transaction for purposes of paragraph (e) of this section, the character of the gain is determined as if the transaction had not been identified as a hedging transaction if—

(A) The transaction is not a hedging transaction (as defined in paragraph (b) of this section);

(B) The identification of the transaction as a hedging transaction was due to inadvertent error; and

(C) 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.

(2) Transactions not identified—(i) In general. Except as provided in paragraphs (f)(2)(ii) and (iii) of this section, the absence of an identification that satisfies the requirements of paragraph (e)(1) of this section is binding and establishes that a transaction is not a hedging transaction. Thus, subject to the exceptions, the rules of paragraphs (a)(1) and (2) of this section do not apply, and the character of gain or loss is determined without reference to whether the transaction is a surrogate for a noncapital asset, serves as insurance against a business risk, serves a hedging function, or serves a similar function or purpose.

(ii) Inadvertent error. If a taxpayer does not make an identification that satisfies the requirements of paragraph (e) of this section, the taxpayer may treat gain or loss from the transaction as ordinary income or loss under paragraph (a)(1) or (2) of this section if—

(A) The transaction is a hedging transaction (as defined in paragraph (b) of this section);

(B) The failure to identify the transaction was due to inadvertent error; and

(C) All of the taxpayer’s hedging transactions in all open years are being treated on either original or, if necessary, amended returns as provided in paragraphs (a)(1) and (2) of this section.

(iii) Anti-abuse rule. If a taxpayer does not make an identification that satisfies all the requirements of paragraph (e) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a hedging transaction, then gain from the transaction is ordinary. The reasonableness of the taxpayer’s failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (b) 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.

(3) Transactions by members of a consolidated group—(i) Single-entity approach. If a consolidated group is under the general rule of paragraph (d)(1) of this section (the single-entity approach), the rules of this paragraph (f) apply only to transactions that are not intercompany transactions.

(ii) Separate-entity election. If a consolidated group has made the election under paragraph (d)(2) of this section, then, in addition to the rules of paragraphs (f)(1) and (2) of this section, the following rules apply:

(A) If an intercompany transaction is identified as a hedging transaction but does not meet the requirements of paragraphs (d)(2)(ii)(A) and (B) of this section, then, notwithstanding any contrary provision in §1.1502–13, each party to the transaction is subject to the rules of paragraph (f)(1) of this section with respect to the transaction as though it had incorrectly identified its position in the transaction as a hedging transaction.

(B) If a transaction meets the requirements of paragraphs (d)(2)(ii)(A) and (B) of this section but the transaction is not identified as a hedging transaction, each party to the transaction is subject to the rules of paragraph (f)(2) of this section. (Because the transaction is an intercompany hedging transaction, the character and timing rules of §1.1502–13 do not apply. See paragraph (d)(2)(iii)(A) of this section.)

(g) Effective date. The rules of this section apply to transactions entered into on or after January 18, 2001.

Robert E. Wenzel, Deputy Commissioner of Internal Revenue.

These proposed regulations set forth standards by which a plan sponsor may satisfy the notice to interested parties requirement. The proposed regulations affect retirement plan sponsors, plan participants and other interested parties with respect to an application for a determination letter, and certain representatives of interested parties.

DATES: Written or electronic comments and requests for a public hearing must be received by April 17, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–129608–00), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–129608–00), Courier’s Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/reglist.html.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, contact Pamela R. Kinard, (202) 622-6060; concerning the submission of comments, contact LaNita VanDyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Parts 1 and 601) under section 7476 of the Internal Revenue Code of 1986 (Code).

Section 7476(b)(2) provides that, with respect to a pleading filed by a petitioner for a request for a determination on the qualified status of a retirement plan under section 7476(a), the Tax Court may find the pleading to be premature unless the petitioner establishes to the satisfaction of the court that he has complied with the requirements prescribed by the regulations of the Secretary regarding the notice to interested parties.

On May 21, 1976, Final Income Tax Regulations (T.D. 7421, 1976–1 C.B. 405) under section 7476 were published in the Federal Register (41 FR 20874). The final regulations provide guidance on the nature and method of giving notice to interested parties. Existing §1.7476–1(a)(1) provides that in order to receive a determination on the qualified status of a retirement plan, the applicant must provide evidence that individuals who qualified as interested parties received notification of the determination letter application. In general, interested parties are defined in §1.7476–1(b)(1) as all present employees of the employer eligible to participate in the plan, and all other present employees whose principal place of employment is the same as the principal place of employment of the employees eligible to participate. For plan terminations, §1.7476–1(b)(5) defines interested parties as all present employees with accrued benefits, all former employees with vested benefits, and all beneficiaries of deceased former employees currently receiving benefits under the plan.

Existing §1.7476–2(b) provides that the notice must be given in writing, must contain the information in §601.201(o)(3) (Statement of Procedural Rules) and must be given in the manner prescribed in §1.7476–2(c). For present employees, §1.7476–2(c)(1) provides that the notice must be given in person, by mailing, by posting, or by printing it in a publication of the employer or an employee organization that is reasonably available to employees. For interested parties who are in a unit of employees covered by a collective-bargaining agreement, the notice must also be given in person or by mail to the collective-bargaining representative of the interested parties. For former employees and beneficiaries who qualify as interested parties, §1.7476–2(c)(2)(i) provides that notice shall be given in person or by mail to the last known address of the interested party.


In order to continue to advance the goal of permitting plan sponsors to use electronic media in administering their retirement plans, this amendment to the regulations eliminates the writing requirement for the notice to interested parties. Instead, the proposed regulations set forth new standards for satisfying the notice requirement that would ensure that interested parties will receive timely and adequate notice.

Explanation of Provisions

This notice of proposed rulemaking would amend §§1.7476–2 and 601.201 regarding the nature and method of giving notices to interested parties. The proposed regulations do not change the information that the notice must contain or the time period in which the notice must be given. These regulations continue to provide that the notice to interested parties must contain the information and be given within the time period prescribed in §601.201(o)(3) (Statement of Procedural Rules). The proposed regulations would set forth new standards for providing the notice to interested parties. These new standards permit greater flexibility in the manner in which the notice may be provided.

The proposed regulations provide that, in the case of a present employee, former employee, or beneficiary who is an interested party, the notice may be provided by any method that reasonably ensures that all interested parties will receive the notice. The method used must be reasonably calculated to provide timely and adequate notice to all interested parties. In addition, the proposed regulations provide that if an interested party who is a present employee is in a unit of employees covered by a collective-bargaining agreement between employee representatives and one or more employers, notice shall also be given to the collective-bargaining representative of such interested party by any method that reasonably ensures that the collective-bargaining representative will receive the notice. The proposed regulations also provide if the notice to interested parties is delivered using an electronic medium under a system that satisfies the requirements of Q&A-5 of §1.402(f)–1, the notice will be deemed to be provided in a
manner that satisfies the notice to interested parties requirement.

The proposed regulations provide that whether the notice to interested parties is given in a manner that satisfies the requirements under these regulations will be determined on the basis of all the facts and circumstances. These regulations further provide that since the facts and circumstances will differ depending on the interested party, it is possible that more than one method of delivery (including nonelectronic writing) must be used in order to ensure timely and adequate notice to all interested parties.

The proposed regulations also revise §601.201 (Statement of Procedural Rules) to conform to the changes in §1.7476–2.

Proposed Effective Date

These regulations are proposed to be effective with respect to applications made on or after the date they are published in the Federal Register as final regulations. Plan sponsors may rely on these proposed regulations for guidance pending the issuance of final regulations. If, and to the extent, future guidance is more restrictive than the guidance in these proposed regulations, the future guidance will be applied without retroactive effect.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 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) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these proposed regulations 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) or electronic comments that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed rule and how it may be made easier to understand. 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.

Drafting Information

The principal author of these regulations is Pamela R. Kinard of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

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 1.7476–2 is amended as follows:

1. Paragraph (b) and (c) are revised.
2. Paragraph (d) is redesignated as paragraph (e) and a new paragraph (d) is added.
3. Paragraph (e)(1) is revised.

The revisions and additions read as follows:

§1.7476–2 Notice to interested parties.

(b) Nature of notice. The notice required by this section shall —

1. Contain the information and be given within the time period prescribed in §601.201(o)(3) of this chapter (Statement of Procedural Rules); and,

2. Be given in a manner prescribed in paragraph (c) of this section.

(c) Method of giving notice. (1) In the case of a present employee, former employee, or beneficiary who is an interested party, the notice may be provided by any method that reasonably ensures that all interested parties will receive timely and adequate notice. If an interested party who is a present employee is in a unit of employees covered by a collective-bargaining agreement between employee representatives and one or more employers, notice shall also be given to the collective-bargaining representative of such interested party by any method that satisfies this paragraph. Whether the notice is provided in a manner that satisfies the requirements of this paragraph will be determined on the basis of all the facts and circumstances. Because the facts and circumstances will differ depending on the interested party, it is possible that more than one method of delivery must be used in order to ensure timely and adequate notice to all interested parties.

2. If the notice to interested parties is delivered using an electronic medium under a system that satisfies the requirements of Q&A-5 of §1.402(f)–1, the notice will be deemed to be provided in a manner that satisfies the requirements of paragraph (c)(1) of this section.

(d) Examples. The principles of this section are illustrated by the following examples:

Example 1. (i) Employer A is amending Plan C and applying for a determination letter. Plan C is not maintained pursuant to one or more collective-bargaining agreements and is not being terminated. As part of the determination letter application process, Employer A provides the notice required under this section to interested parties. For present employees, Employer A provides the notice by posting the notice at those locations within the principal places of employment of the interested parties which are customarily used for employer notices to employees with regard to labor-management relations matters.

(ii) In this Example 1, Employer A satisfies the notice to interested parties requirement described in this section.

Example 2. (i) Employer B is amending Plan D and applying for a determination letter. As part of the determination letter application process, Employer B provides the notice required under this section to interested parties.

(ii) Employer B has multiple worksites. Employer B’s employees located at worksites 1 through 4 have access to computers at their workplace. However, Employer B’s employees located at worksite 5 do not have access to computers.

(iii) For present employees with access to computers (worksites 1 through 4), Employer B provides the notice by posting the notice on Employer B’s web site (Internet or intranet). Employer B customarily posts employer notices to employees at worksites 1 through 4 with regard to labor-management relations matters on its web site. For present employees without access to computers (worksites 5),
Employer B provides the notice by posting the notice at worksite 5 in a location that is customarily used for employer notices to employees with regard to labor-management relations matters.

(iv) Employer B also sends the notice by e-mail to each collective-bargaining representative of interested parties who are present employees of Employer B covered by a collective-bargaining agreement between employee representatives and Employer B, using the e-mail address previously provided to Employer B by such collective-bargaining representative.

(v) In this Example 2, Employer B satisfies the notice to interested parties requirement described in this section.

Example 3. (i) Employer C is terminating Plan E and applying for a determination letter as to whether the plan termination affects the continuing qualification of Plan E. As part of the determination letter application process, Employer C provides the notice required under this section to interested parties.

(ii) All of Employer C’s employees have access to computers. Each employee has an e-mail address where he or she can receive messages from Employer C. Employer C has set up kiosks for employees’ use. The kiosks are located within the principal places of employment of the employees and are customarily used for employer notices to employees with regard to labor-management relations matters.

(iii) For present employees, Employer C provides the notice by sending the notice by e-mail.

(iv) Employer C also sends the notice by e-mail to each collective-bargaining representative of interested parties who are present employees of Employer C covered by a collective-bargaining agreement between employee representatives and Employer C, using the e-mail address previously provided to Employer C by such collective-bargaining representative.

(v) In addition, Employer C sends the notice by e-mail to each collective-bargaining representative of former employees or beneficiary, who did not provide an e-mail address, Employer C sends the notice by regular mail to the last known address of such former employee or beneficiary.

(vi) In this Example 3, Employer C satisfies the notice to interested parties requirement described in this section.

(e) Effective date. (1) The provisions of this section shall apply to applications referred to in paragraph (a) of §1.7476–1 made on or after the date the regulations are published in the Federal Register as final regulations.

* * * * *

PART 601 — STATEMENT OF PROCEDURAL RULES

Paragraph 1. The authority citation for part 601 continues to read, in part, as follows:

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

Par. 2. Section 601.201 is amended as follows:

1. In paragraph (o)(3)(xv), the first sentence is replaced by two new sentences.

2. In paragraph (o)(3)(xvi), introductory text is revised.

The revisions read as follows:

§601.201 Rulings and determination letters.

* * * * *

(o) * * * (3) * * *

(xv) When the notice referred to in paragraph (o)(3)(xvi) of this section is given in the manner set forth in §1.7476–2(c), the following time limitations for providing the notice apply. When the notice is given other than by mailing, it should be given not less than 7 days nor more than 21 days prior to the date that the application for a determination is made. * * *

(xvi) The notice referred to in paragraph (o)(3)(xvi) of this section shall be given in the manner prescribed in §1.7476–2 and shall contain the following information: * * * * *

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on January 16, 2001, 8:45 a.m., and published in the issue of the Federal Register for January 17, 2001, 66 FR 3954)

Supplemental Information on Treasury Bills for Publication 1212

Announcement 2001–29

Banks, brokers, and other middlemen who report discount on Treasury bill redemptions on Form 1099-INT must use the owner’s purchase price, where available, to determine the amount of discount to report. This information can usually be obtained from the owner’s or middleman’s records. However, if the owner’s purchase price is not available from existing records, the middleman must report the discount as if the holder had purchased the Treasury bill at its original issue price. In this case, the middleman must use as the original issue price the noncompetitive issue price for the longest-maturity Treasury bill maturing on that date.

For Treasury bill redemptions when the owner’s purchase price cannot be determined, the following list gives the noncompetitive issue prices and corresponding amounts of discount to be reported on Form 1099-INT for Treasury bills maturing May through July 2001. This list, which should also help middlemen determine any amounts subject to backup withholding, supplements the list that appears in the 2000 edition of Publication 1212, List of Original Issue Discount Instruments.
## SHORT-TERM UNITED STATES TREASURY BILLS
Issued at a discount and maturing May 2001 - July 2001

<table>
<thead>
<tr>
<th>CUSIP Number</th>
<th>Maturity Date</th>
<th>Issue Date</th>
<th>Noncompetitive Issue Price (% of Principal Amount)</th>
<th>Dollar Amount of OID to be reported (per $1,000 of Maturity Value)</th>
</tr>
</thead>
<tbody>
<tr>
<td>912795GE5</td>
<td>05/03/01</td>
<td>11/02/00</td>
<td>96.929</td>
<td>30.71</td>
</tr>
<tr>
<td>912795GF2</td>
<td>05/10/01</td>
<td>11/09/00</td>
<td>96.914</td>
<td>30.86</td>
</tr>
<tr>
<td>912795GG0</td>
<td>05/17/01</td>
<td>11/16/00</td>
<td>96.931</td>
<td>30.69</td>
</tr>
<tr>
<td>912795GH8</td>
<td>05/24/01</td>
<td>11/24/00</td>
<td>96.958</td>
<td>30.42</td>
</tr>
<tr>
<td>* 912795GJ4</td>
<td>05/31/01</td>
<td>06/01/00</td>
<td>93.933</td>
<td>60.67</td>
</tr>
<tr>
<td>912795GK1</td>
<td>06/07/01</td>
<td>12/07/00</td>
<td>97.048</td>
<td>29.52</td>
</tr>
<tr>
<td>912795GL9</td>
<td>06/14/01</td>
<td>12/14/00</td>
<td>97.073</td>
<td>29.27</td>
</tr>
<tr>
<td>912795GM7</td>
<td>06/21/01</td>
<td>12/21/00</td>
<td>97.139</td>
<td>28.61</td>
</tr>
<tr>
<td>912795GN5</td>
<td>06/28/01</td>
<td>12/28/00</td>
<td>97.219</td>
<td>27.81</td>
</tr>
<tr>
<td>912795HA2</td>
<td>07/05/01</td>
<td>01/04/01</td>
<td>97.290</td>
<td>27.10</td>
</tr>
<tr>
<td>912795HC8</td>
<td>07/12/01</td>
<td>01/11/01</td>
<td>97.561</td>
<td>24.39</td>
</tr>
<tr>
<td>912795GP0</td>
<td>07/19/01</td>
<td>01/18/01</td>
<td>97.444</td>
<td>25.56</td>
</tr>
<tr>
<td>912795HD6</td>
<td>07/26/01</td>
<td>01/25/01</td>
<td>97.513</td>
<td>24.87</td>
</tr>
</tbody>
</table>

*52-Week Bill
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.
Cl.—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.

April 2, 2001

2001–14 I.R.B.
Finding List of Current Actions on Previously Published Items

Bulletins 2001–1 through 2001–13

Announcement:

98–99
Modified by

99–79
Superseded by

2000–78
Obsoleted by

2000–97
Corrected by

Cumulative Bulletin:

1998–2
Corrected by

Notices:

94–3
Modified by

98–39
Modified by
Notice 2001–9, 2001–4 I.R.B. 375

98–40
Modified by
Notice 2001–9, 2001–3 I.R.B. 375

99–53
Modified and superseded by

2000–21
Superseded by

2000–22
Modified and superseded by
Notice 2001–8, 2001–4 I.R.B. 374

2000–26
Modified by

2000–43
Extended by

Proposed Regulations:

EE–130–86
Partially withdrawn by

REG–106542–98
Corrected by

REG–116733–98
Withdrawn by

Proposed Regulations—Continued:

REG–116048–99
Withdrawn by

REG–106702–00
Corrected by

Revenue Procedures:

83–87
Superseded by

90–18
Amplified and superseded by

92–19
Superseded by

96–15
Modified by

96–17
Modified by

99–18
Modified and superseded by

99–47
Superseded by

99–49
Modified and amplified by


Revenue Procedures—Continued:

2000–8
Superseded by

2000–16
Modified and superseded by

2000–22
Modified and superseded by

2001–3
Corrected by

2001–13
Clarified by
Notice 2001–12, 2001–3 I.R.B. 328

Revenue Rulings:

64–328
Modified by

66–110
Modified by

85–30
Clarified by

88–95
Clarified by

92–19
Supplemented in part by

2000–56
Corrected by

2001–4
Modified by

Treasury Decisions:

7530
Removed by

8889
Corrected by

8913
Corrected by

INDEX
Internal Revenue Bulletins
2001–1 through 2001–13

The abbreviation and number in parenthesis following the index entry refer to the specific item; numbers in roman and italic type following the paranthesis refer to the Internal Revenue Bulletin in which the item may be found and the page number on which it appears.

Key to Abbreviations:
Ann Announcement
CD Court Decision
DO Delegation Order
EO Executive Order
PL Public Law
PTE Prohibited Transaction Exemption
RP Revenue Procedure
RR Revenue Ruling
SPR Statement of Procedural Rules
TC Tax Convention
TD Treasury Decision
TDO Treasury Department Order

EMPLOYEE PLANS—Cont.

Group health plans:
Continuation coverage requirements (TD 8928) 8, 685
HIPAA nondiscrimination:
Bona fide wellness programs (REG–114084–00) 7, 633
Certain grandfathered church plans, exception (REG–114083–00) 7, 630
Eligibility not limited by certain health factors (TD 8931) 7, 542;
(REG–114082–00) 7, 629
GUST remedial amendment period, M&P plans and volume submitter plans (Ann 12) 6, 526
Letter rulings:
Determination letters, and information letters issued by Associates Chief Counsel (RP 1) 1, 1
Information letters, etc. (RP 4) 1, 121
Life insurance contracts, “split-dollar” arrangements (Notice 10) 5, 459
Nondiscrimination rules, governmental and church plans, relief from (Notice 9) 4, 375
Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
Proposed Regulations:
26 CFR 1.125–1 Q&A–8, amended; 1.125–2 Q&A–6(a), amended; 1.125–2 Q&A–6(b), (c), and (d), withdrawn; 1.125–2 Q&A–6(e), redesignated as (b); tax treatment of cafeteria plans (REG–209461–79) 8, 712
26 CFR 1.401(a)(9)–0 through –8, added; 1.403(b)–2, added; 1.408–8, added; 54.9974–2, added; required minimum distributions (REG–130477–00 and REG–130481–00) 11, 865
26 CFR 1.417(e)–1, amended; special rule for written explanation by qualified retirement plans provided after annuity starting date (REG–109481–99) 13, 961
26 CFR 1.420–1, added; defined benefit pension plan, transfer of excess assets (REG–116468–00) 6, 522
26 CFR 54.9802–1, amended; group health plans, HIPAA nondiscrimination requirements, eligibility not limited by certain health factors (REG–114082–00) 7, 629
26 CFR 54.9802–1(f), amended; group health plans, HIPAA nondiscrimination requirements, bona fide wellness programs (REG–114084–00) 7, 633
26 CFR 54.9802–2, added; group health plans, HIPAA nondiscrimination requirements for certain grandfathered church plans, exception (REG–114083–00) 7, 630
31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
Qualified retirement plans:
Required minimum distributions (Ann 18) 10, 791
Written explanation provided after annuity starting date (REG–109481–99) 13, 961
Regulations:
26 CFR 1.125–4, amended; 1.125–4T, removed; tax treatment of cafeteria plans (TD 8921) 7, 532
26 CFR 54.4980B–0 through –8, amended; 54.4980B–9, –10, added; group health plans, continuation coverage requirements (TD 8928) 8, 685
26 CFR 54.9802–1, added; 54.9802–1T, removed; group health plans, HIPAA nondiscrimination requirements, eligibility not limited by certain health factors (TD 8931) 7, 542
Required minimum distributions (REG–130477–00 and REG–130481–00) 11, 865
Technical advice to:
Directors and chiefs, appeals offices, from Associates Chief Counsel & Division Counsel/Associate Chief Counsel (TE/GE) (RP 2) 1, 79
IRS employees (RP 5) 1, 164
User fees, request for letter rulings (RP 8) 1, 239

EMPLOYMENT TAX

Electronic filing, Form 940 (RP 9) 3, 328
Electronic furnishing of payee statements, voluntary (TD 8942) 13, 929;
(REG–107186–00) 13, 973
Forms:
W-2, new code (Ann 7) 3, 357
W-2, voluntary electronic furnishing of payee statements (TD 8942) 13, 929;
(REG–107186–00) 13, 973
EMPLOYMENT TAX—Cont.

940, electronic filing (RP 9) 3, 328
1098-E, voluntary electronic furnishing of payee statements (TD 8942) 13, 929; (REG–107186–00) 13, 973
1098-T, voluntary electronic furnishing of payee statements (TD 8942) 13, 929; (REG–107186–00) 13, 973
Indian tribal governments under FUTA, treatment of (Ann 16) 8, 715
Interest-free adjustments (REG–110374–00) 12, 915
Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Proposed Regulations:
26 CFR 31.3406(g)–1(d), revised; reporting requirements for interest on deposits paid to nonresident aliens (REG–126100–00) 11, 862
26 CFR 31.6051–1, amended; electronic payee statements, voluntary (REG–107186–00) 13, 973
26 CFR 31.6205–1, revised; interest-free adjustments (REG–110374–00) 12, 915
26 CFR 31.6302–1, amended; 31.6302(c)–3, amended; removal of Federal Reserve banks as federal depositaries (REG–107176–00) 4, 428
31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
Railroad retirement, rate determination, quarterly, January 1, 2001, 2, 258

Regulations:
26 CFR 31.6051–1T, added; electronic payee statements, voluntary (TD 8942) 13, 929
26 CFR 31.6053–1, –4, amended; tips, tip reporting, employer established electronic systems (TD 8910) 2, 258

Reporting requirements for interest on deposits paid to nonresident aliens (REG–126100–00) 11, 862
Statutory stock options (Notice 14) 6, 516

Tips:
Tips reporting:
Employer-designed tip reporting, food and beverage industry (EmTRAC) programs (Notice 1) 2, 261

EMPLOYMENT TAX—Cont.

Employer established electronic systems (TD 8910) 2, 258
Voluntary tip reporting agreements pro formas (TRDA and TRAC) (Ann 1) 2, 277

ESTATE TAX

Art valuation requests, change of address for submissions (Ann 22) 11, 895
Charitable deductions, guaranteed annuity and unitrust interest (TD 8923) 6, 485
Generation-skipping transfer tax and retention of exempt status (TD 8912) 5, 452
Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Proposed Regulations:
26 CFR 1.641(b)–3, amended; 1.642(c)–1, revised; 1.645–1, added; 1.671–4, amended; 1.6702–1, amended; 301.6109–1, amended; election to treat trust as part of an estate (REG–106542–98) 5, 473; correction (Ann 24) 10, 793
31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Regulations:
26 CFR 20.2055–2, amended; charitable deductions, guaranteed annuity and unitrust interest (TD 8923) 6, 485
26 CFR 26.2601–1, amended; generation-skipping transfer issues (TD 8912) 5, 452

Trusts, election to treat trust as part of an estate (REG–106542–98) 5, 472; correction (Ann 24) 10, 793
Valuation of art requests, change of address for submissions (Ann 22) 11, 895

EXCISE TAX

Air transportation, mileage awards (Notice 6) 3, 327
Excess benefit transactions (TD 8920) 8, 654; (REG–246256–96) 8, 713
Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Proposed Regulations:
26 CFR 53.4958–0T through –8T, added; 53.4963–1, amended; 301.6213–1, amended; 301.6501(e)–1, amended; 301.6501(n)–1, amended; 301.7422–1, amended; 301.7454–2, amended; 301.7611–1, amended; 602.101, amended; excise taxes on excess benefit transactions (TD 8920) 8, 654

EXCISE TAX—Cont.

Advance letter rulings and determination letters, areas which will not be issued from Associates Chief Counsel & Division Counsel/Associate Chief Counsel (TE/GE) (RP 3) 1, 121; correction (Ann 25) 11, 895
Excise taxes on excess benefit transactions (TD 8920) 8, 654; (REG–246256–96) 8, 713
Indian tribal governments treated as states, list (RP 15) 5, 465
Letter rulings, information letters, etc. (RP 4) 1, 121
Plain language publications and voluntary compliance programs (Ann 14) 7, 648
Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Proposed Regulations:
26 CFR 53.4958–0 through –8, added; excise taxes on excess benefit transactions (REG–246256–96) 8, 713
31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Regulations:
26 CFR 53.4958–0T through –8T, added; 53.4963–1, amended; 301.6213–1, amended; 301.6501(e)–1, amended; 301.6501(n)–1, amended; 301.7422–1, amended; 301.7454–2, amended; 301.7611–1, amended; 602.101, amended; excise taxes on excess benefit transactions (TD 8920) 8, 654
INCOME TAX—Cont.

Automobile owners and lessees, determination of correct tax liability, 2001 inflation adjustment (RP 19) 9, 732
Business expenses, changes in method of accounting (Notice 23) 12, 911
Case Resolution Pilot Program, extension (Notice 13) 6, 514
Charitable deductions, transfers to charitable lead trust (TD 8923) 6, 485
Classification of certain business entities, check-the-box regulations (REG–110659–00) 12, 917
Consumer Price Index (CPI) adjustments, below-market loans (Ann 19) 10, 791
Conversion to the euro (TD 8927) 11, 807
Corporations:
  Assumed liabilities (TD 8924) 6, 489;
  (REG–106791–00) 6, 521
  Consolidated groups, tentative carryback adjustments (TD 8919) 6, 505;
  (REG–119352–00) 6, 525
  Distributions of stock or securities in connection with an acquisition:
    Purchase of 50% or greater interest in the corporation making the distribution or being distributed (REG–107566–00) 3, 346
  Withdrawal of REG–116733–98 (Ann 11) 4, 432
  Recognition of gain on certain distributions of stock or securities (TD 8913) 3, 300; correction (Ann 26) 11, 896
  Corporation: Tax shelter:
    Contingent liability (Notice 17) 9, 730
    Intermediary transactions (Notice 16) 9, 730
  Cost-of-living adjustments for inflation, 2001 (RP 13) 3, 337; clarified (Notice 12) 3, 328
Credits:
Deemed-paid credit computations (REG–104683–00) 4, 407
Foreign tax credit limitations:
  Affiliated groups and interest expense allocations (TD 8916) 4, 360
  Income subject to separate limitations (REG–104683–00) 4, 407
  Increasing research activities, definition of qualified research (TD 8930) 5, 433
  Low-income housing credit:
  Resident population estimates, 2001 (Notice 21) 11, 818
Satisfactory bond; “bond factor” amounts for the period:
  October through December 2000 (RR 2) 2, 225;
  January through March 2001 (RR 10) 10, 755
Research credit (Notice 2) 2, 265
Research credit computation (Notice 19) 10, 784
Cumulative Bulletin 1998–2, numerical finding list, finding list of current actions on previously published items and index; corrections (Ann 5) 2, 286
Dealers in securities futures contracts (Notice 27) 13, 942
Debt instrument, annuity issued by insurance company (REG–125237–00) 12, 919
Debt substitution, election to treat as realization event (RP 21) 9, 742
Disclosure of returns or return information to designee of taxpayer (TD 8935) 8, 702; (REG–103320–00) 8, 714
Disqualified person, definition of (REG–107175–00) 13, 971
Earnings and profits adjustments, exercise of stock option (RR 1) 9, 726
Election of small business trusts; ESBT:
  Qualifications and treatments (REG–251701–96) 4, 396
  Tiered structures (TD 8915) 4, 359
Electronic filing; magnetic media, Form W-4, Employee’s Withholding Allowance Certificate, specifications (RP 16) 4, 376
Electronic furnishing of payee statements, voluntary (TD 8942) 13, 929;
  (REG–107186–00) 13, 973
Employee stock ownership plans, deductibility of redemption proceeds (RR 6) 6, 491
Federal tax deposits, removal of Federal Reserve banks as depositories (TD 8918) 4, 372;
  (REG–107176–00) 4, 428
Financial asset securitization investment trusts (FASITs) (RP 12) 3, 335
Foreign corporations, requirements relating to certain exchanges (TD 8938) 13, 929;
  (LR–230–76) 13, 945
Forms:
  W-2, new code (Ann 7) 3, 357

INCOME TAX—Cont.

INCOME TAX—Cont.

GIFT TAX

Art valuation requests, change of address for submissions (Ann 22) 11, 895
Charitable deductions, transfers to charitable lead trust (TD 8923) 6, 485
Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
Proposed Regulations:
  31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
Regulations:
  26 CFR 25.2522(c)–3, amended; charitable deductions, lifetime charitable lead trust (TD 8923) 6, 485
  Valuation of art requests, change of address for submissions (Ann 22) 11, 895

INCOME TAX—Cont.

Advance letter rulings and determination letters, areas which will not be issued from:
Associates Chief Counsel & Division Counsel/Associate Chief Counsel (TE/GE) (RP 3) 1, 111; correction (Ann 25) 11, 895
Associate Chief Counsel International (RP 7) 1, 236
Aircraft maintenance costs (RR 4) 3, 295
Appeals, extension of test of mediation procedure (Ann 9) 3, 357
Archer MSA (Ann 21) 9, 752
Art valuation requests, change of address for submissions (Ann 22) 11, 895
Attorney’s fees, recovery of (TD 8922) 6, 508; (REG–121928–98) 6, 520

EXEMPT ORGANIZATIONS—Cont.

Revocations (Ann 20) 8, 716
Technical advice to:
  Directors and chiefs, appeals offices, from Associates Chief Counsel & Division Counsel/Associate Chief Counsel (TE/GE) (RP 2) 1, 79
IRS employees (RP 5) 1, 164
User fees, request for letter rulings (RP 8) 1, 239
Withdrawal, Voluntary Compliance on Alien Withholding Program (VCAP) (RP 20) 9, 738
W-2, voluntary electronic furnishing of payee statements (TD 8942) 13, 929; (REG–107186–00) 13, 973

W-4, Employee's Withholding Allowance Certificate, specifications (RP 6) 4, 376

W-9, Request for Taxpayer Identification Number and Certification (Ann 15) 8, 715

1042S, specifications for filing magnetically or electronically (Ann 3) 2, 278

1098-E, voluntary electronic furnishing of payee statements (TD 8925) 6, 374

1098-T, voluntary electronic furnishing of payee statements (TD 8942) 13, 973

1120, Schedule N, Foreign Operations

LIFO:
Optional dollar-value LIFO inventory computation method for used vehicle dealers (RP 23) 10, 784

Price indexes, department stores for:
November 2000 (RR 5) 5, 451
December 2000 (RR 9) 8, 652
January 2001 (RR 14) 12, 898

Joint and several liability, relief from (REG–106446–98) 13, 945

Last known address (RP 18) 8, 708

1099-B, definition of (TD 8993) 12, 899

Letter rulings, determination letters, and information letters issued by Associates Chief Counsel (RP 1) 1, 1

Life insurance contracts, “split-dollar” arrangements (Notice 10) 5, 459

Long-term contracts, accounting for (TD 8929) 10, 756

Methods of accounting:
General rule for 2001 (RP 24) 10, 788

Inventories, small taxpayers (RP 10) 2, 272

Short-term loans, stated interest, cash method banks, automatic change (RP 25) 12, 913

Partnerships:
Corporate partner’s stock, partnership termination (REG–106702–00) 4, 424; correction (Ann 28) 13, 975

Final short-year tax return, determination of basis (Notice 5) 3, 327

Mergers and divisions (TD 8925) 6, 496

Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Pre-filing agreement program (RP 22) 9, 745

Presidentially declared disaster areas:
Disaster and combat zone, tax-related deadlines (TD 8911) 3, 321

Major disaster and emergency areas (RR 15) 13, 922

Proposed Regulations:
26 CFR 1.263(g)–1 through –5, added; 1.1092(d)–1, amended; capitalization of interest and carrying charges properly allocable to straddles (REG–105801–00) 13, 965
26 CFR 1.301–1, amended; liabilities assumed in certain corporate transactions (REG–106791–00) 6, 521

26 CFR 1.355–0, amended; 1.355–7, added; recognition of gain on certain distributions of stock or securities in connection with an acquisition (REG–107566–00) 3, 346

26 CFR 1.444–4, added; 1.641(c)–0, –1, added; 1.1361–0, –1, amended; 1.1362–6, –7, amended; 1.1377–1, –3, amended; electing small business trusts (REG–251701–96) 4, 396

26 CFR 1.705–1, amended; 1.705–2, added; basis adjustments upon the sale of a corporate partner’s stock (REG–106702–00) 4, 424; correction (Ann 28) 13, 975

26 CFR 1.863–3, added; 1.863–8, –9, added; source of income from space and ocean activities, communications activities (REG–106030–98) 11, 820

26 CFR 1.902–0, –1, amended; 1.904–0, –4, –5, –6, amended; 1.904–5, revised; 1.904(b)–1, –2, revised; 1.904(b)–3, –4, removed; 1.904(j)–1, added; application of section 904 to income subject to separate limitations and computations of deemed paid credit under section 902 (REG–104683–00) 4, 407

26 CFR 1.1031(k)–1, amended; definition of disqualified person (REG–107175–00) 13, 971

26 CFR 1.1271–0, amended; 1.1275–1, amended; debt instruments with original issue discount, annuity contracts (REG–125237–00) 12, 919

26 CFR 1.1502–78, amended; corporations, consolidated groups, tentative carryback adjustments (REG–119352–00) 6, 525

26 CFR 1.6013–4, added; 1.6015–0 through –9, added; relief from joint and several liability (REG–106446–98) 13, 945

26 CFR 1.6042–2, amended; 1.6050S–1, –2, added; 301.6724–1, amended; electronic payee statements, voluntary (REG–107186–00) 13, 973

26 CFR 1.6049–4(b)(5), revised; 1.6049–6, added; 1.6049–8, revised; reporting requirements for interest on deposits paid to nonresident aliens (REG–126100–00) 11, 862
26 CFR 1.6302–1, –2, amended; removal of Federal Reserve banks as federal depositaries (REG–107176–00) 4, 428
26 CFR 7.367(c)–1, –2, withdrawn; requirements relating to certain exchanges involving a foreign corporation (LR–230–76) 13, 945
26 CFR 301.6103(c)–1, added; disclosure of return and return information to designee of taxpayer (REG–103320–00) 8, 714
26 CFR 301.7430–0, removed; 301.7430–7, added; attorney’s fees, recovery of (REG–121928–98) 6, 320
26 CFR 301.7701–3, amended; classification of certain business entities, check-the-box regulations (REG–110659–00) 12, 917
31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834

Publications:
547, Casualties, Disasters, and Thefts, revised (Ann 6) 3, 357
551, Basis of Assets, revised 2000 (Ann 2) 2, 277
575, changes in minimum required distributions (Ann 23) 10, 791
583, Starting a Business and Keeping Records, revised (Ann 8) 3, 357
590, changes in minimum required distributions (Ann 23) 10, 791
1245, Specifications for Filing Forms W-4, Employee’s Withholding Allowance Certificate, magnetically or electronically (RP 6) 4, 376

Qualified transportation fringe benefits (TD 8933) 11, 794

Qualified zone academy bonds, limitation (TD 8930) 5, 433

26 CFR 1.118–2, added; contribution in aid of construction (CIAC), regulated public utilities, water or sewerage disposal (TD 8936) 9, 720
26 CFR 1.132–0, –5, amended; 1.132–9, added; 602.101, amended; qualified transportation fringe benefits (TD 8933) 11, 794
26 CFR 1.163–7, amended; 1.1271–0, amended; 1.1275–1(f), –2, revised; 1.1275–2T, removed; 1.1275–7, added; reopenings of Treasury securities and other debt instruments, original issue discount (TD 8934) 12, 904
26 CFR 1.170A–6, amended; lifetime charitable lead trust (TD 8923) 6, 485
26 CFR 1.301–1, amended; 1.301–1T, added; assumed liabilities (TD 8924) 6, 489
26 CFR 1.355–0, amended; 1.355–6, revised; recognition of gain on certain distributions of stock or securities (TD 8913) 3, 300; correction (Ann 26) 11, 896
26 CFR 1.367(b)–0, amended; 1.367(b)–12, added; 7.367(b)–12, removed; stock transfer rules, transition rules (TD 8937) 11, 806
26 CFR 1.367(b)–3(b)4, withdrawn; stock transfer rules (Ann 27) 11, 897
26 CFR 1.444–4T, added; ESBT, electing small business trusts, tiered structures (TD 8915) 4, 359
26 CFR 1.467–0, –1, amended; 1.467–2, added; 1.467–3, revised; rental agreements involving payments of $2,000,000 or less (TD 8917) 7, 538
26 CFR 1.468A–5, amended; 1.503(a)–1, amended; 1.547–2, amended; 1.856–6, amended; 1.860–2, amended; 1.963–6, amended; 1.992–3, amended; 1.6081–2, –3, –4, –6, –7, amended; 301.6110–4, –5, –6, amended; 301.6212–2, added; 301.6301–1, amended; 301.6305–1, revised; 301.6320–1T, amended; 301.6325–1, revised; 301.6330–1T, amended; 301.6331–2, amended; 301.6332–2, amended; 301.6335–1, amended; 301.6503(c)–1, amended; 301.6672–1, amended; 301.6903–1, amended; last known address, definition of (TD 8939) 12, 899
26 CFR 1.643(a)–8, added; 1.664–1, –2, –3, amended; charitable remainder trusts, deemed sale, trust distributions, abusive transactions (TD 8926) 6, 492
26 CFR 1.708–1, amended; 1.752–1, –5, amended; partnership mergers and divisions (TD 8925) 6, 496
26 CFR 1.861–9, –11, –14, added; 1.861–9T, –11T, –14T, revised; 1.902–1, amended; 1.904–0, –4, –5, amended; application of section 904 to income subject to separate limitations and section 864(c) affiliated group expense allocation and apportionment rules (TD 8916) 4, 360
26 CFR 1.894–1, amended; 1.894–1T, removed; guidance regarding claims for certain income tax convention benefits (Ann 4) 2, 286
26 CFR 1.985–1, –4, amended; 1.985–8, added; 1.985–8T, removed; 1.1001–5, added; 1.1001–5T, removed; conversion to the euro (TD 8927) 11, 807
26 CFR 1.998–1, revised; hyperinflationary currency (TD 8914) 8, 653
26 CFR 1.1502–78T, added; corporations, consolidated groups, tentative carryback adjustments (TD 8919) 6, 505
26 CFR 1.6041–2T, added; 1.6050S–1T, –2T, added; 301.6724–1T, added; 602.101, amended; electronic payee statements, voluntary (TD 8942) 13, 929
26 CFR 7.367(c)–1, –2, removed; requirements relating to certain exchanges involving a foreign corporation (TD 8938) 13, 929
26 CFR 301.6103(c)–1, removed; 301.6103(c)–1T, added; disclosure of returns or return information to designee of taxpayer (TD 8935) 8, 702
26 CFR 301.6302–1T, added; removal of Federal Reserve banks as depositaries (TD 8918) 4, 372
26 CFR 301.7430–7T, added; attorney's fees, recovery of (TD 8922) 6, 508
26 CFR 301.7502–1, revised; 301.7502–1T, removed; 301.7502–2, added; timely mailing treated as timely filing (TD 8932) 11, 813
26 CFR 301.7508–1, added; 301.7508–A–1, added; for combat zone service or Presidentially declared disasters, tax related deadlines (TD 8911) 3, 321
Rental agreements (TD 8917) 7, 538
Reopenings, debt instruments, Treasury securities, original issue discount (TD 8934) 12, 904
Reporting requirements for interest on deposits paid to nonresident aliens (REG–126100–00) 11, 862
Short-term loans, stated interest, cash method banks, automatic change (RP 25) 12, 913
Source of income from space and ocean activities, communications activities (REG–106030–98) 11, 820
Standard Industry Fare Level (SIFL) formula (RR 13) 12, 898
Stock transfer rules:
  Supplemental rules (Ann 27) 11, 897
  Transition rules (TD 8937) 11, 806
Straddles; capitalization of interest and carrying charges (REG–105801–00) 13, 965
Substantial understatement penalty, adequate disclosure (RP 11) 2, 275
Tax convention, claims for benefits (Ann 4) 2, 286
Tax shelters, leasing transactions, exceptions (Notice 18) 9, 731
Technical advice to directors and chiefs, appeals offices, from Associates Chief Counsel and Division Counsel/Associate Chief Counsel (TE/GE) (RP 2) 1, 79
Timely mailing treated as timely filing (TD 8932) 11, 813
Trusts:
  Charitable remainder trusts, deemed sale, trust distributions, abusive transactions (TD 8926) 6, 492
  Election to treat trust as part of an estate (REG–106542–98) 5, 473; correction (Ann 24) 10, 793
ESBTs, electing small business trusts, estimated tax payments (Notice 25) 13, 941
Qualified revocable trust treated as part of an estate (Notice 26) 13, 942
Valuation of art requests, change of address for submissions (Ann 22) 11, 895
Withholdings:
  Payments to financial institutions in U.S. possessions (Notice 11) 5, 464
  Qualified intermediary agreements, clarifications (Notice 4) 2, 267
  Voluntary Compliance on Alien Withholding Program (VCAP) (RP 20) 9, 738

SELF-EMPLOYMENT TAX

Practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
Proposed Regulations:
  31 CFR Part 10, amended; practice before the Internal Revenue Service; Circular 230 (REG–111835–99) 11, 834
### Publications

<table>
<thead>
<tr>
<th>Qty.</th>
<th>Stock Number</th>
<th>Title</th>
<th>Price Each</th>
<th>Total Price</th>
</tr>
</thead>
</table>

**Standing Order Service**

To automatically receive future editions of *Internal Revenue Cumulative Bulletins* without having to initiate a new purchase order, sign below for Standing Order Service.

<table>
<thead>
<tr>
<th>Qty.</th>
<th>Standing Order</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>ZIRC</td>
<td>Internal Revenue Cumulative Bulletins</td>
</tr>
</tbody>
</table>

**Authorization**

I hereby authorize the Superintendent of Documents to charge my account for Standing Order Service:

- [ ] VISA  [ ] MasterCard  [ ] Discover/NOVUS
- [ ] Superintendent of Documents Deposit Account

Authorizing signature (Standing orders not valid unless signed.)

Please print or type your name.

Daytime phone number (_______)

**SuDocs Deposit Account**

A Deposit Account will enable you to use Standing Order Service to receive subsequent volumes quickly and automatically. For an initial deposit of $50 you can establish your Superintendent of Documents Deposit Account.

- [ ] YES! Open a Deposit Account for me so I can order future publications quickly and easily. I'm enclosing the $50 initial deposit.

### Subscriptions

<table>
<thead>
<tr>
<th>Qty.</th>
<th>List ID</th>
<th>Title</th>
<th>Price Each</th>
<th>Total Price</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>IRB</td>
<td>Internal Revenue Bulletin</td>
<td>$170</td>
<td></td>
</tr>
</tbody>
</table>

**New Deposit Account?**

[ ] Check here

**Check method of payment:**

- [ ] Check payable to Superintendent of Documents
- [ ] Deposit Account
- [ ] VISA  [ ] MasterCard  [ ] Discover/NOVUS
- [ ] [ ] (expiration date)

Thank you for your order!

Authorizing signature

Company or personal name (Please type or print)

Additional address/attention line

Street address

City, State, Zip code

Daytime phone with area code

E-mail address

Purchase order number (optional)

**Phone orders:** (202) 512–1800

**Fax orders:** (202) 512–2250

**Mail orders:** Superintendent of Documents

P.O. Box 371954

Pittsburgh, PA 15250–7954

**Online orders:** http://bookstore.gpo.gov/irs

DO NOT SEND THIS ORDER FORM TO IRS.

Important: Please include this completed order form with your payment.
INTERNAL REVENUE BULLETIN

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletin is sold on a yearly subscription basis by the Superintendent of Documents. Current subscribers are notified by the Superintendent of Documents when their subscriptions must be renewed.

CUMULATIVE BULLETINS

The contents of this weekly Bulletin are consolidated semiannually into a permanent, indexed, Cumulative Bulletin. These are sold on a single copy basis and are not included as part of the subscription to the Internal Revenue Bulletin. Subscribers to the weekly Bulletin are notified when copies of the Cumulative Bulletin are available. Certain issues of Cumulative Bulletins are out of print and are not available. Persons desiring available Cumulative Bulletins, which are listed on the reverse, may purchase them from the Superintendent of Documents.

ACCESS THE INTERNAL REVENUE BULLETIN ON THE INTERNET


INTERNAL REVENUE BULLETINS ON CD–ROM

Internal Revenue Bulletins are available annually as part of Publication 1796 (Tax Products CD–ROM). The CD–ROM can be purchased from National Technical Information Service (NTIS) on the Internet at www.irs.gov/cdorders (discount for online orders) or by calling 1-877-233-6767. The first release is available in mid-December and the final release is available in late January.

HOW TO ORDER

Check the publications and/or subscription(s) desired on the reverse, complete the order blank, enclose the proper remittance, detach entire page, and mail to the Superintendent of Documents, P.O. Box 371954, Pittsburgh, PA 15250–7954. Please allow two to six weeks, plus mailing time, for delivery.

WE WELCOME COMMENTS ABOUT THE INTERNAL REVENUE BULLETIN

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can e-mail us your suggestions or comments through the IRS Internet Home Page (www.irs.gov) or write to the IRS Bulletin Unit, W:CAR:MP:FP, Washington, DC 20224.

Internal Revenue Service
Washington, DC 20224

Official Business
Penalty for Private Use, $300