Internal Revenue
bulletin

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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

Rev. Rul. 2002–40, page 30.
Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for July 2002.

Notice 2002–42, page 36.
This notice provides guidance to taxpayers concerning the tax benefits of the New York Liberty Zone business employee credit, Qualified New York Liberty Bonds, and Liberty Advance Refunding Bonds, as provided under the Job Creation and Worker Assistance Act of 2002.

Rev. Proc. 2002–45, page 40.
This procedure provides a safe harbor valuation method for valuing options under the golden parachute payment rules of section 280G of the Code. It also includes an expanded table to be used in conjunction with Rev. Proc. 2002–13, 2002–8 I.R.B. 549. Rev. Proc. 2002–13 modified.

REG–103823–99, page 44.
Proposed regulations under section 167(g) of the Code relate to deductions available to taxpayers using the income forecast method of depreciation. A public hearing is scheduled for September 4, 2002.

REG–126024–01, page 64.
Proposed regulations provide rules relating to the reporting of gross proceeds payments to attorneys. The regulations reflect changes to the law made by the Taxpayer Relief Act of 1997. The regulations will affect attorneys who receive payments of gross proceeds on behalf of their clients and certain payors (for example, defendents in lawsuits and their insurance companies and agents) that, in the course of their trades or businesses, make payments to these attorneys. A public hearing is scheduled for September 30, 2002.

EMPLOYEE PLANS

Notice 2002–43, page 38.
Phased retirement; request for comments. This notice requests comments from the public on issues that might arise in the context of "phased retirement" in the instance of qualified defined benefit plans.

EXEMPT ORGANIZATIONS

Announcement 2002–64, page 72.
A list is provided of organizations now classified as private foundations.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

ESTATE TAX

Rev. Rul. 2002–39, page 33.
Accidental death benefits. This ruling concludes that the accidental death benefits payable pursuant to New York City and New York State pension laws to specified beneficiaries of a deceased New York City firefighter or police officer who died in the line of duty are not includible in either one's gross estate, except to the extent the benefits represent a return of the decedent's contributions to the pension fund. The ruling will clarify that the portion of the death benefit not attributable to employee contributions is not includible in the gross estate, thus alleviating the necessity, in most cases, for filing an estate tax return.

EXCISE TAX

Rev. Proc. 2002–45, page 40.
This procedure provides a safe harbor valuation method for valuing options under the golden parachute payment rules of section 280G of the Code. It also includes an expanded table to be used in conjunction with Rev. Proc. 2002–13, 2002–8 I.R.B. 549. Rev. Proc. 2002–13 modified.

REG–103829–99, page 59.
Proposed regulations under section 4051 of the Code relate to the definition of a highway vehicle for purposes of various excise taxes.

ADMINISTRATIVE

Notice 2002–44, page 39.
This notice provides a central filing address for certain claims under section 41 of the Code for the credit for increasing research activities (research credit) and clarifies that claims for refund claiming the research credit will be administratively considered by the Service only if filed in accordance with applicable regulatory requirements under sections 6402 and 6511 of the Code.

REG–115285–01, page 62.
Proposed regulations exclude certain Low-Income Taxpayer Clinics (LITCs) that qualify for grants under section 7526 of the Code from the definition of income tax return preparer under section 7701(a)(36) of the Code. These proposed regulations also exclude certain persons who are employed by, or volunteer for, such clinics.

Announcement 2002–61, page 71.
The Service announces that Publication 551, *Basis of Assets*, is currently available. This publication, revised May 2002, provides basic federal tax and recordkeeping information to determine the basis of property.

Announcement 2002–62, page 72.
The Service announces that Publication 583, *Starting a Business and Keeping Records*, is currently available. This publication, revised May 2002, provides basic federal tax and recordkeeping information for people who are starting a business.

Announcement 2002–63, page 72.
The Service announces that it is revising its policy concerning when it will request tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities appearing on audited financial statements.

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:

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, 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.

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

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

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

The adjusted applicable federal long-term rate is set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, on this page.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 1274, 1288, and other sections of the Code, tables set forth the rates for July 2002.

Rev. Rul. 2002–40

This revenue ruling provides various prescribed rates for federal income tax purposes for July 2002 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the blended annual rate for 2002 for purposes of section 7872.

REV. RUL. 2002–40 TABLE 1

Applicable Federal Rates (AFR) for July 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	2.84%	2.82%	2.81%	2.80%
110% AFR	3.12%	3.10%	3.09%	3.08%
120% AFR	3.41%	3.38%	3.37%	3.36%
130% AFR	3.70%	3.67%	3.65%	3.64%
Mid-Term				
AFR	4.60%	4.55%	4.52%	4.51%
110% AFR	5.07%	5.01%	4.98%	4.96%
120% AFR	5.53%	5.46%	5.42%	5.40%
130% AFR	6.01%	5.92%	5.88%	5.85%
150% AFR	6.95%	6.83%	6.77%	6.73%
175% AFR	8.12%	7.96%	7.88%	7.83%
Long-Term				
AFR	5.69%	5.61%	5.57%	5.55%
110% AFR	6.27%	6.17%	6.12%	6.09%
120% AFR	6.84%	6.73%	6.67%	6.64%
130% AFR	7.42%	7.29%	7.22%	7.18%

REV. RUL. 2002–40 TABLE 2

Adjusted AFR for July 2002

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	2.18%	2.17%	2.16%	2.16%
Mid-term adjusted AFR	3.57%	3.54%	3.52%	3.51%
Long-term adjusted AFR	4.91%	4.85%	4.82%	4.80%

REV. RUL. 2002–40 TABLE 3

Rates Under Section 382 for July 2002

Adjusted federal long-term rate for the current month	4.91%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	5.01%

REV. RUL. 2002–40 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for July 2002

Appropriate percentage for the 70% present value low-income housing credit	8.20%
Appropriate percentage for the 30% present value low-income housing credit	3.51%

REV. RUL. 2002–40 TABLE 5

Rate Under Section 7520 for July 2002

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.6%

REV. RUL. 2002–40 TABLE 6

Blended Annual Rate for 2002

Section 7872(e)(2) blended annual rate for 2002	2.78%

Section 1288.—Treatment of Original Issue Discounts on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, page 30.

Section 2033.—Property in Which the Decedent Had an Interest

26 CFR 20.2033–1: Property in which the decedent had an interest.

Are accidental death benefits that are payable pursuant to New York City and New York State pension laws to specified beneficiaries of a deceased New York City firefighter or police officer who died in the line of duty includible in the decedent's gross estate for federal estate tax purposes? Are the portion of the death benefit that represents a return of the decedent's contributions to the pension fund includible in the gross estate? See Rev. Rul. 2002–39, on this page.

Section 2039.—Annuities

26 CFR 20.2039–1: Annuities.
(Also §§ 2033; 20.2033–1.)

Accidental death benefits. This ruling concludes that the accidental death benefits payable pursuant to New York City and New York State pension laws to specified beneficiaries of a deceased New York City firefighter or police officer who died in the line of duty are not includible in either one's gross estate, except to the extent the benefits represent a return of the decedent's contributions to the pension fund. The ruling will clarify that the portion of the death benefit not attributable to employee contributions is not includible in the gross estate, thus alleviating the necessity, in most cases, for filing an estate tax return.

Rev. Rul. 2002–39

ISSUE

Are the accidental death benefits payable pursuant to New York City and New York State laws to specified beneficiaries of a New York City firefighter or police officer who died as a result of injuries sustained in the line of duty includible in the decedent's gross estate?

FACTS

Decedent, a New York City firefighter, died in 2001, as a result of injuries sustained in the line of duty. At the time of death, Decedent was a member of the New York Fire Department Subchapter Two Pension Fund (Fund) to which Decedent made contributions totaling 10*x* dollars while employed as a firefighter. Decedent was survived by Spouse. After Decedent's death, pursuant to section 13–347(a) of the Administrative Code of the City of New York (N.Y.C. Admin. Code), the pension fund made a 10*x* dollar payment to Decedent's estate, representing a return of Decedent's contributions to the fund. In addition, pursuant to section 13–347(b) of the N.Y.C. Admin. Code and section 208–f of the New York State General Municipal Law, annuities representing accidental death benefits became payable to Spouse for life. The aggregate present value of the annuities payable to Spouse was 150*x* dollars on the date of Decedent's death.

LAW AND ANALYSIS

Section 13–347 of the N.Y.C. Admin. Code provides for the payment of accidental death benefits to certain specified beneficiaries of a member of the Fund, if the member's death was the natural and proximate result of an accident sustained while in the performance of duty. N.Y.C. Admin. Code, Retirement and Pensions, section 13–347 (2001). Section 13–347(a) provides for the payment to the decedent's estate, or to such person designated by the decedent, of the decedent's accumulated contributions to the pension fund. Section 13–347(b) provides for the payment of an annuity equal to one-half of the member's salary to the decedent's surviving spouse for life, or if no surviving spouse (or if the surviving spouse dies before the children reach age 18 (age 23 for students)), to the decedent's children until they reach age 18 (age 23 for students). If none of these beneficiaries survive the decedent, the payment will be made to dependent parents of the decedent as designated by the decedent or, if no designation, the dependent parents as determined by the state comptroller.

Section 13–332 of the N.Y.C. Admin. Code provides that accidental death benefits payable pursuant to section 13–347(b) are funded by contributions from New York City to the pension reserve fund. On the other hand, under sections 13–327 and 13–328, contributions by members of the Fund are made to the annuity savings fund and the annuity reserve fund.

In addition to the benefits provided by New York City, under applicable New York State law, a special death benefit is payable to the decedent's surviving spouse for life, or if no surviving spouse to the decedent's children under the age of 18 (age 23 if the child is a student). This special death benefit is payable if the decedent was a member of a pension or retirement system of a police department or paid fire department of a city, town, or village and the decedent died as a result of injuries sustained in the performance of duty. The benefit is a pension equal to the decedent's salary, reduced by any death benefit payable by the city, town, or village in the form of a pension and any social security and worker's compensation benefits. These benefits are payable with funds appropriated from the New York State's general fund. N.Y. Gen. Mun. Law, section 208–f (McKinney 2001).

Section 2033 of the Internal Revenue Code provides that the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of death.

Section 2039(a) provides for the inclusion in the decedent's gross estate of the value of an annuity or other payment receivable by any beneficiary by reason of surviving the decedent under any form of contract or agreement (other than insurance on the decedent's life) if, under the contract or agreement, an annuity or other payment was payable to the decedent, or the decedent possessed the right to receive the annuity or other payment for life or for any period not ascertainable without reference to decedent's death or for any period which does not in fact end before decedent's death.

Section 2039(b) provides that § 2039 (a) shall apply to only the part of the

value of the annuity or other payment receivable under the contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. Any contributions by the decedent's employer shall be considered to be contributed by the decedent.

Section 20.2039–1(b)(1) of the Estate Tax Regulations provides that the term "contract or agreement" includes any arrangement, understanding or plan, or any combination of these arising by reason of the decedent's employment. If the decedent's employer made contributions to two different funds, one to provide an annuity to the employee upon the employee's retirement and the other to provide a survivor benefit to the employee's designated beneficiary upon the employee's death, the rights and benefits accruing to the employee by reason of employment under both plans are considered together in determining whether the value of the survivor benefits is includible in the decedent's gross estate under § 2039(a). See § 20.2039–1(b)(2), *Example 6*.

Rev. Rul. 76–501, 1976–2 C.B. 267, concludes that the present value of a survivor annuity paid under federal law to the spouse of a member of the armed forces who died from a service connected disability is not includible in the decedent's gross estate under either § 2033 or § 2039. The annuity is not includible under § 2033, because the annuity is payable only to individuals designated by statute and the decedent had no power to designate the recipient of the benefit. Further, the annuity is payable from government appropriations and not from any fund in which the decedent had a vested interest. Thus, the benefit is not property in which the decedent had an interest at the time of death. Further, the annuity is not includible under § 2039. The annuity is not payable under any form of contract or agreement entered into by the decedent or arising by reason of the decedent's employment as required under § 2039(a). Rather, these benefits are payable pursuant to a public law enacted to provide for dependents of veterans whose death resulted from injuries suffered in the line of duty. *See also* Rev. Rul. 79–397, 1979–2 C.B. 322 (the value of death benefits payable pursuant to federal law under the Public Safety Officers' Benefit Act to survivors of decedents who died in the line of duty are not includible in the gross estate); Rev. Rul. 76–102, 1976–1 C.B. 272 (amounts paid under the Federal Coal Mine Health and Safety Act of 1969 are not includible in the gross estate). These rulings involve a statutory benefit that is paid to certain beneficiaries because the decedent's occupation was the proximate cause of the decedent's death. These benefits are contrasted with survivor annuities paid on the death of a retiree under statutory state or federal pension plans that have as a primary function the payment of post-retirement benefits to the plan participant, and that are characterized by employment-related bargained-for benefits and election of survivor benefits. The value of survivor benefits payable under these employment-related post-retirement plans are includible in the gross estate under § 2039. Rev. Rul. 77–95, 1977–1 C.B. 274; Rev. Rul. 75–505, 1975–2 C.B. 364.

In the instant case, the $10x$ dollar payment paid pursuant to section 13–347(a) of the N.Y.C. Admin. Code represents a return of the Decedent's contributions to the pension fund and is payable to any beneficiary, including the Decedent's estate, designated by the Decedent. This payment constitutes property in which Decedent had an interest at the time of death. Accordingly, the $10x$ dollar payment is includible in Decedent's gross estate under § 2033.

However, the annuities valued in the aggregate at $150x$ dollars, payable to Decedent's spouse under section 13–347(b) of the N.Y.C. Admin. Code and section 208–f of the N.Y. Gen. Mun. Law, are not payable pursuant to any form of contract or agreement arising by reason of Decedent's employment. Rather, similar to the situations presented in Rev. Rul. 76–501, Rev. Rul. 79–397, and Rev. Rul. 76–102, these benefits are payable pursuant to public statutory laws providing for a system of benefit payments to the dependents of firefighters, but only if the firefighter dies in the line of duty. Thus, these benefits are distinguishable from survivor benefits payable on the death of a retiree (or the death of an employee before retirement) under a pension plan intended to provide post-retirement benefits. In addition, the benefits are payable only to certain specified individuals after Decedent's death, and thus, Decedent had no right to receive the payments during life. Accordingly, the accidental death benefits payable pursuant to section 13–347(b) of the N.Y.C. Admin. Code and section 208–f of the N.Y. Gen. Mun. Law are not includible in the Decedent's gross estate under § 2039(a).

Further, the annuities paid pursuant to section 13–347(b) of the N.Y.C. Admin. Code and section 208–f of the N.Y. Gen. Mun. Law are not attributable to any contributions made by the Decedent to a pension fund, nor did the Decedent have any power to designate the beneficiaries of the benefits. Rather, the benefits are funded by New York City and New York State and are payable to beneficiaries, other than the Decedent's estate, specifically designated by the statute. Thus, because the Decedent possessed no property or ownership rights in these death benefits, the value of these annuities is not includible in Decedent's gross estate under § 2033.

The result would be the same if Decedent were a New York City police officer who died in the line of duty and Decedent's survivors became entitled to receive accidental death benefits under New York City and New York State laws. Thus, accidental death benefits payable to certain specified beneficiaries of a member of the New York Police Department Subchapter Two Pension Fund pursuant to section 13–244(a) of the N.Y.C. Admin. Code representing a return of Decedent's contributions to the pension fund would be includible in the gross estate under § 2033. However, accidental death benefits payable pursuant to section 13–244(b) of the N.Y.C. Admin. Code and section 208–f of the N.Y. Gen. Mun. Law would not be includible in the Decedent's gross estate under either § 2033 or § 2039.

HOLDING

The accidental death benefits payable pursuant to New York City and New York State laws to specified beneficiaries of a deceased New York City firefighter or police officer who died in the line of duty are not includible in the decedent's gross estate, except to the extent the benefits represent a return of the decedent's contributions to the pension fund.

DRAFTING INFORMATION

The principal author of this revenue ruling is William Blodgett of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Blodgett at (202) 622–3090 (not a toll-free call).

Section 6402.—Authority to Make Credits or Refunds

If the Secretary determines that a taxpayer made an overpayment of tax because the taxpayer failed to take into account the credit for increasing research activities under section 41 of the Internal Revenue Code on its original return, what gives the Secretary the authority to credit the overpayment against any liability in respect of an internal revenue tax and refund any balance? See Notice 2002–44, page 39.

Section 6511.—Limitations on Credit or Refund

If a taxpayer made an overpayment of tax because the taxpayer failed to take into account the credit for increasing research activities under section 41 of the Internal Revenue Code on its original return, what is the period of limitations for filing a claim for credit and refund? See Notice 2002–44, page 39.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, page 30.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 2002. See Rev. Rul. 2002–40, page 30.

Part III. Administrative, Procedural, and Miscellaneous

New York Liberty Zone Questions and Answers

Notice 2002–42

PURPOSE

This notice provides guidance concerning the New York Liberty Zone business employee credit, Qualified New York Liberty Bonds, and Liberty Advance Refunding Bonds.

BACKGROUND

Section 301 of the Job Creation and Worker Assistance Act of 2002, Pub.L. No.107–147, provides various tax benefits for the area of New York City damaged or affected by the terrorist attack on September 11, 2001. This notice provides guidance with respect to three of these provisions: (1) section 1400L(a) of the Internal Revenue Code, which provides a new targeted group for the Work Opportunity Tax Credit (WOTC), (2) section 1400L(d), which authorizes issuance of an aggregate of $8 billion of tax-exempt private activity bonds to finance the acquisition, construction, reconstruction and renovation of certain nonresidential real property, residential rental property, and public utility property, and (3) section 1400L(e), which authorizes the issuance of an aggregate of $9 billion of certain tax-exempt, advance refunding bonds.

OVERVIEW OF THE PROVISIONS

New York Liberty Zone business employee credit

Under Section 51 of the Code, the WOTC is available on an elective basis to an employer that hires individuals from one or more of eight targeted groups. To qualify as a member of a targeted group, the employee must be certified by a state employment security agency. The credit equals 40 percent of the qualified first-year wages of an employee who is employed 400 or more hours (25 percent for those employed fewer than 400 hours but at least 120 hours). Generally, qualified first-year wages are wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual begins work for the employer. The maximum credit per employee is $2,400 (40 percent of the first $6,000 of qualified first-year wages).

Section 1400L(a) provides for a new targeted group for the WOTC: New York Liberty Zone business employees. The new targeted group includes individuals who perform substantially all of their services in the New York Liberty Zone (NYLZ), and may include individuals who perform substantially all of their services elsewhere in New York City for a business that relocated from the NYLZ due to the physical destruction or damage of its workplace within the NYLZ by the September 11, 2001, terrorist attack. Instead of being based on "qualified first-year wages," the new credit is based on "qualified wages," which are wages paid or incurred to a NYLZ business employee for work performed during 2002 and 2003. With the exception of the certification requirement, the other section 51 rules regarding the WOTC apply.

Qualified New York Liberty Bonds and Liberty Advance Refunding Bonds

Section 1400L(d) creates a new type of tax-exempt bond known as Qualified New York Liberty bonds (Liberty Bonds). Section 1400L(e) provides for additional advance refundings of certain tax-exempt bonds (Liberty Advance Refunding Bonds). In general, Liberty Bonds and Liberty Advance Refunding Bonds may be issued by certain eligible issuers in the State of New York if, among other things, they are designated as Liberty Bonds or Liberty Advance Refunding Bonds by the Governor of New York or the Mayor of New York City. These Bonds must be issued after March 9, 2002, and before January 1, 2005. Liberty Bonds and Liberty Advance Refunding Bonds are subject to certain of the provisions of sections 103 and 141–150 of the Code.

Section 149(e) and the regulations thereunder require issuers of tax-exempt bonds to report certain bond related information to the Internal Revenue Service. That information is reported on Form 8038 series information returns. The information is generally required to be submitted by the 15th day of the second calendar month after the close of the calendar quarter in which the bonds were issued. These provisions apply to the issuance of Liberty Bonds and Liberty Advance Refunding Bonds.

QUESTIONS AND ANSWERS

Set forth below are questions and answers with regard to these provisions.

NYLZ Business Employee Credit

In general

Q1. What is a NYLZ business?

A1. A NYLZ business is any business that is either (1) located in the NYLZ, or (2) located in New York City, outside the NYLZ, as a result of physical destruction or damage of the place of business by the September 11, 2001, terrorist attack. A NYLZ business does not include, however, any business that employed an average of more than 200 employees on business days during the taxable year. See Q/A 9-12 for the calculation of the average number of employees on business days.

Q2. What is the NYLZ?

A2. The NYLZ is that portion of Manhattan in New York, New York, located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway).

NYLZ Business Employee

Q3. Who is a NYLZ business employee?

A3. For any period, a NYLZ business employee is any employee of a NYLZ business who performs substantially all of his or her services during the period for the business in the NYLZ. The term can also include an employee of a NYLZ business located outside of the NYLZ if substantially all of the employee's services are performed during the period in New York City.

Q4. What does "substantially all" of the services performed by the employee mean?

A4. For this purpose, "substantially all" means 80 percent or more.

Q5. Must the employee be a new hire for the employer to claim a credit under this provision?

A5. No. The employee may be an existing employee, a new employee, or a rehire.

Q6. Are independent contractors, partners, and self-employed persons considered "employees" for purposes of the NYLZ business employee credit?

A6. No.

Qualified Wages

Q7. What are "qualified wages"?

A7. "Qualified wages" are wages paid or incurred by the employer during the tax year to a NYLZ business employee of the employer for work performed during 2002 or 2003.

Q8. Is there a limit to the amount of wages that an employer can take into account for any employee?

A8. Yes. The qualified wages that may be taken into account for any employee are limited to the first $6,000 of qualified wages per calendar year.

NYLZ Business

Q9. How does an employer determine whether it has met the average 200 employee limit for the purpose of claiming the NYLZ business credit?

A9. An employer can use any reasonable method of calculating the average number of employees on business days during the taxable year. For example, an employer may count employees on each business day and average the numbers, or count employees on the last day of each pay-period and average those numbers. If an employer uses different pay periods for different groups of employees, it may calculate the average number of employees in the groups separately, and then add the averages. See also Q/A 11 for controlled corporations, partnerships, etc.; and Q/A 12 for part-time employees.

Q10. What is a business day for this purpose?

A10. A business day is any day on which the business is open to the public or business is regularly conducted.

Q11. How does an employer count employees if it is part of a controlled group of corporations or a member of partnerships, proprietorships, etc., that are under common control?

A11. The rules of section 52 of the Code, which provides special rules for the WOTC for employers that are members of controlled groups or under common control, apply for purposes of determining the average number of employees in Q/A9.

Q12. When calculating the average number of employees, how does the employer count part-time employees?

A12. The employer may count each part-time employee as one employee. In the alternative, the employer may count each part-time employee as a fraction of an employee, using any reasonable method of determining full-time equivalents. Q&A-5 of § 54.4980B–2 of the Qualified Pension, Etc., Plans Regulations provides examples of reasonable methods.

Q13. Is a franchisee eligible to claim this credit?

A13. Yes.

Q14. Will the Service require an employer to have the New York State Department of Labor determine the number of its employees on September 11, 2001?

A14. No.

Q15. Can a tax-exempt organization claim the NYLZ business employee credit?

A15. No.

Other Issues

Q16. How do the rules differ for a NYLZ business with employees inside the NYLZ and one that includes employees outside the NYLZ?

A16. A NYLZ business located inside the NYLZ may claim the credit on the basis of qualified wages it pays to all of its NYLZ business employees. In the case of a NYLZ business located outside the NYLZ, the number of employees that it can take into account on a given day is limited to the excess of the number of employees of the employer in the NYLZ on September 11, 2001, over the number of NYLZ business employees located within the NYLZ on that day. The examples below illustrate these rules, including the situation in which a NYLZ business is located both within and outside the NYLZ.

Example 1. A is a NYLZ business that remained in the NYLZ. Throughout 2002, A had 40 NYLZ business employees. A did not exceed the 200-employee limit for 2002. A can claim the credit on the basis of the qualified wages it paid to each of its employees without regard to the number of employees it had on September 11.

Example 2. B is a NYLZ business that relocated to a location outside the NYLZ but within New York City. On September 11, 2001, B had 130 employees in the NYLZ. On each business day in 2002, B had 150 employees within New York City but outside the NYLZ. B did not exceed the 200-employee limit for 2002. B can claim the credit on the basis of the qualified wages it paid to no more than 130 of its employees.

Example 3. C is a NYLZ business that had two places of business in the NYLZ on September 11, 2001. One place of business remained in the NYLZ. C relocated the other place of business to a location outside the NYLZ but within New York City. On September 11, 2001, C had 60 employees in the NYLZ. Throughout 2002, 40 employees performed services at the place of business inside the NYLZ, and 30 employees performed services at the place of business outside the NYLZ. C did not exceed the 200-employee limit for 2002. C can claim the credit on the basis of the qualified wages it paid to no more than 60 employees (the 40 employees inside the NYLZ and 20 of the employees outside the NYLZ).

Example 4. The facts are the same as in Example 3, except that, throughout 2002, 70 employees performed services at the place of business inside the NYLZ, and 20 employees performed services at the place of business outside the NYLZ. C can claim the credit on the basis of the qualified wages it paid to all 70 employees inside the NYLZ. C cannot claim the credit on the basis of the qualified wages it paid to any of the employees outside the NYLZ.

Q17. Can a NYLZ business use wages paid to an employee to claim both the new credit and the existing WOTC or Welfare-to-Work credit?

A17. No. However, the business can use the employee's wages to claim the other credit, if the employee's wages are not used to claim the NYLZ credit and the employee is either a member of a targeted group for purposes of the WOTC (section 51) or a long-term family assistance recipient for purposes of the Welfare-to-Work credit (section 51A). In addition, wages paid to the same employee in different tax years might be used to obtain two different tax credits.

Example 5. The facts are the same as in Example 4 above. C cannot claim the WOTC or the Welfare-to-Work credit on the basis of wages paid to any of the NYLZ employees. C can claim the WOTC or the Welfare-to-Work credit on the basis of wages paid to the employees outside the NYLZ, provided all the requirements for the credit are met.

Q18. When claiming the credit, must a NYLZ business outside of the NYLZ provide substantiation that it relocated as a result of the physical destruction or damage of its place of business by the September 11, 2001, terrorist attack?

A18. No. The Service could, of course, request this substantiation on examination.

Claiming the Credit

Q19. How does an employer claim the credit?

A19. An employer must attach Form 8884, *New York Liberty Zone Business Employee Credit*, to its income tax return. An employer who claims the WOTC for any other targeted group will also have to attach Form 5884, *Work Opportunity Credit*.

Liberty Bonds and Liberty Advance Refunding Bonds

Q20. How are the limitation amounts in section 1400L(d)(3)(B) allocated?

A20. One-half of each limitation amount is allocated to bonds designated by the Governor, and the other half is allocated to bonds designated by the Mayor. The Governor and the Mayor are not required to utilize these limitation amounts at the same time. In addition, the Governor and the Mayor may utilize the limitation amounts in any order relative to their designation of bonds for other qualified project costs.

Q21. Is the New York City Municipal Water Finance Authority eligible for the advance refunding provisions of section 1400L(e)(1)?

A21. Yes. The reference in section 1400L(e)(2)(B) to the "New York Municipal Water Finance Authority" is deemed to refer to the New York City Municipal Water Finance Authority.

Q22. Are bonds issued by the New York City Transit Authority (NYCTA) or the Triborough Bridge and Tunnel Authority (TBTA) eligible for the advance refunding provisions of section 1400L(e)(1) if they otherwise satisfy the requirements of that provision?

A22. Yes. Bonds issued by NYCTA and TBTA that otherwise satisfy the provisions of section 1400L(e)(1) are treated as issued by the Metropolitan Transportation Authority of the State of New York.

Q23. Are bonds issued by the Municipal Assistance Corporation for The City of New York (MAC) eligible for the advance refunding provisions in section 1400L(e)(1) if they otherwise satisfy the requirements of that section?

A23. Yes. The Chairmen and Ranking Members of both the House Ways and Means Committee and the Senate Finance Committee have advised the Treasury Department that they believe bonds issued by the MAC should be included in these provisions, and that they plan to introduce and enact legislation to clarify this treatment, effective as if originally included in the Job Creation and Worker Assistance Act of 2002, at the earliest opportunity.

Q24. What information must an issuer of Liberty Bonds provide to the Service in order to comply with section 149(e)?

A24. An issuer of Liberty Bonds must complete Form 8038, *Information Return for Tax-Exempt Private Activity Bond Issues*, in accordance with the instructions and complete Part II by checking the box on Line 11m (Other), write in "Liberty Bonds" for the description, and enter the amount of the bonds in the Issue Price Column. In addition, the Issuer must attach a copy of the document used by the Governor or Mayor to designate the bonds as Liberty Bonds.

Q25. What information must an issuer of Liberty Advance Refunding Bonds provide to the Service in order to comply with section 149(e)?

A25. An issuer of Liberty Advance Refunding Bonds must complete the appropriate Form 8038 Series return (Form 8038, 8038–G, or 8038–GC) in accordance with the instructions for a refunding bond and attach a copy of the document used by the Governor or Mayor to designate the bonds as Liberty Advance Refunding Bonds.

IRS WEBSITE

This notice is also available on the Internal Revenue Service website (*www.irs.gov*). Any additional questions and answers the Service develops will be released in further guidance and placed on the website.

QUALIFIED NEW YORK LIBERTY ZONE PROPERTY UNDER THE ACT

For guidance regarding qualified property or qualified New York Liberty Zone property provided by sections 168(k) and 1400L(b), see Rev. Proc. 2002–33, 2002–20 I.R.B. 963 (May 20, 2002).

DRAFTING INFORMATION

The principal author of this notice is Shoshanna Chaiton of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this notice, including the New York Liberty Zone business employee credit, please contact Ms. Chaiton at (202) 622–6080 (not a toll-free call). For questions concerning the Liberty Bonds and Liberty Advance Refunding Bonds provisions, please contact Timothy L. Jones at (202) 622–3980 (not a toll-free call).

Request for Comments on Phased Retirement

Notice 2002–43

The Internal Revenue Service and the Treasury Department request comments on issues relating to "phased retirement" arrangements under qualified defined benefit plans.

BACKGROUND

In recent years, both employers and employees have expressed interest in encouraging older, more experienced workers to stay in the workforce. One approach that some employers have taken is to offer employees the opportunity for "phased retirement." While there is no single approach to phased retirement, these arrangements generally provide employees who are at or near eligibility for retirement with the opportunity for a reduced schedule or workload, thereby providing a smoother transition from full-time employment to retirement. These arrangements permit the employer to retain the services of an experienced employee and provide the employee with the opportunity to continue active

employment at a level that also allows greater flexibility and time away from work.

As people are living longer, healthier lives, it is important to reduce the risk of individuals outliving their retirement savings. Phased retirement can provide employees additional time to save for retirement because employees continue working (while they are healthier and thus able to do so) and can accrue additional benefits and reduce or forgo early spending of their retirement savings. However, phased retirement can also increase the risk of outliving retirement savings for employees who begin drawing upon their retirement savings before normal retirement age. Even though the annuity distribution options offered by defined benefit plans preclude outliving benefits, early distribution of a portion of the participant's benefit will reduce the benefits available after normal retirement age.

ISSUES ON WHICH COMMENTS ARE REQUESTED

The Service and Treasury are interested in comments regarding approaches for encouraging employees and employers to provide opportunities for employees to continue active employment and suggestions for areas in which additional guidance might be appropriate. The following are some of the issues raised by phased retirement arrangements with respect to which comments are requested:

- Under what circumstances, if any, would permitting distributions from a defined benefit plan before the employee attains normal retirement age be consistent with the requirement that a defined benefit plan be established and maintained primarily for purposes of providing benefits after retirement?
  - Would bright-line rules in this area be beneficial?
  - Would it be relevant to consider whether an employee has attained early retirement age under a plan?
  - Would it be relevant to consider the extent to which an employee has actually reduced his or her workload?
- If there are situations in which distributions from a defined benefit plan before the employee attains normal retirement age are consistent with the requirement that a defined benefit plan be established and maintained primarily for purposes of providing benefits after retirement, how would additional benefits be calculated under a defined benefit plan that provides for such distributions while the employee continues employment? For example:
  - How would the reduction in compensation for a participant who is working under a phased retirement arrangement be addressed under the plan?
  - How would any early retirement subsidy be taken into account?
- Are there other requirements applicable to defined benefit plans for which additional guidance would be necessary? For example:
  - For purposes of nondiscrimination testing and compliance with § 401(a)(4), when is a formula under a plan that permits phased retirement uniform? When does a distribution alternative fail to be currently available to a nondiscriminatory group? What other testing issues are raised under § 401(a)(4)?
  - What, if any, guidance would be necessary or appropriate to ensure that plans comply with the requirements of §§ 401(a)(11) and 417 regarding the provision of a qualified joint and survivor annuity and consent requirements?
    - Should the portion of the benefit payable as a result of phased retirement be treated as a separable benefit for purposes of these and other rules?
  - What, if any, guidance would be necessary or appropriate regarding compliance with the anti-backloading and other accrued benefit requirements under § 411?
  - What, if any, guidance would be necessary or appropriate regarding compliance with § 415?
  - Are there any issues under § 411(d)(6) that would need to be addressed for employers to be able to adopt phased retirement arrangements on an initial basis?
  - How should phased retirement arrangements be distinguished from a situation in which an employee separates from employment before normal retirement age and then is hired as a consultant or independent contractor for the former employer?

COMMENTS REQUESTED

The Service and Treasury invite comments on the issues identified in this notice and other issues relating to phased retirement. Comments should be submitted by January 1, 2003, in writing, and should reference Notice 2002–43.

Comments may be submitted to CC:ITA:RU (Notice 2002–43), room 5226, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, DC 20044. Comments may be hand delivered between the hours of 8 a.m. and 5 p.m., Monday through Friday to: CC:ITA:RU (Notice 2002–43), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, D.C. Alternatively, comments may be submitted via the Internet at *Notice.Comments@irscounsel.treas.gov.* All comments will be available for public inspection and copying.

DRAFTING INFORMATION

The principal author of this notice is Michael Rubin of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, contact the Employee Plans taxpayer assistance telephone service between the hours of 8:00 a.m. and 6:30 p.m. Eastern Time, Monday through Friday by calling 1–877–829–5500 (a toll-free number). Mr. Rubin can be reached at (202) 283–9888 (not a toll-free number).

Credit for Increasing Research Activities: New Filing Address and Guidance on Certain Claims for Credit or Refund

Notice 2002–44

SECTION 1. PURPOSE

This notice provides a central filing address for certain claims arising under § 41 of the Internal Revenue Code, while offering a separate filing process to certain taxpayers under audit.

An overpayment of tax for a taxable year generated, in whole or in part, by the research credit and not taken into account on a taxpayer's original return may be taken into account by the timely filing of a claim for credit or refund.

Under § 6402(a), the Secretary is authorized to credit, within the applicable period of limitations, an overpayment against any liability in respect of an internal revenue tax of the person who made the overpayment, and must generally refund any balance to that person. Section 6511(b)(1) provides that no credit or refund shall be allowed or made after the expiration of the period of limitation prescribed in § 6511(a), unless a claim for credit or refund is filed by the taxpayer within such period.

SECTION 2. CLAIMS FOR CREDIT OR REFUND SUBJECT TO THIS NOTICE

This notice applies to taxpayers required to file Form 1120, *U.S. Corporation Income Tax Return*, with claims for credit or refund attributable, in whole or in part, to the research credit that (1) were not reported on an original Form 1120 or a Form 1120X, *Amended U.S. Corporation Income Tax Return*, filed on or before the due date of the original Form 1120, including extensions, and (2) were not filed with the Internal Revenue Service on or before the date this notice was published in the Internal Revenue Bulletin.

SECTION 3. CLAIMS FOR CREDIT OR REFUND NOT SUBJECT TO THIS NOTICE

Claims for credit or refund attributable, in whole or in part, to the research credit that (1) were reported on an original Form 1120 or a Form 1120X filed on or before the due date of the original Form 1120, including extensions, or (2) were filed with the Service on or before the date this notice was published in the Bulletin are not subject to this notice.

Furthermore, claims for credit or refund attributable, in whole or in part, to the research credit and reported on Form 1040, *U.S. Individual Income Tax Return*, or Form 1040X, *Amended U.S. Individual Income Tax Return*, are not subject to this notice.

SECTION 4. REQUIREMENTS FOR CLAIMS FOR CREDIT OR REFUND SUBJECT TO THIS NOTICE

.01 *In General*. All claims for credit or refund subject to this notice, other than claims for credit or refund identified in section 4.02 below, shall be filed with the Ogden Service Center at the following address:

Internal Revenue Service Center
1973 North Rulon White Road
Ogden, UT 84201

The claim for credit or refund shall indicate at the top "Refund-Research Credit" and include a copy of the Form 6765, *Credit for Increasing Research Activities*, (if any) filed with the original return.

.02 *Taxable Years Currently under Audit*. At the taxpayer's election, claims for credit or refund subject to this notice for a taxable year currently under audit by the Service may, with the concurrence of the LMSB Team Manager (or SB/SE Manager) and in lieu of the requirements set forth in section 4.01 above, be filed directly with the LMSB Team Manager (or SB/SE Manager) and a copy mailed to the following address:

Internal Revenue Service
Attn: Research Credit
Large and Mid-Size Business Division LM:PFTG
Mint Bldg, 3rd Floor, Room M3–443
1111 Constitution Ave., NW
Washington, DC 20224

The claim for credit or refund shall indicate at the top "Refund-Research Credit" and include a copy of the Form 6765 (if any) filed with the original return. All claims for credit or refund subject to this notice must include a completed Form 6765.

SECTION 5. CONTACT INFORMATION

For procedural questions regarding this notice, contact Nathan B. Rosen of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice, at (202) 622–4910 (not a toll-free call). For substantive questions regarding the § 41 research credit, contact Daniel A. Rosen of the Office of Division Counsel (Large and Mid-Size Business) at (212) 298–2060 (not a toll-free call) or Jolene J. Shiraishi of the Office of Associate Chief Counsel (Passthroughs and Special Industries) at (202) 622–3120 (not a toll-free call).

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also, Part 1, 280G.)

Rev. Proc. 2002–45

SECTION 1. PURPOSE

Revenue Procedure 2002–13, 2002–8 I.R.B. 549, provided guidance on valuing stock options for nonpublicly traded stock and publicly traded stock for purposes of §§ 280G and 4999 of the Internal Revenue Code. This revenue procedure modifies portions of Rev. Proc. 2002–13.

SECTION 2. BACKGROUND

Rev. Proc. 2002–13 provides a methodology for valuing stock options for purposes of §§ 280G and 4999. Stock options must be valued for purposes of §§ 280G and 4999 when a payment in the nature of compensation involves a stock option, such as when the grant of the option is a payment in the nature of compensation contingent on a change in ownership or control or, with respect to an option previously granted to the taxpayer, when the option becomes substantially vested within the meaning of § 1.83–3(b) and (j) as a result of the change in ownership or control. Rev. Proc. 2002–13 does not apply for purposes of valuing a payment in cash, even though the cash is determined by reference to the cancellation of a stock option.

Generally, Rev. Proc. 2002–13 provides that a taxpayer may value a stock option using any valuation method that is consistent with generally accepted accounting principles (such as Statement of Financial Accounting Standards No. 123 (Fin. Accounting Standards Bd. 1995 (FAS 123)) and that takes into account the factors provided in § 1.280G–1 of the Proposed Income Tax Regulations, Q&A-13, published in the **Federal Register** on February 20, 2002 (REG–209114–90,

2002–9 I.R.B. 576 [67 F.R. 7630]) (the 2002 proposed regulations) and on May 5, 1989 (PS–217–84, 1989–1 C.B. 1038 [54 F.R. 19390]) (the 1989 proposed regulations). In addition, section 4 of Rev. Proc. 2002–13 provides a valuation method based on the Black-Scholes model.

Rev. Proc. 2002–13 provides that, if the stock option is one that could otherwise be valued under Rev. Proc. 98–34, 1998–1 C.B. 983, because the stock option is a "Compensatory Stock Option," as defined in section 3 of Rev. Proc. 98–34 (*i.e.*, a nonpublicly traded option for stock that is publicly traded on an established securities market), then, for purposes of §§ 280G and 4999 and Rev. Proc. 2002–13, the valuation is not considered consistent with generally accepted accounting principles unless the valuation is made in accordance with Rev. Proc. 98–34 or the valuation safe harbor method described in section 4 of Rev. Proc. 2002–13.

Rev. Proc. 98–34 provides a methodology for valuation of certain compensatory stock options for purposes of gift, estate, and generation-skipping transfer taxes. The methodology described in Rev. Proc. 98–34 is an option pricing model that takes into account factors similar to those established in FAS 123. This methodology applies only to the valuation of a nonpublicly traded compensatory stock option for stock that, on the valuation date, is publicly traded on an established securities market.

Since the issuance of Rev. Proc. 2002–13, commentators have suggested that the two valuation methods available for Compensatory Stock Options do not adequately take into account all of the facts and circumstances relevant to the valuation of Compensatory Stock Options in the context of a change in ownership or control. Commentators have also requested an extension of the effective date provided in Rev. Proc. 2002–13, or a modification of Rev. Proc. 2002–13 to establish a safe harbor for Compensatory Stock Options, to provide opportunity for consideration of comments.

SECTION 3. MODIFICATIONS TO REV. PROC. 2002–13

01. Under Rev. Proc. 2002–13, a stock option for stock that is not publicly traded (*i.e.*, an option that is not a Compensatory Stock Option as defined in Rev. Proc. 98–34) is considered properly valued for purposes of §§ 280G and 4999 if such value is determined using any valuation method that is consistent with generally accepted accounting principles (such as FAS 123) and takes into account the factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations. For purposes of the preceding sentence, the safe harbor valuation method provided in section 4 of Rev. Proc. 2002–13 is considered consistent with generally accepted accounting principles and takes into account the factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations. Pending further guidance, a stock option for stock that is publicly traded (*i.e.*, an option that is a Compensatory Stock Option as defined in Rev. Proc. 98–34) will be considered properly valued if the valuation method satisfies the standard set forth in Rev. Proc. 2002–13 for stock options that are not Compensatory Stock Options. Accordingly, the value of a Compensatory Stock Option will be considered properly determined if such value is determined in accordance with Rev. Proc. 98–34, with the safe harbor valuation method in section 4 of Rev. Proc. 2002–13, or with a valuation method that is consistent with generally accepted accounting principles (such as FAS 123) and that takes into account the factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations. For purposes of §§ 280G and 4999, however, regardless of whether the option is a Compensatory Stock Option, a stock option will not be considered properly valued if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change in ownership or control or without regard to the other factors provided in § 1.280G–1, Q/A-13 of both the 1989 and 2002 proposed regulations.

02. The Appendix to this revenue procedure provides a valuation table for use under section 4 of Rev. Proc. 2002–13 that supersedes the table provided in the appendix to Rev. Proc. 2002–13. The expanded table includes an additional column for use when the remaining term of the option is 3 months. For purposes of section 4.04 of Rev. Proc. 2002–13, if the remaining term of the option is less than 12 months, the taxpayer may round down to the 3-month interval.

03. For purposes of determining the term factor under section 4.04 of Rev. Proc. 2002–13, the number of full months may be rounded down to the next lowest 12-month interval.

04. Section 4.02 of Rev. Proc. 2002–13 provides that, for purposes of valuing a stock option using the safe harbor valuation table in section 4 of Rev. Proc. 2002–13, the volatility factor used for stock that is publicly traded on an established securities market (or otherwise) is based on the volatility of the underlying stock used for purposes of FAS 123 and disclosed in the most recent financial statement of the corporation. In order to use the safe harbor in section 4 of Rev. Proc. 2002–13, the volatility factor in section 4.02 must be based on the volatility for the most recent year used for purposes of complying with FAS 123 and disclosed in the most recent financial statements of the corporation.

SECTION 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 2002–13, 2002–8 I.R.B. 549, is modified.

SECTION 5. REQUEST FOR COMMENTS

Comments are requested regarding the methods described in this revenue procedure and Rev. Proc. 2002–13. In particular, comments are requested on how to determine the appropriate term assumptions for purposes of valuing stock options in connection with a change in ownership or control and on other approaches to addressing the particular facts and circumstances associated with a change in ownership or control (for example, whether it is appropriate to permit recalculation of the value of an option under certain circumstances, such as termination of employment within a short period after a change in ownership or control). All comments will be available for public inspection and copying. Comments must be submitted by August 12, 2002. Comments should be sent to CC:ITA:RU (Rev. Proc. 2002–45), room 5226, Internal Revenue Service, POB

7604, Ben Franklin Station, Washington, DC 20044. Comments may also be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (Rev. Proc. 2002–45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. In the alternative, e-mail your comments to: *Notice.Comments@irscounsel.treas.gov*.

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective June 13, 2002. Taxpayers may apply the rules in this revenue procedure for the valuation of a stock option on or after April 26, 2002.

SECTION 7. DRAFTING INFORMATION

The principal author of this revenue procedure is Erinn Madden of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue procedure, contact Ms. Madden at (202) 622–6030 (not a toll-free call).

Appendix

	Term (months)	3	12	24	36	48	60	72	84	96	108	120
Volatility	Spread Factor*											
Low	200%	66.8%	67.3%	67.9%	68.4%	69.0%	69.5%	69.9%	70.3%	70.7%	71.0%	71.2%
	180%	64.5%	65.0%	65.7%	66.4%	67.1%	67.7%	68.3%	68.8%	69.3%	69.6%	69.9%
	160%	61.8%	62.4%	63.3%	64.1%	65.0%	65.8%	66.5%	67.1%	67.7%	68.1%	68.5%
	140%	58.6%	59.4%	60.4%	61.5%	62.5%	63.5%	64.4%	65.1%	65.8%	66.4%	66.9%
	120%	54.9%	55.8%	57.1%	58.4%	59.7%	60.9%	62.0%	62.9%	63.7%	64.5%	65.1%
	100%	50.4%	51.5%	53.2%	54.8%	56.4%	57.9%	59.1%	60.3%	61.3%	62.2%	63.0%
	80%	44.9%	46.3%	48.5%	50.6%	52.6%	54.3%	55.9%	57.3%	58.5%	59.6%	60.5%
	60%	38.0%	40.0%	42.9%	45.6%	48.0%	50.1%	52.0%	53.7%	55.2%	56.5%	57.6%
	40%	29.3%	32.3%	36.3%	39.7%	42.6%	45.2%	47.4%	49.4%	51.2%	52.7%	54.1%
	20%	18.1%	23.3%	28.5%	32.7%	36.2%	39.3%	41.9%	44.3%	46.4%	48.2%	49.9%
	0%	6.4%	13.6%	19.9%	24.7%	28.8%	32.3%	35.4%	38.1%	40.5%	42.7%	44.7%
	-20%	0.6%	5.4%	11.2%	16.1%	20.4%	24.2%	27.6%	30.6%	33.4%	35.9%	38.1%
	-40%	0%	0.9%	4.1%	7.9%	11.6%	15.2%	18.5%	21.7%	24.6%	27.3%	29.9%
	-60%	0%	0.0%	0.6%	2.0%	4.0%	6.4%	9.0%	11.6%	14.3%	16.8%	19.3%
Medium	200%	66.8%	67.4%	68.6%	69.9%	71.1%	72.2%	73.1%	73.9%	74.5%	75.0%	75.4%
	180%	64.5%	65.2%	66.7%	68.2%	69.6%	70.9%	71.9%	72.8%	73.5%	74.1%	74.6%
	160%	61.8%	62.7%	64.5%	66.3%	68.0%	69.4%	70.6%	71.6%	72.5%	73.2%	73.7%
	140%	58.6%	59.8%	62.0%	64.2%	66.1%	67.7%	69.1%	70.3%	71.2%	72.0%	72.7%
	120%	54.9%	56.4%	59.2%	61.7%	63.9%	65.8%	67.4%	68.8%	69.9%	70.8%	71.6%
	100%	50.4%	52.5%	55.9%	58.9%	61.5%	63.7%	65.5%	67.0%	68.3%	69.4%	70.3%
	80%	44.9%	47.9%	52.2%	55.7%	58.7%	61.2%	63.2%	65.0%	66.5%	67.7%	68.8%
	60%	38.2%	42.6%	47.8%	52.0%	55.4%	58.3%	60.6%	62.7%	64.3%	65.8%	67.0%
	40%	30.0%	36.3%	42.7%	47.6%	51.6%	54.8%	57.6%	59.9%	61.8%	63.5%	64.9%
	20%	20.3%	29.1%	36.8%	42.5%	47.0%	50.8%	53.9%	56.5%	58.8%	60.7%	62.3%
	0%	10.4%	21.2%	30.0%	36.4%	41.6%	45.8%	49.4%	52.4%	55.0%	57.2%	59.1%
	-20%	3.0%	13.0%	22.2%	29.2%	34.9%	39.7%	43.7%	47.2%	50.2%	52.8%	55.0%
	-40%	0.3%	5.7%	13.8%	20.8%	26.8%	32.0%	36.4%	40.4%	43.8%	46.8%	49.5%
	-60%	0%	1.2%	5.9%	11.4%	16.9%	22.1%	26.7%	31.0%	34.8%	38.3%	41.4%

	Term (months)	3	12	24	36	48	60	72	84	96	108	120
Volatility	Spread Factor*											
High	200%	66.8%	68.1%	70.7%	73.1%	75.0%	76.6%	77.8%	78.8%	79.5%	80.0%	80.4%
	180%	64.5%	66.1%	69.1%	71.7%	73.9%	75.6%	77.0%	78.1%	78.9%	79.5%	79.9%
	160%	61.8%	63.8%	67.3%	70.3%	72.7%	74.6%	76.1%	77.3%	78.2%	78.9%	79.4%
	140%	58.6%	61.3%	65.3%	68.6%	71.3%	73.4%	75.1%	76.4%	77.4%	78.2%	78.8%
	120%	54.9%	58.3%	63.0%	66.8%	69.7%	72.1%	73.9%	75.4%	76.6%	77.4%	78.1%
	100%	50.6%	55.0%	60.4%	64.6%	67.9%	70.6%	72.6%	74.3%	75.6%	76.6%	77.3%
	80%	45.3%	51.1%	57.4%	62.2%	65.9%	68.8%	71.1%	73.0%	74.4%	75.6%	76.5%
	60%	39.1%	46.6%	54.0%	59.4%	63.5%	66.8%	69.4%	71.4%	73.1%	74.4%	75.4%
	40%	31.7%	41.4%	50.0%	56.1%	60.7%	64.4%	67.3%	69.6%	71.5%	73.0%	74.2%
	20%	23.2%	35.4%	45.3%	52.1%	57.4%	61.5%	64.8%	67.4%	69.6%	71.3%	72.7%
	0%	14.3%	28.5%	39.6%	47.4%	53.3%	57.9%	61.6%	64.7%	67.1%	69.1%	70.8%
	-20%	6.4%	20.8%	32.9%	41.5%	48.1%	53.4%	57.6%	61.1%	64.0%	66.4%	68.3%
	-40%	1.5%	12.7%	24.8%	34.0%	41.4%	47.3%	52.2%	56.3%	59.7%	62.5%	64.8%
	-60%	0.1%	5.2%	15.2%	24.3%	32.1%	38.8%	44.4%	49.1%	53.2%	56.6%	59.5%

*Spot (market) Price/Exercise Price – 1 or (S/X–1)

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance on Cost Recovery Under the Income Forecast Method

REG–103823–99

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to deductions available to taxpayers using the income forecast method of depreciation under section 167(g). These proposed regulations reflect changes to the law made by the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997 and affect taxpayers that produce, own, or license films, videos, sound recordings, books, copyrights, patents, and certain other similar properties. This document also provides notice of a public hearing on these regulations.

DATES: Written comments must be received by August 29, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for September 4, 2002, at 10 a.m., must be received by August 13, 2002.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG–103823–99), 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:IT&A:RU (REG–103823–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments directly to the IRS Internet site at *www.irs.gov/regs*. A public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Bernard P. Harvey, (202) 622–3110; concerning submissions and, the hearing and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 to provide regulations under section 167(g) of the Internal Revenue Code of 1986 (Code). Section 167(g) was added to the Code by the Small Business Job Protection Act of 1996, Public Law 104–188, 1604 (110 Stat. 1755, 1836) (Aug. 20, 1996), and significant amendments were made to the provision by the Taxpayer Relief Act of 1997, Public Law 105–34, 1086 (111 Stat. 788, 957) (Aug. 5, 1997).

Explanation of Provisions

The income forecast method of depreciation has been a permissible method for certain properties since the early 1960s. The income forecast method permits taxpayers to recover the depreciable basis in property over the anticipated income to be earned from the property. The income forecast method is available for interests (including interests involving limited rights in property) in motion picture films, video tapes, sound recordings, copyrights, books, and patents. See Rev. Rul. 60–358, 1960–2 C.B. 68; Rev. Rul. 64–273, 1964–2 C.B. 62; Rev. Rul. 79–285, 1979–2 C.B. 91; and Rev. Rul. 89–62, 1989–1 C.B. 78. The income forecast method is appropriate for these types of property because they possess unique income earning characteristics (for example, the income earning potential of a film may vary as a direct result of the film's popularity) and, therefore, the economic usefulness of these properties cannot be measured adequately by the property's physical condition or by the passage of time. In 1996, Congress enacted statutory income forecast rules to ensure that, for certain properties, the allowances for depreciation appropriately match the basis of an income forecast property with the income derived therefrom. In 1997, Congress placed limitations on the type of property that could be depreciated using the income forecast method.

Computation of Allowances for Depreciation

The proposed regulations provide that, under the income forecast method, a taxpayer's allowance for depreciation for a given year for an income forecast property generally is an amount that bears the same relationship to the depreciable basis of the property that the "current year income" for that year bears to the "forecasted total income" for the property. The proposed regulations provide a revised computation for computing a taxpayer's allowance for depreciation in years when conditions necessitate using a revised forecasted total income that differs from the forecasted total income used in computing depreciation allowances in previous years. Pursuant to these rules, taxpayers may revise forecasted total income and use the revised computation in taxable years after income forecast property is placed in service when information becomes available that indicates that forecasted total income (or revised forecasted total income) previously used to compute income forecast depreciation is inaccurate. Under the revised computation, a taxpayer's allowance for depreciation for the current and all future years for an income forecast property is an amount that bears the same relationship to the unrecovered depreciable basis of the property that the current year income for that year bears to the result obtained by subtracting from revised forecasted total income for the property the amounts of current year income for prior taxable years. Taxpayers are required to use the revised computation in certain situations (discussed in this preamble under the heading of *Income From the Property*).

The proposed regulations also provide several special rules for computing allowances for depreciation under the income forecast method. A special rule applies for certain basis redeterminations whereby an additional "catch up" allowance for depreciation is allowed in the year that basis is redetermined. Under this special

rule, the additional depreciation allowance is an amount equal to the cumulative allowances for depreciation that would have been permitted in previous years had the basis redetermination amount been included in basis in the year the property was placed in service. It is intended that this additional allowance will ameliorate the potential back-loading of depreciation deductions that may otherwise occur if the additional amount were taken into account over the remaining income from the property and diminish the amount of look-back interest that may otherwise accrue. This special rule does not apply if the additional basis is treated as separate property.

Pursuant to section 167(g)(1)(C), a taxpayer's adjusted basis in an income forecast property is to be recovered by the end of the tenth taxable year following the taxable year in which the income forecast property is placed in service. The proposed regulations also provide that generally a taxpayer may deduct the adjusted basis in income forecast property in the year income from the property ceases completely and permanently (unless the income cessation arises in connection with the disposition of income forecast property). If additional amounts are paid or incurred with respect to income forecast property in taxable years after either of these special rules is applied, the additional amounts may be deducted when paid or incurred unless such amounts give rise to separate property.

Use of the income forecast method is elected on a property-by-property basis. Once elected, the income forecast method is a method of accounting that may not be changed without the consent of the Commissioner. Modifications to forecasted total income to take into account information that becomes available after the property is placed in service in accordance with these proposed regulations is not a change in a method of accounting requiring the Commissioner's consent.

Section 167(g) sets forth rules for the use of the income forecast method and any similar method. Thus, any method that calculates depreciation based on the flow of income generated by a property (or group of properties) is a "similar method" subject to the requirements of this regulation, including, *e.g.*, the requirement that the look-back method be applied in certain circumstances. Congress did not identify any method that should be treated as a similar method. Treasury and the IRS seek comments on other methods that should be treated as coming within the scope of the term *any similar method*.

Commentators suggested that we specifically approve a method of depreciation based on the application of percentages derived from historical patterns of income for similar properties as a similar method because to do so would simplify the computation of depreciation deductions for large groupings of properties. This suggestion has not been adopted because it is not clear that the historical patterns of income used to apply the suggested approach will accurately reflect the income from any particular income forecast property. Moreover, this suggested approach is not predicated upon the unique income earning characteristics of an income forecast property.

Basis Rules

The cost of producing income forecast property is capitalized and recovered through an allowance for depreciation. The proposed regulations follow the general principles set forth in the regulations under sections 263, 263A, 446, and 461 for determining the basis of income forecast property. Commentators have written to Treasury and the IRS requesting guidance on various issues involving the timing of inclusion in basis of direct costs of income forecast property that are contingent upon the amount of income earned from the property (or other similar factors) and the means by which those costs may be deducted. In accordance with these requests, and in light of section 167(g)(1)(B), the proposed regulations address certain basis issues that are peculiar to the income forecast method of computing depreciation allowances.

Section 263A applies to income forecast property produced by the taxpayer. Section 1.263A–1(c)(2)(ii) provides that an amount required to be capitalized under section 263A may not be included in basis any earlier than the taxable year during which the amount is incurred within the meaning of §1.446–1(c)(1)(ii). Section 1.446–1(c)(1)(ii) provides that under an accrual method of accounting a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which the "all events test" is satisfied. Sections 1.446–1(c)(1)(ii) and 1.461–1(a)(2) set forth the "all events test" which provides that a liability is incurred in the taxable year in which: (1) all the events have occurred that establish the fact of liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred with respect to the liability. Because section 167(g)(1)(B) provides that the adjusted basis of income forecast property depreciated using the income forecast method includes only amounts with respect to which the requirements of section 461(h) are satisfied, these rules are specifically restated in the proposed regulations.

The proposed regulations reiterate that contingent amounts that are either direct costs of the production of income forecast property or indirect costs properly allocable to the production of income forecast property are not added to basis until the taxable year in which the all events test, including the economic performance requirement of section 461(h), is satisfied. Under the proposed rules, the timing of the inclusion of certain of these costs in basis may be affected by § 1.461–1(a)(2)(iii)(A), § 1.461–1(a)(2)(iii)(D) and section 404.

Thus, the proposed regulations provide that contingent basis amounts that are either direct costs of income forecast property or indirect costs properly allocable to income forecast property are generally treated as basis redetermination amounts which increase the basis of income forecast property in the year paid or incurred. As noted above, the proposed regulations provide a special allowance applicable to certain basis redetermination amounts.

Commentators have also suggested that *Transamerica Corp. v. United States*, 999 F.2d 1362 (9th Cir. 1993), supports including contingent amounts in the basis of income forecast property beginning in the year the property is placed in service. In *Transamerica*, the Ninth Circuit interpreted Rev. Rul. 60–358, *supra*, as it applied in taxable years prior to the enactment of section 167(g), the economic performance requirements of section 461(h),

the uniform capitalization requirement of section 263A, and other changes. The Ninth Circuit held that contingent basis amounts may be included in the basis of income forecast property in the year that the property is placed in service so long as the forecasted total income used in the computation of depreciation under the income forecast method includes an amount of income from the property sufficient to indicate that the contingency will be satisfied. Commentators urge the continuing application of the *Transamerica* approach because this approach matches most closely the costs of creating an income forecast property with the income earned therefrom. Treasury and the IRS recognize that it may appear to be reasonable to include estimated amounts in the basis of income forecast property when the operation of the income forecast formula requires the use of estimated amounts in the forecasts of income that are used to determine the amount of income forecast depreciation, particularly where the income forecasts indicate that the contingencies will be resolved, and resolved relatively quickly, after the property is placed in service. Treasury and the IRS also recognize that the historic operation of the income forecast formula deters taxpayers from increasing their forecast of income in order to increase the contingent basis amounts includible in the basis of income forecast property because the increases in forecasted total income operate to increase the denominator of the income forecast formula and thus diminish the amount of depreciation of the income forecast property. This deterrent effect operates in most (but not all) situations to prevent the cumulative amount of income forecast depreciation deductions in any given taxable year from exceeding the total amount actually incurred in any given taxable year, which is the primary concern with the inclusion of contingent amounts in basis. However, because Congress specifically provided in section 167(g)(1)(B) that the adjusted basis of income forecast property includes only those amounts which satisfy the requirements of section 461(h) and because all events that establish the fact of the liability for contingent amounts have not occurred, the proposed regulations do not follow the *Transamerica* approach.

Commentators have also argued that *Associated Patentees, Inc. v. Commissioner*, 4 T.C. 979 (1945), supports an immediate deduction for contingent basis amounts arising from the provision of either property or services in the production of income forecast property that are paid or incurred in years after the year in which income forecast property is placed in service. The proposed regulations do not adopt this interpretation of *Associated Patentees* because providing a more favorable cost recovery rule for contingent basis amounts than for fixed amounts would create an unwarranted incentive for characterizing costs as contingent amounts. Contingent basis amounts arising from the provision of either property or services in the production of income forecast property must be capitalized into the basis of income forecast property in accordance with § 1.263A–1(e).

Salvage Value

The proposed regulations do not provide that the basis upon which depreciation is computed under the income forecast method is reduced for salvage value. The unique statutory scheme Congress adopted for income forecast property requires this departure from the rules generally applicable to property depreciated under section 167, and from the provisions of Rev. Rul. 60–358, *supra*, which had governed income forecast depreciation prior to the enactment of section 167(g). Based on the provisions of section 167(g), Congress intended that taxpayers be able to recover their entire basis in income forecast property within the period beginning with the year income forecast property is placed in service and ending with the 10th taxable year after the year the property is placed in service and that basis be recovered over the total income earned in connection with the property within that same time frame.

Section 167(g)(1)(C) requires taxpayers to recover the adjusted basis of income forecast property as of the beginning of the 10th taxable year after the property is placed in service as an allowance for depreciation in such year. The term *adjusted basis* refers to the basis of property for purposes of determining gain or loss, which is determined generally by adjusting the cost or other basis in property prescribed by section 1012 by the adjustments required by section 1016. See § 1.1011–1. The use of this term in section 167(g)(1)(C) indicates that Congress intended that the entire basis of an income forecast property be recovered within the period beginning with the year income forecast property is placed in service and ending with the 10th taxable year after the year the property is placed in service. The legislative history confirms this reading of the provision, stating that "(a)ny costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year." H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 299 (1996).

Consistent with this rule, the estimated income from the property is all the income projected to be earned over the first eleven taxable years the property is used by any taxpayer. Under section 167(g)(1)(A), the adjusted basis of income forecast property is to be recovered through allowances for income forecast depreciation over the "amount of income earned in connection with the property" through the end of the tenth taxable year after the year in which the income forecast property is placed in service. The legislative history to section 167(g)(1)(A) states that "income to be taken into account under the income forecast method includes all estimated income generated by the property." H.R. Conf. Rep. No. 737, at 297. By referring to income generated by the property, and not to income to be earned by the taxpayer, Congress established a regime whereby a taxpayer using the income forecast method must include within forecasted total income amounts that are to be earned not only by the taxpayer, but also by any subsequent owner during the eleven year period.

Income From the Property

The income forecast formula uses the ratio of current year income to forecasted total income from the property to determine the current allowance for depreciation. Both current year income and forecasted total income are to be computed in accordance with a taxpayer's method of accounting. Pursuant to Code section 167(g)(1)(A) and (g)(5)(C), forecasted total income is to include all anticipated

income from any source through the end of the tenth taxable year following the year in which the income forecast property is placed in service (except, as discussed below, in the year of disposition of income forecast property). Thus, for example, in the case of a film, such income includes income from foreign and domestic theatrical, television, and other releases and syndications; income from video tape releases, sales, rentals, and syndications; and incidental income associated with the property such as income from the financial exploitation of characters, designs, titles, scripts, and scores, but only to the extent that such incidental income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of section 267(b)). Apportionment rules are provided for situations when income from the exploitation of characters, designs, titles, scripts, scores, and other incidental income may relate to more than one income forecast property.

Under the proposed regulations, taxpayers are required at the end of the taxable year in which income forecast property is placed in service to make an accurate projection of all anticipated income to be earned from the income forecast property based on the conditions known to exist at that time. This estimate is referred to as forecasted total income. As discussed above, forecasted total income includes not only the income that the taxpayer forecasts it will earn by the end of the tenth taxable year after the year in which the income forecast property is placed in service, but also income that may be earned by other owners of the income forecast property during that same period.

The proposed regulations also require taxpayers to evaluate the accuracy of their forecasts annually. In order to perform these evaluations of forecasted total income, taxpayers must compute revised forecasted total income. Revised forecasted total income is the sum of current year income for the current taxable year and all prior taxable years, plus all income from the income forecast property that the taxpayer reasonably believes will be includible in current year income in taxable years after the current taxable year up to and including the 10th taxable year after the year in which the income forecast property is placed in service. Taxpayers are required to use the revised computation if forecasted total income in the immediately preceding taxable year falls outside a range bounded on the low end by 90 percent of revised forecasted total income for the current taxable year, and on the upper end by 110 percent of revised forecasted total income for the current taxable year. (In the situation where revised forecasted total income was used to compute income forecast depreciation in the immediately preceding taxable year, this comparison is made by comparing the revised forecasted total income for the current taxable year to revised forecasted total income for the immediately preceding taxable year.) Taxpayers may elect to alter their computations of income forecast depreciation (using the revised computation detailed below) when revised forecasted total income differs from forecasted total income.

Pursuant to Code section 167(g)(5)(B), income from the syndication of a television series need not be included in the income forecast computation prior to the fourth taxable year beginning after the date the first episode of the series is placed in service, unless an arrangement relating to future syndication exists. In such a case, syndication income is included in the income forecast computation at the time the arrangement relating to future syndication is made. This special rule also applies for purposes of applying the look-back method.

Special rules apply if income forecast property is disposed of prior to the end of the 10th taxable year after the year the property is placed in service. In such a case, section 167(g)(5)(E) requires that for purposes of applying the look-back method, income from the disposition of the property is to be taken into account. Failure to apply a similar rule for purposes of computing income forecast depreciation in the year of disposition may permit a depreciation differential that would not be corrected through the operation of the look-back method (because the differential would arise in a year for which the period of time to which look-back interest would apply would be zero). Accordingly, the proposed regulations require taxpayers to take income from the disposition of income forecast property into account in the year of disposition in computing revised forecasted total income both for purposes of computing its income forecast depreciation and for purposes of applying the look-back method.

Income Forecast Property

Section 167(g)(6) limits the types of property for which the income forecast method may be utilized. The income forecast method is available for interests (including interests involving limited rights in property) in motion picture films, video tapes, sound recordings, copyrights, books, and patents. In addition, section 167(g)(6)(E) provides the authority for Treasury and the IRS to extend the income forecast method to other types of property. The proposed regulations extend the method to theatrical productions and authorize the Commissioner to publish guidance designating other properties.

The proposed regulations generally require the income forecast method to be applied on a property-by-property basis. In certain limited circumstances, interests in multiple properties may be grouped together and treated as a single income forecast property. The ability to treat multiple income forecast properties as a single property for purposes of applying the income forecast method of depreciation is limited, however, to certain episodes of a television series or to multiple interests in specified income forecast properties acquired for broadcast pursuant to a single contract. The special allowance applicable to certain basis redetermination amounts is not available to basis redetermination amounts associated with interests in multiple income forecast properties treated as a single income forecast property under these rules. Commentators have requested that broad groupings of dissimilar properties be permitted in accordance with historic financial accounting practices. Because it is not clear that income would be clearly reflected if broader groupings of properties were permitted, this suggestion has not been incorporated into the proposed

regulations. Treasury and the IRS request comments on whether the proposed permitted groupings are appropriate and whether additional groupings should be allowed.

Under section 167(g)(5)(A)(ii), an amount incurred after income forecast property is placed in service that is significant and that gives rise to a significant increase in income when compared to the previous amount of forecasted total income is treated as a separate income forecast property and depreciated accordingly. Under the proposed regulations, an amount that does not exceed the lesser of 5 percent of the depreciable basis of the income forecast property with which the amount is associated or $100,000 is not considered significant for this purpose. An amount incurred after income forecast property is placed in service that is not significant or that does not give rise to a significant increase in income is subject to the general rules and is treated as a basis redetermination amount.

In addition, a cost incurred in a taxable year following the year in which the taxpayer has recovered through depreciation the entire adjusted basis of an income forecast property is treated as a separate income forecast property. If it is expected to give rise to a significant increase in income, the amount of the cost is treated as income forecast property that is newly placed in service. Otherwise, it is deductible in the year paid or incurred.

Look-back

In general, the look-back method applies any time property is depreciated using the income forecast method. A taxpayer using the income forecast method is required to pay, or is entitled to receive, interest computed under the look-back method for any year to which the look-back requirement applies. A taxpayer must pay look-back interest if deductions are accelerated due to the underestimation of total income expected to be earned with respect to the property. Conversely, a taxpayer is entitled to receive look-back interest if deductions are delayed as a result of overestimating total income expected to be earned with respect to the property. The look-back method applies separately to each income forecast property, unless properties are aggregated pursuant to special rules contained in the proposed regulations.

Generally, the look-back method is applied in the third and tenth taxable years following the year in which the income forecast property is placed in service. The look-back method also applies in the year income from the income forecast property ceases with respect to the taxpayer (and with respect to all persons who would be treated as a single taxpayer with the taxpayer under rules similar to those in section 41(f)(1)).

The look-back method does not apply to any income forecast property the basis of which is $100,000 or less in the year the look-back method would otherwise apply (redetermined without any reduction for depreciation allowed or allowable). In addition, the look-back method is not applicable for any year which would otherwise be a recomputation year if a 10 percent test is satisfied. The 10 percent test is met if forecasted total income (and, if applicable, revised forecasted total income) for each prior year is greater than 90 percent of revised forecasted total income for the year which would otherwise be a recomputation year and is less than 110 percent of revised forecasted total income for the year which would otherwise be a recomputation year. If the look-back method is applied for the third taxable year following the year in which income forecast property is placed in service, a special rule applies in determining whether the 10 percent test is satisfied in any subsequent year. Under the special rule, the amount of the forecasted total income or the revised forecasted total income for each taxable year up to and including the third taxable year following the year in which income forecast property is placed in service is deemed to be equal to the revised forecasted total income that was used for purposes of applying the look-back method in the third taxable year following the year in which income forecast property is placed in service.

In order to apply the look-back method, prior year allowances for depreciation for income forecast property are recomputed using revised forecasted total income for the recomputation year in lieu of forecasted total income (or, if appropriate, revised forecasted income) from the property that was used in the computation of depreciation under the income forecast method in the prior year. If a taxpayer sells or otherwise disposes of income forecast property, the amount realized upon the disposition of the property is included in determining revised forecasted total income from the property in the year of disposition. These recomputed depreciation allowances are then used to determine either a hypothetical overpayment of tax or a hypothetical underpayment of tax.

Generally, taxpayers must determine the hypothetical overpayment or underpayment of tax arising from the change in depreciation allowances by recomputing their tax liability. Thus, a taxpayer's tax liability for each prior year is recomputed by substituting the recomputed depreciation allowances for the depreciation allowances originally claimed. The recomputed tax liability is then compared to the taxpayer's actual liability. For purposes of this comparison, the taxpayer must determine the actual tax liability for each prior year based on the information available on the later of (1) the due date of the return, including extensions, (2) the date of an amended return, (3) the date a return is adjusted by examination, or (4) the date of any previous application of the look-back requirement for the income forecast property. The result of this comparison is a hypothetical overpayment or underpayment of tax for each prior year in which allowances for depreciation were claimed for income forecast property subject to the look-back method.

Pass-through entities that are not closely-held pass-through entities must use a simplified method to compute their hypothetical overpayment or underpayment for each prior year in which allowances for depreciation were claimed for income forecast property subject to the look-back method. Under the simplified method, taxpayers apply a set rate (*i.e.*, the highest rate applicable under section 1 or 11) to the net changes in depreciation allowances for each year. Treasury and the IRS considered, but did not provide, an election for other taxpayers to use the simplified method similar to the election set forth in § 1.460–6(d)(4)(ii). Treasury and the IRS request comments on whether the use of the simplified method should be extended to taxpayers other than those required to use the simplified

method, and if so, whether additional safeguards beyond the consistency rules for related taxpayers, the rules precluding changes from the simplified method without permission, and the overpayment ceiling would be appropriate.

Regardless of the method used, the resulting hypothetical overpayments or underpayments are then used to compute interest that is to be charged or credited on each of these amounts. Interest is generally computed from the due date of the return (not including extensions) for the years in which changes in depreciation allowances occur to the due date of the recomputation year (not including extensions). Special rules are provided for taxpayers who do not use the simplified method where changes in depreciation allowances affect tax liability in years other than the year in which the changes in depreciation allowances occur. Interest is computed using the overpayment rate under section 6621. The amounts resulting from these computations are netted to arrive at look-back interest due to the taxpayer or payable to the government for the recomputation year. For purposes of computing taxable income, look-back interest is treated as interest on an overpayment or underpayment of tax. Under section 167(g)(5)(D), look-back interest required to be paid is treated as a tax liability for penalty purposes.

Proposed Effective Date

The regulations are proposed to apply to property placed in service on or after the date that final regulations are published in the **Federal Register**.

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 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 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 the Treasury Department 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 September 4, 2002, at 10 a.m. in the Internal Revenue Service Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. 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 30 minutes before the hearing starts at the Constitution Avenue entrance. 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 this 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 August 13, 2002.

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 Bernard P. Harvey, Office of Associate 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 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. Sections 1.167(n)–0 through 1.167(n)–7 are added to read as follows:

§ 1.167(n)–0 Outline of regulation sections for section 167(g).

This section lists the major captions contained in § 1.167(n)–1 through § 1. 167(n)–7

§ 1.167(n)–1 Income forecast method.

(a) Overview.
(b) Method of accounting.
(1) In general.
(2) Election of the income forecast method.

§ 1.167(n)–2 Basis.

(a) Depreciable basis.
(1) In general.
(2) Timing of basis determinations and redeterminations.
(3) Separate Property.
(b) Basis redeterminations.
(c) Unrecovered depreciable basis.
(d) Example.

§ 1.167(n)–3 Income from the property.

(a) Current year income.
(1) In general.
(2) Special rule for advance payments.
(b) Forecasted total income.
(c) Revised forecasted total income.
(d) Special rules.
(1) Disposition of the property.

(2) Syndication income from television series.
(3) Apportionment of income in certain circumstances.
(4) Examples.

§ 1.167(n)–4 Computation of depreciation using the income forecast method.

(a) Computation of depreciation allowance.
(b) Revised computation.
(1) Change in estimated income.
(2) Requirement to use the revised computation.
(c) Basis redeterminations.
(1) Calculation of depreciation allowance.
(2) Example.
(d) Special rules.
(1) Final year depreciation.
(2) Certain basis redeterminations.
(3) Disposition of property.
(4) Separate property.
(e) Examples.

§ 1.167(n)–5 Property for which the income forecast method may be used.

(a) In general.
(b) Specific exclusions.
(c) Costs treated as separate property.
(1) Costs giving rise to a significant increase in income.
(2) Significant increase in income.
(3) Special rule for costs paid or incurred after the end of the final year.
(4) Time separate property is placed in service.
(5) Examples.
(d) Aggregations treated as a single income forecast property.
(1) Multiple episodes of a television series produced in the same taxable year.
(2) Multiple episodes of a television series produced in more than one taxable year.
(3) Multiple interests acquired pursuant to a single contract.
(4) Videocassettes and DVDs.

§ 1.167(n)–6 Look-back method.

(a) Application of the look-back method.
(b) Operation of the look-back method.
(1) In general.
(2) Property-by-property application.
(c) Recalculation of depreciation allowances.
(1) Computation.
(2) Revised forecasted total income from the property.
(3) Special rule for basis redeterminations.
(d) Hypothetical overpayment or underpayment of tax.
(1) In general.
(2) Hypothetical overpayment or underpayment, actual recomputation.
(3) Hypothetical overpayment or underpayment, simplified method.
(4) Definitions.
(e) Recomputation year.
(1) In general.
(2) Look-back method inapplicable in certain *de minimis* cases.
(f) *De minimis* basis exception.
(g) Treatment of look-back interest.
(1) In general.
(2) Additional interest due on interest only after tax liability due.
(3) Timing of look-back interest.
(4) Statute of limitations; compounding of interest on look-back interest.
(h) Example.

§ 1.167(n)–7 Effective date.

§ 1.167(n)–1 Income forecast method.

(a) *Overview*. This section and §§ 1.167(n)–2 through 1.167(n)–7 provide rules for computing depreciation allowances under section 167 for property depreciated using the income forecast method. Because the income forecast method is only appropriate for property with unique income earning characteristics, only property specified in § 1.167(n)–5 may be depreciated under the income forecast method. A taxpayer using the income forecast method generally computes depreciation allowances each year based upon the ratio of current year income to forecasted total income from the property as described in § 1.167(n)–4. Current year income and forecasted total income are determined in accordance with the provisions of § 1.167(n)–3. In addition, a taxpayer must determine depreciable basis for income forecast property in accordance with the basis rules of § 1.167(n)–2. Property depreciated under the income forecast method generally is subject to the look-back rules of § 1.167(n)–6 whereby taxpayers must determine the amount of interest owed on any hypothetical underpayment of tax, or due on any hypothetical overpayment of tax, attributable to the use of estimated income in the computation of income forecast depreciation. Under these rules, look-back computations must be performed in specified recomputation years, which are generally the 3rd and 10th taxable years after the taxable year that the property is placed in service.

(b) *Method of accounting*—(1) *In general*. The computation of depreciation under the income forecast method is elected on a property-by-property basis, and is a method of accounting under section 446 that may not be changed without the consent of the Commissioner. However, a change in forecasted total income in accordance with the rules of § 1.167(n)–4 is not a change in method of accounting requiring the Commissioner's consent.

(2) *Election of the income forecast method*. A taxpayer elects the income forecast method by computing allowances for depreciation for the eligible property in accordance with the provisions of this section and §§ 1.167(n)–2 through § 1.167(n)–6. See § 1.167(n)–5 for rules regarding eligible property.

§ 1.167(n)–2 Basis.

(a) *Depreciable basis*—(1) *In general*. The basis upon which the allowance for depreciation is computed with respect to income forecast property is the basis of the income forecast property for purposes of section 1011 without regard to the adjustments described in section 1016(a)(2) and (3).

(2) *Timing of basis determinations and redeterminations*. Costs paid or incurred in or after the taxable year in which the income forecast property is placed in service are taken into account in accordance with a taxpayer's method of accounting in redetermining the basis of income forecast property in the taxable year paid or incurred (*i.e.*, when all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability). See §§ 1.446–1(c)(1)(i) and (ii), 1.461–1(a)(1) and (2), and 1.263A–1(c). Accordingly, contingent payments may not be included in the basis of income forecast property when

the property is placed in service, but are included in the basis of income forecast property in the taxable year in which they are paid or incurred, even if the forecasted total income used in the computation of income forecast depreciation allowances is sufficient to indicate that the contingency will be satisfied.

(3) *Separate property*. Certain amounts paid or incurred in taxable years after income forecast property is placed in service are treated as separate property for purposes of computing depreciation allowances under the income forecast method. See § 1.167(n)–5(c).

(b) *Basis redeterminations*. If an amount required to be capitalized into the basis of income forecast property is paid or incurred after the income forecast property is placed in service, and if the amount required to be capitalized is not treated as separate property in accordance with § 1.167(n)–5(c), the basis of the income forecast property is redetermined and the amount required to be capitalized is the basis redetermination amount. The redetermined basis of the income forecast property is the depreciable basis of the income forecast property increased by the basis redetermination amount. In the year basis is redetermined (and in subsequent taxable years), the redetermined basis must be used to determine depreciation under the income forecast method. An additional allowance for depreciation under the income forecast method is allowed in the taxable year the basis of certain income forecast property is redetermined. *See* § 1.167(n)–4(c).

(c) *Unrecovered depreciable basis*. For any taxable year, the unrecovered depreciable basis of an income forecast property is the depreciable basis of the property less the adjustments described in section 1016(a)(2) and (3).

(d) *Example*. The provisions of § 1.167(n)–2 are illustrated by the following example:

(i) *Studio* contracts with *Actor* to star in a motion picture film to be produced by *Studio*. Both *Studio* and *Actor* are calendar year taxpayers; *Studio* is an accrual basis taxpayer and *Actor* is a cash basis taxpayer. As compensation for *Actor's* services, the contract guarantees *Actor* a payment of five percent of the gross income from the film, beginning after the film has earned a total gross income (net of distribution costs) of $ 100x. *Studio* estimates that the film will earn a total gross income of $160x by the end of the 10th taxable year following the taxable year that the film is placed in service. The film is placed in service and earns $ 65x of gross income in year one, $ 30x in year two, and $ 25x in year three. Because the income from the film does not exceed $100x in either year one or year two, *Studio* pays nothing under the contract to *Actor* in years one and two. In year three, the cumulative income from the film reaches $120x, which exceeds the $100x threshold by $20x. Based on this excess, *Studio* calculates that it owes *Actor* $ 1x, calculated by multiplying $20x by *Actor's* contractual percentage of five percent. *Studio* pays $1x to *Actor* 20 days after the end of year three.

(ii) *Studio* may not include the $1x paid to *Actor* in the basis of the film in years one or two because *Studio* does not have a fixed liability to pay *Actor* any amount under the contract in years one and two. Furthermore, while *Studio* does have a fixed liability to pay *Actor* $1x in year three, the requirements of section 404 are not met in year three and *Studio* thus may not include the $1x in the basis of the film in year three. In year four, when section 404 is satisfied, *Studio* incurs the $1x in accordance with § 1.263A–1(c) and increases its basis in the film. The $1x is treated as a basis redetermination amount under § 1.167(n)–2(b) in year four.

§ 1.167(n)–3 Income from the property.

(a) *Current year income*—(1) *In general*. Current year income is the income from an income forecast property for the current year (less the distribution costs of the income forecast property for such year), determined in accordance with the taxpayer's method of accounting. All income earned in connection with the income forecast property is included in current year income, except as provided in paragraph (d) of this section. In the case of a film, television show, or similar property, such income includes, but is not limited to—

(i) Income from foreign and domestic theatrical, television, and other releases and syndications;

(ii) Income from releases, sales, rentals, and syndications of video tape, DVD, and other media; and

(iii) Incidental income associated with the property, such as income from the financial exploitation of characters, designs, titles, scripts, and scores, but only to the extent that such incidental income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of section 267(b)).

(2) *Special rule for advance payments*. In the year that income forecast property is placed in service, current year income for an income forecast property includes income included in gross income for any prior taxable year in connection with the property. This paragraph applies separately to any cost treated as separate property under § 1.167(n)–5(c).

(b) *Forecasted total income*. Forecasted total income is the sum of current year income for the year that income forecast property is placed in service, plus all income from the income forecast property that the taxpayer reasonably believes will be includible in current year income in subsequent taxable years (as adjusted for distribution costs) up to and including the 10th taxable year after the year in which the income forecast property is placed in service. Forecasted total income is based on the conditions known to exist at the end of the taxable year for which the income forecast property is placed in service.

(c) *Revised forecasted total income*. If information is discovered in a taxable year following the year in which income forecast property is placed in service that indicates that forecasted total income is inaccurate, a taxpayer must compute revised forecasted total income for the taxable year. Revised forecasted total income is based on the conditions known to exist at the end of the taxable year for which the revised forecast is being made. Revised forecasted total income for the taxable year is the sum of current year income for the taxable year and all prior taxable years, plus all income from the income forecast property that the taxpayer reasonably believes will be includible in current year income in taxable years after the current taxable year up to and including the 10th taxable year after the year in which the income forecast property is placed in service. Where a taxpayer computes revised forecasted total income in accordance with this § 1.167(n)–3(c), *see* § 1.167(n)–4(b) for the computation of the allowance for income forecast depreciation.

(d) *Special rules*—(1) *Disposition of the property*. In computing the depreciation allowance for an income forecast property, income from the sale or other disposition of income forecast property is not included in current year income. However, if the income forecast property is disposed of prior to the end of the 10th taxable year following the taxable year in which the property is placed in service, income from the sale or other disposition

of income forecast property is taken into account in calculating revised forecasted total income both for purposes of calculating the allowance for depreciation in the year of disposition and for purposes of applying look-back. See § 1.167(n)–4(d)(3) and § 1.167(n)–6(c)(2).

(2) *Syndication income from television series*. (i) In the case of a television series produced for distribution on television networks, current year income and forecasted total income (or, if applicable, revised forecasted total income) used in the computation of the depreciation allowance for such property under § 1.167(n)–4 need not include income from syndication of the television series before the earlier of—

(A) The fourth taxable year beginning after the date the first episode in the series is placed in service; or

(B) The earliest taxable year in which the taxpayer has an arrangement relating to the syndication of the series.

(ii) For purposes of this paragraph (d)(2), an arrangement relating to syndication of a series of television shows means any arrangement other than the first run exhibition agreement. For example, an arrangement for exhibition of a television series by individual television stations is an arrangement for syndication if it results in an exhibition of one or more episodes of the series beginning after one or more episodes of the series have been exhibited on a television network. A first run exhibition agreement is an agreement under which any episode (including a pilot episode) of a television series is first placed in service within a particular market.

(3) *Apportionment of income in certain circumstances*. When income from a particular source relates to more than one income forecast property, the taxpayer must make a reasonable allocation of the income among those properties based on all relevant factors. Situations where allocation is necessary include income generated by a syndication arrangement involving more than one income forecast property, incidental income described in paragraph (a)(1)(iii) of this section that relates to more than one motion picture, and income associated with income forecast property when expenditures relating to the property have given rise to separate property as defined in § 1.167(n)–5(c). For example, when a taxpayer sells or licenses merchandise that features the likeness of a character that has appeared in more than one film, relevant factors might include merchandise sales figures prior to the release of the subsequent film, specific identification of certain merchandise with one particular film, and the taxpayer's prior experience with similar situations.

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

Example 1. *C* produces a motion picture film featuring the adventures of a fictional character. *C* sells merchandise using the character's image, enters into licensing agreements with unrelated parties for the use of the image, and uses the image to promote a ride at an amusement park that is wholly owned by *C*. Pursuant to paragraph (a)(1) of this section, income from the sales of merchandise by *C* to consumers and income from the licensing agreements are included in current year income. No portion of the admission fees for the amusement park is included in current year income because the amusement part is wholly owned by *C*.

Example 2. Assume the same facts as in *Example 1*. *C* forecasts that the cumulative amount of current year income it will earn (net of distribution costs) from the year it places the motion picture film in service through the end of the 7th taxable year thereafter to be $345x. *C* also forecasts that the motion picture film will earn current year income of $155x from the beginning of the 8th taxable year through the end of the 10th taxable year after the year the income forecast property is placed in service. *C* anticipates the sale of the motion picture film at the end of the 7th taxable year after the year the property is placed in service and in fact sells the motion picture film for $200x on the last day of the 7th taxable year after the year the property is placed in service. *C*'s computations of forecasted total income must reflect the fact that *C* forecasts that $500x will be earned by the motion picture film through the end of the 10th taxable year after the year the property is placed in service ($345x from the year the film is placed in service through the end of the 7th taxable year after the taxable year that the property was placed in service, plus $155x *C* forecasts from the beginning of the 8th taxable year through the end of the 10th taxable year after the year the property is placed in service). Even though *C* only expects to earn $345x prior to the sale of the film, *C* may not use $345x as forecasted total income in computing its depreciation allowance under the income forecast method. Similarly, *C* may not use the combination of the amounts it expects to earn prior to the sale ($345x) plus the anticipated sales proceeds ($200x) or $545x as forecasted total income, except when computing its depreciation allowance for the 7th taxable year after the year in which the income forecast property was placed in service and for purposes of computing look-back interest.

§ 1.167(n)–4 Computation of depreciation using the income forecast method.

(a) *Computation of depreciation allowance*. Generally, the depreciation allowance for an income forecast property for a given taxable year is computed by multiplying the depreciable or redetermined basis of the property (as defined in § 1.167(n)–2) by a fraction, the numerator of which is current year income (as defined in § 1.167(n)–3(a)) and the denominator of which is forecasted total income (as defined in § 1.167(n)–3(b)).

(b) *Revised computation*—(1) *Change in estimated income*. The depreciation allowance for an income forecast property for any taxable year following the year in which income forecast property is placed in service may be computed using the computation provided in this paragraph (b)(1) if revised forecasted total income differs from forecasted total income. Thus, for example, a taxpayer using the income forecast method for a motion picture may revise upward the forecast of total income from the motion picture (to arrive at revised forecasted total income) in a taxable year wherein the taxpayer discovers that the motion picture is more popular than originally expected, and may thereafter use the revised computation to compute the allowance for income forecast depreciation for the motion picture. Under the revised computation, the unrecovered depreciable basis of the income forecast property (as defined in § 1.167(n)–2(c)) is multiplied by a fraction, the numerator of which is current year income and the denominator of which is obtained by subtracting from revised forecasted total income the amounts of current year income from prior taxable years.

(2) *Requirement to use the revised computation*. The revised computation described in paragraph (b)(1) of this section must be used in any taxable year following the year in which income forecast property is placed in service if forecasted

total income (as defined in § 1.167(n)–3(b)) (or, if applicable, revised forecasted total income (as defined in § 1.167(n)–3(c)) in the immediately preceding taxable year is either—

(i) Less than 90 percent of revised forecasted total income for the taxable year; or

(ii) Greater than 110 percent of revised forecasted total income for the taxable year.

(c) *Basis redeterminations*—(1) *Calculation of depreciation allowance*. An additional depreciation allowance is available under this paragraph in the taxable year that basis is redetermined under § 1.167(n)–2(b) when that taxable year is subsequent to the taxable year in which income forecast property is placed in service, but prior to the 10th taxable year following the taxable year in which the property is placed in service. The additional depreciation allowance is that portion of the basis redetermination amount that would have been recovered through depreciation allowances in prior taxable years if the basis redetermination amount had been included in depreciable basis in the taxable year that the property was placed in service. This § 1.167(n)–4(c) does not apply to property treated as a single income forecast property pursuant to § 1.167(n)–5(d)(1) through (4).

(2) *Example*. The provisions of paragraph (c)(1) of this section are illustrated by the following example:

Example. *D*, an accrual basis movie producer, enters into a contract with *E*, an author, under which *D* will make a film based on *E's* book. *E* performs no services for *D*, but merely permits *D* to use the book as a basis for *D's* film. *D* pays *E* a fixed dollar amount upon entry into the agreement and promises to pay *E* a contingent payment of five percent of *D's* income from the film, beginning after the film has earned $100,000 (net of distribution costs). *D* estimates that forecasted total income from the film will be $200,000. The film earns $65,000 of current year income in year one, $30,000 in year two, and $25,000 in year three. *D* takes allowances for depreciation in year one ($65,000 divided by $200,000, multiplied by the basis of the film) and year two ($30,000 divided by $200,000, multiplied by the basis of the film). In year three, *D's* liability to *E* becomes fixed and *D* pays *E* $1,000. The $1,000 incurred by *D* is a basis redetermination amount that increases the basis of the film for purposes of computing *D's* depreciation allowance for the film for year three. In addition to the year three allowance based on current year income ($25,000 divided by $200,000 multiplied by the basis of the film, which includes for year three the $1,000 basis redetermination amount), *D* is entitled to an additional allowance for depreciation for year three under paragraph (c)(1). This additional allowance is $475, the sum of the allowance of $325 that would have been allowed in year one ($65,000 divided by $200,000, multiplied by the $1,000 payment to *E*) and the allowance of $150 that would have been allowed in year two ($30,000 divided by $200,000, multiplied by $1,000) if the $1,000 had been included in basis in the year that the film was placed in service.

(d) *Special rules*—(1) *Final year depreciation*. Except as provided in paragraphs (d)(2) and (3) of this section, a taxpayer may deduct as a depreciation allowance the remaining depreciable basis of income forecast property depreciated under the income forecast method in the earlier of—

(i) The year in which the taxpayer reasonably believes, based on the conditions known to exist at the end of the taxable year, that no income from the income forecast property will be included in current year income in any subsequent taxable year up to and including the 10th taxable year following the taxable year the income forecast property is placed in service; or

(ii) The 10th taxable year following the taxable year the income forecast property is placed in service.

(2) *Certain basis redeterminations*. A taxpayer may deduct as a depreciation allowance the amount of any basis redetermination that occurs in a taxable year in which the taxpayer reasonably believes, based on the conditions known to exist at the end of the taxable year, that no income from the income forecast property will be included in current year income in any subsequent taxable year. In addition, a taxpayer may deduct as a depreciation allowance the amount of any basis redetermination that occurs in a taxable year following a taxable year in which a deduction is allowable under paragraph (d)(1) of this section.

(3) *Disposition of property*. Paragraph (d)(1) of this section does not apply to income forecast property that is sold or otherwise disposed of before the end of the 10th taxable year following the taxable year that the property is placed in service. In the case of such a disposition, the allowance for depreciation in the year of disposition is calculated by multiplying the depreciable basis (or, if applicable, the redetermined basis) of the property by a fraction, the numerator of which is current year income and the denominator of which is the sum of the amount realized on the disposition of the property plus all amounts included in current year income in the year of disposition and in taxable years prior to the year of disposition.

(4) *Separate property*. The deductions provided in paragraphs (d)(1) and (2) of this section apply separately to property that is treated as separate property under § 1.167(n)–5(c).

(e) *Examples*. The provisions of this section are illustrated by the following examples:

Example 1. *F* places in service income forecast property with a depreciable basis of $100x, and estimates that forecasted total income from the property will be $200x. In taxable year one, current year income is $80x. The depreciation allowance for year one is $40x, computed by multiplying the depreciable basis of the property of $100x by the fraction obtained by dividing current year income of $80x by forecasted total income of $200x.

Example 2. Assume the same facts as in *Example 1*. In year two, *F's* current year income is $40x. In addition, *F* computes revised forecasted total income to be $176x. *F* is required to compute its depreciation allowance for this property using the revised computation of paragraph (b)(1) of this section because forecasted total income in year one of $200x is greater than 110 percent of revised forecasted total income in year two (110 percent of $176x = $193.6x). The depreciation allowance for taxable year two computed under the revised computation is $25x, computed by multiplying the unrecovered depreciable basis of $60x by the fraction obtained by dividing current year income of $40x by $96x (revised forecasted total income of $176x less current year income from prior taxable years of $80x).

Example 3. Assume the same facts as in *Example 2*. Because *F* used the revised computation in year two, the revised computation applies in year three. In year three, *F's* current year income is $32x. The depreciation allowance for year three computed under the revised computation is $20x, computed by multiplying the unrecovered depreciable basis of $60x by the fraction obtained by dividing current year income of $32x by $96x (revised forecasted total income of $176x less current year income from taxable years prior to the change in estimate taxable year of $80x).

§ 1.167(n)–5 Property for which the income forecast method may be used.

(a) *In general*. The depreciation allowance under § 1.167(n)–4 may be computed under the income forecast method only with respect to eligible property. Eligible property is limited to an interest (including interests involving limited rights in property) in the following property—

(1) Property described in section 168(f)(3) and (4);

(2) Copyrights;

(3) Books;

(4) Patents;

(5) Theatrical productions; and

(6) Other property as designated in published guidance by the Commissioner.

(b) *Specific exclusions*. The income forecast method does not apply to any amortizable section 197 intangible (as defined in section 197(c) and § 1.197–2(d)).

(c) *Costs treated as separate property*—(1) *Costs giving rise to a significant increase in income*—(i) *In general*. For purposes of § 1.167(n)–1 through § 1.167(n)–6 , any amount paid or incurred after the income forecast property is placed in service must be treated as a separate property if the cost is significant and gives rise to an increase in income that is significant and that was not included in either forecasted total income or revised forecasted total income in a prior taxable year.

(ii) *Exception for de minimis amounts*. For purposes of this paragraph, a cost that is less than the lesser of 5 percent of the depreciable basis (as of the date the amount is paid or incurred) of the income forecast property to which the amount relates or $100,000 is not significant. Such a cost is therefore not treated as separate property but is instead treated as a basis redetermination amount in accordance with § 1.167(n)–2(b).

(2) *Significant increase in income*. For purposes of this paragraph, whether an increase in income is significant is determined by comparing the amount that would be considered revised forecasted total income from the amounts treated as separate property to the most recent estimate of forecasted total income or revised forecasted total income used in calculating an allowance for depreciation with respect to the income forecast property.

(3) *Special rule for costs paid or incurred after the end of the final year*. For purposes of § 1.167(n)–1 through § 1.167(n)–6, any amount paid or incurred with respect to an income forecast property in a taxable year following the year in which the taxpayer claims a depreciation allowance in accordance with the final year depreciation rules of § 1.167(n)–4(d)(1) is treated as a basis redetermination amount under § 1.167(n)–2(b) provided the amount is not expected to give rise to a significant increase in current year income in any taxable year.

(4) *Time separate property is placed in service*. Separate property is treated as placed in service in the year the amount giving rise to the property is paid or incurred.

(5) *Examples*. The provisions of this paragraph (c) are illustrated in the following examples:

Example 1. *G* releases a film in 2001 and begins to recover the depreciable basis in the film using the income forecast method in the year 2001. In 2003, the film is re-edited and restored, and director's commentary is added in order to prepare the film for release on DVD. The total cost of preparing the film for the DVD release exceeds both 5 percent of the depreciable basis of the film and $100,000. *G* did not anticipate the income from the DVD market, and did not include any DVD release income in the income projections for the film in prior years. If *G* anticipates that the additional DVD release income will be significant in relation to the forecasted total income used in calculating an allowance for depreciation for 2002 (the previous taxable year), the additional amount gives rise to separate property and must be recovered over the forecasted total income from the DVD. If not, *G* must treat the additional amounts as additions to basis under § 1.167(n)–2(b).

Example 2. *G* releases a film in 2001 and recovers the depreciable basis in the film using the income forecast method in the years 2001 through 2011. In 2018, the film is re-edited and restored, and director's commentary is added in order to prepare the film for release on a newly discovered technology. If *G* anticipates that the additional new technology release income will be significant in relation to the revised forecasted total income used in calculating an allowance for depreciation for 2011 (the last taxable year for which an allowance was claimed), the cost of preparing the release gives rise to separate property and must be recovered over the forecasted total income from the new technology release. If not, *G* may deduct the cost in 2018, the year paid or incurred.

(d) *Aggregations treated as a single income forecast property*. Taxpayers must apply the income forecast method on a property-by-property basis, unless one of the aggregation rules provided in paragraphs (d)(1) through (4) of this section applies. If a taxpayer applies one of the aggregation rules provided in paragraphs (d)(1) through (4) of this section, costs incurred in taxable years after the initial income forecast property is placed in service are treated as basis redeterminations under § 1.167(n)–2; however, the additional allowance for depreciation provided in § 1.167(n)–4(c)(1) does not apply. The application of the provisions of paragraphs (d)(1) through (d)(4) is a method of accounting that may not be changed without the consent of the Commissioner. Permissible aggregations are limited to the following:

(1) *Multiple episodes of a television series produced in the same taxable year*. The producer of a television series may treat multiple episodes of a single television series produced in the same taxable year as a single unit of property for purposes of the income forecast method.

(2) *Multiple episodes of a television series produced in more than one taxable year*. The producer of a television series may treat multiple episodes of a single television series that are produced as a single season of episodes and placed in service over a period not in excess of twelve consecutive calendar months as a single unit of property for purposes of the income forecast method notwithstanding that the twelve-month period may span more than one taxable year.

(3) *Multiple interests acquired pursuant to a single contract*. Multiple interests in specifically identified income forecast properties acquired for broadcast pursuant to a single contract may be treated as a single unit of property for purposes of the income forecast method.

(4) *Videocassettes and DVDs*. The purchaser or licensee of videocassettes and DVDs for rental to the public may treat multiple copies of the same title purchased or licensed in the same taxable year as a single unit of property for purposes of the income forecast method.

§ 1.167(n)–6 Look-back method.

(a) *Application of the look-back method*. If a taxpayer claims a depreciation deduction under the income forecast method for any eligible income forecast property, such taxpayer is required to pay (or is entitled to receive) interest computed as described in this paragraph for any year to which the look-back method applies (a recomputation year). The look-back method generally must be applied when income forecast property is disposed of or ceases to generate income. Further, the look-back method generally applies in the 3rd and 10th taxable years following the year in which income forecast property is placed in service. Under

the look-back method, taxpayers must pay interest on deductions accelerated by the underestimation of either forecasted total income or revised forecasted total income from income forecast property. Conversely, taxpayers are entitled to receive interest on deductions delayed by the overestimation of either forecasted total income or revised forecasted total income from income forecast property. If either forecasted total income or revised forecasted total income are overestimated or underestimated, interest may arise from basis redeterminations. The computation of adjusted tax liability as part of the look-back method is hypothetical; application of the look-back method does not require a taxpayer to adjust tax liability as reported on the taxpayer's tax returns, on an amended return, or as adjusted on examination for prior years.

(b) *Operation of the look-back method*—(1) *In general*. Under the look-back method, a taxpayer must perform a series of computations to determine look-back interest that the taxpayer is either required to pay or entitled to receive. As specified in paragraph (c) of this section, a taxpayer must first recompute depreciation allowances using revised forecasted total income rather than forecasted total income from income forecast property for the recomputation year (as defined in paragraph (e) of this section) and each prior year. These recomputed depreciation amounts are then used to determine a hypothetical tax liability that would have arisen had the taxpayer used revised forecasted total income rather than forecasted total income in determining depreciation allowances. The hypothetical tax liability is compared to the taxpayer's prior tax liability and interest is calculated in accordance with paragraph (d) of this section on the resulting hypothetical overpayments or underpayments of tax for each year. Reporting requirements and special rules for the resulting amounts of interest are specified in paragraph (g) of this section.

(2) *Property-by-property application*. Except as provided in this section, the look-back method applies to each property for which the income forecast method is used. Aggregations properly treated as a single income forecast property pursuant to § 1.167(n)–5(d) are treated as a single property for purposes of applying the look-back method.

(c) *Recalculation of depreciation allowances*—(1) *Computation*. Under the look-back method, a taxpayer must compute the depreciation allowances for each income forecast property subject to the look-back method that would have been allowable under § 1.167(n)–1 through § 1.167(n)–5 for prior taxable years if the computation of the amounts so allowable had been made using revised forecasted total income as calculated at the end of the recomputation year.

(2) *Revised forecasted total income from the property*—(i) *In general*. Except as provided in this paragraph (c)(2), revised forecasted total income is determined in accordance with § 1.167(n)–3(c).

(ii) *Syndication income from television series*. Income excluded from forecasted total income (or, if appropriate revised forecasted total income) in any taxable year prior pursuant to § 1.167(n)–3(d)(2) is excluded from revised forecasted total income for purposes of this section for that year.

(iii) *Disposition of income forecast property*. For purposes of this section, income from the disposition of property must be taken into account in determining the amount of revised forecasted total income. Thus, when income forecast property is disposed of prior to the end of the 10th taxable year following the taxable year the property is placed in service, revised forecasted total income from the property for the year of disposition is deemed to be the sum of the amount realized on the disposition of the property plus all amounts included in current year income in the year of disposition and in taxable years prior to the year of disposition.

(3) *Special rule for basis redeterminations*. For purposes of the look-back calculation, any amount that is not treated as a separate property under § 1.167(n)–5(c) that is paid or incurred with respect to income forecast property after the property is placed in service is taken into account by discounting (using the Federal mid-term rate determined under section 1274(d) as of the time the cost is paid or incurred) the amount to its value as of the date the property is placed in service. The taxpayer may elect for the recomputation year with respect to any income forecast property to have the preceding sentence not apply to the property by taking the amount into account in the year that the amount was paid or incurred in the same manner as it was taken into account under § 1.167(n)–2.

(d) *Hypothetical overpayment or underpayment of tax*—(1) *In general*—(i) *Years for which a hypothetical overpayment or underpayment must be computed.* After recalculating depreciation allowances in accordance with paragraph (c) of this section, a taxpayer must calculate a hypothetical overpayment or underpayment of tax for each prior taxable year for which income tax liability is affected by the change in depreciation allowances. A redetermination of income tax liability is required for every tax year for which the income tax liability would have been affected by a change in the allowance for income forecast depreciation in any year. For example, if the change in depreciation allowance results in a net operating loss carryforward that affects income tax liability in a subsequent taxable year, income tax liability must be recomputed for such subsequent year.

(ii) *Methods of determining a hypothetical overpayment or underpayment.* Generally, the calculation of the hypothetical overpayment or underpayment of tax must be made under the method described in paragraph (d)(2) of this section. Certain taxpayers are required to use the simplified method contained in paragraph (d)(3) of this section.

(iii) *Cumulative determination of hypothetical income tax liability*. The redetermination of income tax liability in any prior taxable year for which income tax liability is affected by the change in depreciation allowances must take into account all previous applications of the look-back calculation. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a prior taxable year for which income tax liability is affected by the change in depreciation allowances, the hypothetical income tax liability is compared to the hypothetical income tax liability for that year determined as of the previous application of the look-back method.

(2) *Hypothetical overpayment or underpayment, actual recomputation*—(i) *Computation of change in income tax*

liability. The hypothetical overpayment or underpayment is calculated first by redetermining the tax liability for each prior taxable year (either as originally reported, or as subsequently adjusted on examination or by amended return) using depreciation allowances calculated in paragraph (c) of this section for each prior taxable year in which depreciation allowances were determined under the income forecast method for the income forecast property (affected year). These recomputed depreciation allowances are then substituted for the depreciation allowances allowed (or allowable) for each affected year (whether originally reported, or as subsequently adjusted on examination or by amended return) and a revised taxable income is computed. A hypothetical income tax liability is then computed for each affected year using revised taxable income for that year. The hypothetical income tax liability for any affected year must be computed by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryforwards. The tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. Hypothetical income tax liability for each affected year is then compared to the tax liability determined as of the latest of the following dates—

(A) The original due date of the return (including extensions);

(B) The date of a subsequently amended or adjusted return; or

(C) The date of the previous application of the look-back method, in which case the hypothetical income tax liability for the affected year used in the most recent previous application of the look-back method (previous hypothetical tax liability) is used.

(ii) *Determination of interest*. Once the hypothetical overpayment or underpayment for each year is computed, the adjusted overpayment rate under section 460(b)(7), compounded daily, is applied to the overpayment or underpayment determined under paragraph (d)(2)(i) of this section for the period beginning with the due date of the return (determined without regard to extensions) for the year in which either an overpayment or underpayment arises, and ending on the earlier of the due date of the return (determined without regard to extensions) for the redetermination year, or the first date by which both the income tax return for the filing year is filed and the tax for that year has been paid in full. The amounts of interest on overpayments are then netted against interest on underpayments to arrive at look-back interest that must be paid by the taxpayer or that the taxpayer is entitled to receive.

(iii) *Changes in the amount of a loss or credit carryback or carryforward*. If a recomputation of income forecast depreciation results in an increase or decrease to a net operating loss carryback (but not a carryforward), the interest a taxpayer is entitled to receive or required to pay must be computed on the decrease or increase in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the prior taxable year that generated the carryback and not from the due date of the return for the prior taxable year in which the carryback was absorbed. In the case of a change in the amount of a carryforward as a result of applying the look-back method, interest is computed from the due date of the return for the years in which the carryforward was absorbed.

(iv) *Changes in the amount of income tax liability that generated a subsequent refund*. If the hypothetical income tax liability for any affected year is less than the amount of the affected year tax liability (as reported on the taxpayer's original return, as subsequently adjusted on examination, as adjusted by amended return, or as redetermined by the last previous application of the look-back method), and any portion of the affected year tax liability was refunded as a result of a loss or credit carryback arising in a year subsequent to the affected year, the look-back method applies as follows to properly reflect the time period of the use of the tax overpayment. To the extent the amount of refund because of the carryback exceeds the hypothetical income tax liability for the affected year, the taxpayer is entitled to receive interest only until the due date (not including extensions) of the return for the year in which the carryback arose.

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

Example. Upon the cessation of income from an income forecast property in 2003, the taxpayer computes a hypothetical income tax liability for 2001 under the look-back method. This computation results in a hypothetical income tax liability ($1,200x) that is less than the actual income tax liability the taxpayer originally reported ($1,500x). In addition, the taxpayer had already received a refund of some or all of the actual 2001 income tax liability by carrying back a net operating loss (NOL) that arose in 2002. The time period over which interest would be computed on the hypothetical overpayment of $300x for 2001 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(i) If the amount refunded because of the NOL is $1,500x, interest is credited to the taxpayer on the entire hypothetical overpayment of $300x from the due date of the 2001 return, when the hypothetical overpayment occurred, until the due date of the 2002 return, when the taxpayer received a refund for the entire amount of the 2001 tax, including the hypothetical overpayment.

(ii) If the amount refunded because of the NOL is $1,000x, interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of $300x from the due date of the 2001 return, when the hypothetical overpayment occurred, until the due date of the 2003 return. In this situation interest is credited until the due date of the return for the recomputation year, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the hypothetical income tax liability of $1,200x. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the recomputation year.

(iii) If the amount refunded because of the NOL is $1,300x, interest is credited to the taxpayer on $100x ($1,300x-$1,200x) from the due date of the 2001 return until the due date of the 2002 return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the recomputation year. However, the taxpayer did not receive a refund for the remaining $200x of the overpayment at that time and, therefore, is credited with interest on $200x through the due date of the tax return for 2003, the recomputation year.

(3) *Hypothetical overpayment or underpayment, simplified method*—(i) *Introduction*. This paragraph provides a simplified method for calculating look-back interest. A pass-through entity that is not a closely held pass-through entity is required to apply the simplified method at the entity level with respect to income forecast property and the owners of the entity do not calculate look-back interest for the property. Under the simplified method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate.

(ii) *Operation of the simplified method*. Under the simplified method, depreciation allowances for income forecast property are first recomputed in

accordance with the procedures contained in paragraph (c) of this section. These recomputed depreciation allowances are then compared with depreciation allowances allowed (or allowable) for each prior taxable year (whether originally reported, as subsequently adjusted on examination or by amended return, or as recomputed in the most recent previous application of the look-back method) to arrive at changes in depreciation allowances for the income forecast property. When multiple properties are subject to the look-back method in any given affected year, the changes in depreciation allowances attributable to each income forecast property determined in accordance with paragraph (c) of this section for each such year are cumulated or netted against one another to arrive at a net change in income forecast depreciation for purposes of computing the hypothetical overpayment or underpayment attributable to the year. The hypothetical underpayment or overpayment of tax for each affected year is then determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(3)(iv) of this section) by the increase or decrease in depreciation allowances.

(iii) *Determination of interest*. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each affected year by applying the adjusted overpayment rate under section 460(b)(7), compounded daily, to the overpayment or underpayment determined under paragraph (d)(3)(ii) of this section for the period beginning with the due date of the return (determined without regard to extensions) for the affected year, and ending on the earlier of the due date of the return (determined without regard to extensions) for the recomputation year, or the first date by which both the income tax return for the recomputation year is filed and the tax for that year has been paid in full. The resulting amounts of interest are then netted to arrive at look-back interest that must be paid by the taxpayer or that the taxpayer is entitled to receive.

(iv) *Applicable tax rate*. For purposes of determining hypothetical underpayments or overpayments of tax under the simplified method, the applicable regular rate is generally the highest rate of tax in effect for corporations under section 11. However, the applicable regular tax rate is the highest rate of tax imposed on individuals under section 1 if, at all times during all affected years, more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities. The highest rate of tax imposed on individuals is determined without regard to any additional tax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(4) *Definitions*—(i) *Pass-through entity*. For purposes of this section, a pass-through entity is either a partnership, an S corporation, an estate or a trust.

(ii) *Closely-held pass-through entity*. A closely-held pass-through entity is a pass-through entity that, at any time during any year for which allowances for depreciation are recomputed, 50 percent or more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term *person* has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 1563(e) apply by substituting the term *beneficial interest* for the term *stock* and by substituting the term *pass-through entity* for the term *corporation* used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

(e) *Recomputation year*—(1) *In general*. Except as provided in this paragraph (e), the term *recomputation year* means, with respect to any income forecast property—

(i) The earlier of—

(A) The year the income from the income forecast property ceases with respect to the taxpayer (and with respect to any person who would be treated as a single taxpayer with the taxpayer under rules similar to those in section 41(f)(1)); or

(B) The 3rd taxable year beginning after the taxable year in which the income forecast property was placed in service; and

(ii) The earlier of—

(A) The year the income from the income forecast property ceases with respect to the taxpayer (and with respect to any person who would be treated as a single taxpayer with the taxpayer under rules similar to those in section 41(f)(1)); or

(B) The 10th taxable year following the taxable year the income forecast property is placed in service.

(2) *Look-back method inapplicable in certain de minimis cases*— (i) *De minimis difference between actual and forecasted income*. A taxable year described in paragraph (e)(1) of this section is not a recomputation year if forecasted total income (as defined in § 1.167(n)–3(b)) or, where applicable, revised forecasted total income (as defined in § 1.167(n)–3(c)), for each preceding taxable years is—

(A) Greater than 90 percent of revised forecasted total income for the taxable year that would otherwise be a recomputation year; and

(B) Less than 110 percent of revised forecasted total income for the taxable year that would otherwise be a recomputation year.

(ii) *Application of the de minimis rule where the look-back method was previously applied*. For purposes of applying paragraph (e)(2)(i) of this section in any taxable year after a taxable year in which the look-back method has previously been applied, revised forecasted total income for the year the look-back method was applied, forecasted total income for the year the income forecast property was placed in service, and revised forecasted total income for all taxable years preceding the taxable year in which the look-back method was previously applied are deemed to be equal to the amount of revised forecasted total income that was used for purposes of applying the look-back method in the most recent taxable year for which the look-back method was applied.

(f) *De minimis basis exception*. The look-back method does not apply to any income forecast property with an adjusted basis, determined in accordance with section 1011 but without regard to the adjustments described in section 1016(a)(2) and (3), as of the close of any year that would otherwise be a recomputation year of $100,000 or less.

(g) *Treatment of look-back interest*—(1) *In general*. The amount of interest a taxpayer is required to pay is treated as an

income tax under Subtitle A of the Internal Revenue Code, but only for purposes of Subtitle F of the Internal Revenue Code (other than sections 6654 and 6655), which addresses tax procedure and administration. Thus, a taxpayer that fails to report look-back interest when due is subject to any penalties under Subtitle F of the Internal Revenue Code applicable to a failure to report and pay a tax liability. However, look-back interest to be paid is treated as interest arising from an underpayment of tax under Subtitle A of the Internal Revenue Code, even though it is treated as an income tax liability for penalty purposes. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified method, is personal interest and, therefore, is not deductible in accordance with § 1.163–9T(b)(2). Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability. The determination of whether interest computed under the look-back method is treated as income tax under Subtitle A of the Internal Revenue Code is determined on a net basis for each recomputation year. Thus, if a taxpayer computes both hypothetical overpayments of tax and hypothetical underpayments of tax for years prior to any given recomputation year, the taxpayer has an increase in tax only if the total interest computed on underpayments for all prior taxable years for which income tax liability is affected by the application of the look-back method exceeds the total interest computed on overpayments for such years, taking into account all income forecast property for which the look-back method is required. Interest determined at the entity level under the simplified method is allocated among the owners (or beneficiaries) for reporting purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the allocation rules applicable to such entities.

(2) *Additional interest due on interest only after tax liability due*. For each recomputation year, taxpayers are required to file a Form 8866, "*Interest Computation Under the Look-back Method for Property Depreciated Under the Income Forecast Method,*" at the time the return for that recomputation year is filed to report the interest a taxpayer is required to pay or entitled to receive under the look-back method. Even if the taxpayer has received an extension to file its income tax return for the recomputation year, look-back interest is computed with respect to the hypothetical increase (or decrease) in the tax liability determined under the look-back method only until the initial due date of that return (without regard to the extension). Interest is charged, unless the taxpayer otherwise has a refund that fully offsets the amount of interest due, (or credited) with respect to the amount of look-back interest due (or to be refunded) under the look-back method from the initial due date of the return through the date the return is filed. No interest is charged (or credited) after the due date of the return with respect to the amount of the hypothetical increases (or decreases) in tax liability determined under the look-back method.

(3) *Timing of look-back interest*. For purposes of determining taxable income under Subtitle A of the Internal Revenue Code, any amount refunded to the taxpayer as a result of the application of the look-back method is includible in gross income in accordance with the taxpayer's method of accounting for interest income. Any amount required to be paid is taken into account as interest expense arising from an underpayment of income tax in the tax year it is properly taken into account under the taxpayer's method of accounting for interest expense.

(4) *Statute of limitations; compounding of interest on look-back interest*. For guidance on the statute of limitations applicable to the assessment and collection of look-back interest owed by a taxpayer, see sections 6501 and 6502. A taxpayer's claim for credit or refund of look-back interest *previously paid by or collected from a taxpayer* is a claim for credit or refund of an overpayment of tax and is subject to the statute of limitations provided in section 6511. A taxpayer's claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid or collected from a taxpayer is a general claim against the federal government. For guidance on the statute of limitations that applies to general claims against the federal government, see 28 U.S.C. 2401 and 2501. For guidance applicable to the compounding of interest when the look-back interest is not paid, see sections 6601 to 6622.

(h) *Example*. The provisions of this section are illustrated by the following example:

Example. (i) *H*, a calendar year corporation, creates a motion picture at a cost of $60x. *H* completes the motion picture in 2001 and begins exhibition of the film that same year. Assume that $60x is greater than $100,000. In 2001, *H* anticipates that it will earn $200x from the motion picture (net of distribution costs). *H* therefore uses this amount as Forecasted Total Income when computing depreciation allowances for the motion picture.

(ii) *H* earns current year income of $80x in 2001, $60x in 2002, and $40x in 2003. During the period from 2001 to 2004, one of the actors who appeared in *H*'s film became more popular, and this increase in the actor's popularity increased the demand for *H's* film. In 2004, therefore, *H* revised its forecast of income from the film upward to $240x. *H* earns $20x in 2004 from the motion picture and $10x in 2005.

(iii) Based on these facts, *H's* allowances for depreciation for the motion picture for 2001 would be $24x, computed by multiplying the depreciable basis of the motion picture of $60x by current year income of $80x divided by forecasted total income of $200x under § 1.167(n)–4(a). Similarly, *H's* allowances for depreciation for the motion picture for 2002 would be $18x, computed by multiplying the depreciable basis of the motion picture of $60x by current year income of $60x divided by forecasted total income of $200x, and *H's* allowances for depreciation for the motion picture for 2003 would be $12x, computed by multiplying the depreciable basis of the motion picture of $60x by current year income of $40x divided by forecasted total income of $200x.

(iv) In 2004, *H* determines revised forecasted total income of $240x in accordance with § 1.167(n)–3(c). Because revised forecasted total income in 2004 of $240x is greater than 110 percent of forecasted total income used in computing the allowance for depreciation in the immediately preceding year (110 percent of $200x equals $220x), *H* is required under § 1.167(n)–4(b)(2) to compute the allowance for depreciation in 2004 and thereafter using the revised computation. *H* first computes its unrecovered depreciable basis in the motion picture under § 1.167(n)–2(c) of $6x by subtracting from the depreciable basis of $60x the depreciation allowances for 2001, 2002, and 2003 of $24x, $18x, and $12x. *H* then multiplies the unrecovered depreciable basis of $6x by the current year income for 2004 of $20x divided by $60x (revised forecasted total income $240x less current year income for all years prior to 2004 ($80x + $60x + $40x or $180x), resulting in a depreciation allowance for 2004 of $2x.

(v) In 2005, *H* is required to use the revised computation because *H* used it in 2004. Thus, *H* multiplies the unrecovered depreciable basis of $6x times current year income for 2005 of $10x divided by $60x (revised forecasted total income as computed in 2004), resulting in a depreciation allowance for 2005 of $1x.

(vi) Thus, *H's* allowances for depreciation may be summarized as follows:

Year	Current Year Income	Forecasted Total Income	Revised Forecasted Total Income	Depreciable Basis	Unrecovered Depreciable Basis	Depreciation Allowance
2001	80x	200x		60x		24x
2002	60x	200x		60x		18x
2003	40x	200x		60x		12x
2004	20x		240x		6x	2x
2005	10x		240x		6x	1x

(vii) Under paragraph (e)(1)(i)(B) of this section, 2004 is a recomputation year (because 2004 is the third taxable year after the year in which the motion picture was placed in service) unless a *de minimis* rule applies. The *de minimis* rule in paragraph (e)(2) of this section does not apply in 2004 because forecasted total income of $200x used in the computation of income forecast depreciation in 2001, 2002, and 2003 is not greater than 90 percent of year 2004 revised forecasted total income of $240x (90 percent of $240x = $216x). Thus, *H* must apply the look-back method for 2004.

(viii) If *H* sells the motion picture in 2006 for $25x prior to earning any current year income from the motion picture, *H* would not be entitled to any allowance for depreciation in 2006. (The special rule of § 1.167(n)–3(d)(1) precludes *H* from including income from the sale of the motion picture in current year income, *H* has no other current year income, and § 1.167(n)–4(d)(3) precludes the use of the final year depreciation rule of § 1.167(n)–4(d)(1)). Under paragraph (e)(1)(ii)(A) of this section, 2006 is a recomputation year (because in 2006 the income from the property to *H* ceases) unless a *de minimis* rule applies.

(ix) To determine whether the *de minimis* rule applies, *H* is required to determine revised forecasted total income for 2006. Under paragraph (c)(2) of this section, revised forecasted total income for 2006 is deemed to be the sum of current year income for the years 2001 – 2006 of $210x ($80x + $60x + $40x + $20x + $10x + $0x) plus the amount realized from the sale of the motion picture of $25x or $235x. Revised forecasted total income for 2005 is $240x, and pursuant to paragraph (e)(2)(ii) of this section, revised forecasted total income for the years 2001 – 2004 is deemed (for purposes of determining whether 2006 is a recomputation year) to be the amount of revised forecasted total income used in the 2004 application of the look-back method of $240x. Because $240x is greater than $212x (90 percent of $235x) and less than $259x (110 percent of $235x), the *de minimis* rule applies and *H* is not required to apply the look-back method in 2006.

§ 1.167(n)–7 Effective date.

The regulations under § 1.167(n)–1 through § 1.167(n)–6 are applicable for property placed in service on or after the date that 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 May 30, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 31, 2002, 67 F.R. 38025)

Notice of Proposed Rulemaking

Excise Taxes; Definition of Highway Vehicle

REG–103829–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed rules relating to the definition of a highway vehicle for purposes of various excise taxes. The regulations affect vehicle manufacturers, dealers, and lessors; tire manufacturers; sellers and buyers of certain motor fuels; and operators of heavy highway vehicles.

DATES: Written and electronic comments and requests for a public hearing must be received by September 4, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–103829–99), 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:ITA:RU (REG–103829–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning submissions, Treena Garrett (202) 622–7180; concerning the regulations, Bernard H. Weberman (202) 622–3130 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Highway Use Tax Regulations (26 CFR part 41), the Manufacturers and Retailers Excise Tax Regulations (26 CFR part 48), and the Temporary Excise Tax Regulations Under the Highway Revenue Act of 1982 (Pub. L. 97–424) (26 CFR part 145) relating to the definition of highway vehicle. The proposed definition of highway vehicle applies for purposes of sections 4041 and 4081 (fuel taxes), section 4051 (retail tax on heavy vehicles), section 4071 (tire tax), section 4481 (heavy vehicle use tax), and sections 6421 and 6427 (fuel tax credits and refunds).

The Highway Trust Fund (Fund) was established in 1956 and provides a source of financing for the interstate highway system and other federal-aid highway programs. In adopting a financing system for the Fund, the Congress expressed its intention to employ taxes "involving vehicles used on, or suitable for use on, highways." H. Rep. No. 84–2022, at 39

(1956). Even though the Fund was established for the construction of the highway system, it now functions, both through specific projects such as bridge rehabilitation and block grants to states, as a financial source for the construction and maintenance of almost all public roads. The taxes appropriated to the Fund are the taxes on fuel that is generally suitable for use in highway vehicles; the first retail sale of certain heavy vehicles, which Treasury regulations have limited to vehicles that are highway vehicles; the manufacturer's sale of tires of the type used on highway vehicles; and the use of certain heavy highway vehicles.

For purposes of these taxes, Treasury regulations define a highway vehicle as any self-propelled vehicle or trailer or semitrailer designed to perform a function of transporting a load over the public highway, whether or not also designed to perform other functions. Excluded from the definition are certain types of vehicles, including certain specially designed mobile machinery vehicles (the mobile machinery exception) and certain vehicles specially designed for offhighway transportation.

The mobile machinery exception is intended to apply to vehicle chassis that serve solely as a permanent mount for jobsite machinery, such as jobsite cranes. In creating an exception for mobile machinery vehicles, the regulations assumed that vehicles that transport mobile machinery, like vehicles that are designed for offhighway transportation, would make minimal use of the public highway and thus would receive only minimal benefit from the construction and maintenance of the highway system. However, it has become apparent that the assumption that most mobile machinery vehicles would make minimal use of the public highway is incorrect. Mobile machinery vehicles generally are constructed using highway chassis that are modified only as necessary to accommodate the mounting of the jobsite machinery. These vehicles are subject to the same licensing, safety, and other nontax regulations as are other highway vehicles. Mobile machinery vehicles carry their load, typically heavy jobsite machinery, from jobsite to jobsite over the public highway, and their ability to use the public highway is in no way limited or impaired. Therefore, they derive the same benefit from, and cause the same type of damage to, the public highway as other highway vehicles, and for tax purposes should be treated the same as other highway vehicles. Thus, these regulations propose to remove the mobile machinery exception.

After removal of the mobile machinery exception, mobile machinery vehicles will be subject to the retail tax on heavy vehicles unless the vehicles qualify under the exception for offhighway transportation vehicles. Also, these vehicles may be subject to the heavy vehicle use tax; and tax credits, refunds, and exemptions may not be available for the fuel they use. Amounts charged for the jobsite machinery, including amounts charged for mounting the machinery on the chassis or body, will continue to be excluded from the tax base.

Other exceptions from the definition of highway vehicle will continue to apply. Thus, a vehicle will continue to qualify for the offhighway transportation exception if it is specially designed for the primary function of transporting a particular type of load other than over the public highway and the special design substantially limits or impairs its capability to transport its load over the public highway. Similarly, trailers and semitrailers specially designed to function only as an enclosed stationary shelter for the carrying on of an offhighway function will continue to be excepted from tax. The exemption provided in section 4053(2) for vehicle bodies primarily designed to process, haul, spread, or load or unload feed, seed, or fertilizer for farms is unaffected by this change and will continue to apply. Credits or refunds for taxed fuel used on a farm for farming purposes are also unchanged.

Proposed Effective Date

These regulations are proposed to apply on and after the first day of the first calendar quarter beginning after the day of publication of the final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in 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 Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department 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 may be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the **Federal Register.**

Drafting Information

The principal author of these regulations is Bernard H. Weberman, Office of Associate 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, under the authority of 26 U.S.C. 7805, chapter I of 26 CFR is proposed to be amended as follows:

PART 41—EXCISE TAX ON USE OF CERTAIN HIGHWAY MOTOR VEHICLES

Paragraph 1. The authority citation for part 41 continues to read in part as follows:

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

Par. 2. In § 41.4482(a)–1, paragraph (a)(2) is amended by removing the language "§ 48.4061(a)–1(d)" and adding "§ 48.4051–1" in its place.

PART 48—MANUFACTURERS AND RETAILERS EXCISE TAXES

Par. 3. The authority citation for part 48 continues to read in part as follows:

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

Par. 4. In § 48.4041–8, paragraph (b) is amended as follows:

1. Paragraph (b)(1) is revised.

2. Paragraphs (b)(2) and (b)(3) are removed.

3. Paragraph (b)(4) is redesignated as paragraph (b)(2).

The revision reads as follows:

§ 48.4041–8 Definitions.

* * * * *

(b) * * * (1) *Definition*. For the definition of *highway vehicle*, see § 48.4051–1.

* * * * *

Par. 5. In Subpart H, § 48.4051–1 is added under the undesignated center heading "Motor Vehicles" to read as follows:

§ 48.4051–1 Heavy trucks and trailers; definition of highway vehicle.

(a) *Highway vehicle*—(1) *In general*. A highway vehicle is any self-propelled vehicle, or any trailer or semitrailer, that is capable of transporting a load over the public highway. In determining whether a vehicle is capable of transporting a load over the public highway, it is immaterial that the vehicle is capable of performing other functions, that the load is permanently mounted on the vehicle, or that the load is towed instead of carried.

(2) *Exception*—(i) *Offhighway transportation vehicles*. A vehicle is not treated as a highway vehicle if it is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design its capability to transport a load over the public highway is substantially limited or impaired. A vehicle's design is determined solely on the basis of its physical characteristics. In determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether it is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether it can transport a load at a sustained speed of at least 25 miles per hour. It is immaterial that a vehicle can transport a greater load off the public highway than it is permitted to transport over the public highway.

(ii) *Nontransportation trailers and semitrailers*. A trailer or semitrailer is not treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an offhighway function at an offhighway site. For example, a trailer that is capable only of functioning as an office for an offhighway construction operation is not a highway vehicle.

(b) *Public highway*. *Public highway* means any road (whether a federal or state highway, city street, or otherwise) in the United States that is not a private roadway.

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

Example 1. Vehicle A consists of a truck chassis on which a telescoping boom-type crane that extends to a length of 130 feet has been permanently mounted. The vehicle is capable of transporting the crane over the public highway. Because Vehicle A is a self-propelled vehicle capable of transporting a load (the crane) over the public highway, it is a highway vehicle described in paragraph (a)(1) of this section. It is immaterial that the load is permanently mounted on the chassis.

Example 2. Vehicle B consists of a truck chassis on which a dump body has been installed. The vehicle's empty (tare) weight is 15,000 pounds and its gross vehicle weight rating is 46,000 pounds. It is capable of transporting a load over the public highway. Its drive train and suspension enable it to transport a load off road over soft, uneven terrain but do not limit its ability to transport its load at public highway speeds. Because Vehicle B is a self-propelled vehicle capable of transporting a load over the public highway, it is a highway vehicle. Although Vehicle B has some physical characteristics for transporting its load other than over the public highway (its drive train and suspension), those characteristics are not of a magnitude, when compared with its physical characteristics for transporting the load over the public highway, to establish that it is specially designed for the primary function of transporting its load other than over the public highway. Therefore, Vehicle B is not a vehicle described in the exception provided in paragraph (a)(2)(i) of this section.

Example 3. Vehicle C consists of a truck chassis on which an oversize body designed to transport and apply liquid agricultural chemicals on farms has been installed. It is capable of transporting a load over the public highway. It is 132 inches in width, which is considerably in excess of standard highway vehicle width. For travel on uneven and soft terrain, it is equipped with oversize wheels with high-flotation tires, and nonstandard axles, brakes, and transmission. It has a special fuel and carburetor air filtration system that enable it to perform efficiently in an environment of dirt and dust. It is not able to maintain a speed of 25 miles per hour for more than one mile while fully loaded. Because Vehicle C is a self-propelled vehicle capable of transporting a load over the public highway, it is a highway vehicle described in paragraph (a)(1) of this section. However, its considerable physical characteristics for transporting its load other than over the public highway, when compared with its physical characteristics for transporting the load over the public highway, establish that it is specially designed for the primary function of transporting its load other than over the public highway. Further, the physical characteristics for transporting its load other than over the public highway substantially limit its capability to transport a load over the public highway. Therefore, Vehicle C is a vehicle described in the exception provided in paragraph (a)(2)(i) of this section and is not treated as a highway vehicle.

(d) *Effective date*. This section is applicable on and after the first day of the first calendar quarter beginning after the day of publication of the final regulations in the **Federal Register**.

§ 48.4072–1 [Amended]

Par. 6. In § 48.4072–1, paragraphs (c)(1)(i) and (c)(1)(ii) are amended by removing the language "§ 48.4061(a)–1(d)" and adding "§ 48.4051–1" in its place.

§ 48.4081–1 [Amended]

Par. 7. In § 48.4081–1, paragraph (b), the definition of Diesel-powered highway vehicle is amended by removing the language "§ 48.4041–8(b)" and adding "§ 48.4051–1" in its place.

Par. 8. In § 48.6421–4, paragraph (c) is revised to read as follows:

§ 48.6421–4 Meaning of terms.

* * * * *

(c) *Highway vehicle*. For the definition of *highway vehicle*, see § 48.4051–1.

* * * * *

PART 145—TEMPORARY EXCISE TAX REGULATIONS UNDER THE HIGHWAY REVENUE ACT OF 1982 (PUB. L. 97–424)

Par. 9. The authority citation for part 145 continues to read in part as follows:

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

§ 145.4051–1 [Amended]

Par. 10. Section 145.4051–1 is amended as follows:

1. In paragraph (a)(2), first sentence, the language "(as defined in paragraph (d) of § 48.4061(a)–1 (Regulations on Manufacturers and Retailers Excise Taxes))" is removed and "as defined in § 48.4051–1 of this chapter" is added in its place.
2. In paragraph (a)(4), last sentence, the language "§ 48.4061(a)–1" is removed and "§ 48.4051–1 of this chapter" is added in its place.
3. Paragraph (d) is removed and reserved.

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 3, 2002, 8:45 a.m., and published in the issue of the Federal Register for June 6, 2002, 67 F.R. 38913)

Notice of Proposed Rulemaking

Low-Income Taxpayer Clinics—Definition of Income Tax Return Preparer

REG–115285–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that exclude certain Low-Income Taxpayer Clinics (LITCs) that qualify for grants under section 7526 of the Internal Revenue Code from the definition of income tax return preparer under section 7701(a)(36). These proposed regulations also exclude certain persons who are employed by, or volunteer for, such clinics.

DATES: Written or electronically generated comments and requests for a public hearing must be received by September 9, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–115285–01), 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:ITA:RU (REG–115285–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at: *www.irs.gov/regs.*

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Brinton T. Warren, at (202) 622–4940; concerning submissions of comments and requests for a public hearing, Treena Garrett of the Regulations Unit at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Regulations on Procedure and Administration (26 CFR part 301) relating to the definition of the term *income tax return preparer* under section 7701(a)(36) of the Internal Revenue Code (Code). These proposed regulations exclude certain qualified Low-Income Taxpayer Clinics (LITCs) from the definition of income tax return preparer and exclude certain persons who are employed by, or volunteer at, such clinics.

Section 7701(a)(36), defining the term income tax return preparer, was enacted by section 1203 of the Tax Reform Act of 1976, Public Law 94–455 (90 Stat. 1520) (1976) (TRA 1976). TRA 1976 also enacted many of the provisions of sections 6694 and 6695, which impose penalties for certain acts and omissions by income tax return preparers.

The preparer penalties enacted by TRA 1976 reflect the concern of Congress with improper practices within the commercial tax services industry. See H.R. Rep. No. 94–658, 94th Cong. 1st Sess. 274 (1976), 1976–3 (Vol. 2) C.B. 966. Consistent with the commercial focus of the legislative history, the definition of an income tax return preparer requires that the tax return or claim for refund be prepared "for compensation." Persons who do not receive compensation are not income tax return preparers for purposes of section 7701(a)(36) regardless of the extent to which they are involved with the preparation of a return or claim for refund.

Section 3601(a) of the Internal Revenue Service Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 685) (1998) (RRA 1998), added section 7526 of the Code, which provides for grants to qualified LITCs. Qualified LITCs represent taxpayers in controversies with the IRS and operate programs to inform individuals for whom English is a second language (ESL taxpayers) about their rights and responsibilities as taxpayers (ESL outreach). Qualified LITCs are either clinical programs run by accredited educational institutions that allow students to represent low-income taxpayers, or tax-exempt organizations that provide representation to low-income taxpayers.

Under section 7526(b)(1)(A)(i), a qualified LITC may not charge more than a nominal fee for its authorized services (except for reimbursement of actual costs incurred). These proposed regulations do not address the definition of a nominal fee. The Treasury Department and the IRS specifically request comments on whether the final regulations, or other guidance, should define a nominal fee and, if so, the factors that should be considered in defining a nominal fee. In addition, although the Treasury Department and the IRS believe that a qualified LITC is not authorized by statute to provide return preparation assistance other than as described below, these regulations do not address the qualification of an LITC under section 7526 of the Code.

The Treasury Department and the IRS recognize that in the course of representing a taxpayer in a controversy with the IRS, a qualified LITC may provide assistance with a tax return or claim for refund that is related directly to that controversy. The Treasury Department and the IRS also recognize that as an ancillary part of a qualified LITC's ESL outreach program, the LITC may provide assistance with a tax return or claim for refund that will be treated as return preparation assistance. The Treasury Department and the IRS believe that such return preparation assistance should not cause the LITC, or its employees or volunteers, to be treated as income tax return preparers unless the LITC is compensated for such assistance. Accordingly, these proposed regulations specify when an LITC will be treated as having prepared a tax return or claim of refund for compensation for purposes of section 7701(a)(36).

The Treasury Department and the IRS expect that LITCs will follow the practices specified in sections 6694 and 6695 as the preferred practice for their operations even if they are not income tax return preparers within the meaning of section 7701(a)(36). For example, section 6695(a), in conjunction with section 6107(a), requires that an income tax return preparer furnish the taxpayer a completed copy of a tax return or claim for refund not later than the time the return or claim is presented to the taxpayer for signature.

Explanation of Provisions

The proposed regulations clarify that qualified LITCs, as defined by section 7526, and employees and volunteers of such LITCs, that provide assistance with a tax return or claim for refund will not be treated as income tax return preparers if two requirements are satisfied.

First, any such return preparation assistance must be (i) directly related to a controversy with the IRS for which the LITC is providing assistance or (ii) an ancillary part of an LITC's ESL outreach program. Second, the LITC cannot charge a separate fee or vary a fee based on whether the LITC provides assistance with a return of tax or claim for refund, or charge more than a nominal fee for its services.

Proposed Effective Date

The regulations, as proposed, would apply on the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in 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, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (preferably a signed original and 8 copies) and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register.**

Drafting Information

The principal author of the regulations is Brinton T. Warren of the Office of Associate Chief Counsel (Procedure and Administration), Administrative Provisions and Judicial Practice Division.

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Proposed Amendment to the Regulations

Accordingly, 26 CFR part 301 is proposed to be amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 continues to read in part as follows:

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

Par. 2. Section 301.7701–15 is amended by:

1. Removing the language "and" from the end of paragraph (a)(7)(iii).

2. Removing the period at the end of paragraph (a)(7)(iv) and adding a semicolon in its place.

3. Adding paragraphs (a)(7)(v), (a)(7)(vi), (a)(8)(i) and (a)(8)(ii).

The additions read as follows:

§ 301.7701–15 Income tax return preparer.

* * * * *

(a) * * *

(7) * * *

(v) Any individual who provides tax assistance as part of a qualified Low-Income Taxpayer Clinic (LITC), as defined by section 7526, subject to the requirements of paragraphs (a)(8)(i) and (ii) of this section; and

(vi) Any organization that is a qualified Low-Income Taxpayer Clinic (LITC), as defined by section 7526, subject to the requirements of paragraphs (a)(8)(i) and (ii) of this section.

(8)(i) Paragraphs (a)(7)(v) and (a)(7)(vi) of this section apply only if any assistance with a return of tax or claim for refund under subtitle A of the Internal Revenue Code is directly related to a controversy with the Internal Revenue Service for which the qualified LITC is providing assistance, or is an ancillary part of an LITC program to inform individuals

for whom English is a second language about their rights and responsibilities under the Internal Revenue Code.

(ii) Notwithstanding paragraph (a)(8)(i) of this section, paragraphs (a)(7)(v) and (a)(7)(vi) of this section do not apply if an LITC charges a separate fee or varies a fee based on whether the LITC provides assistance with a return of tax or claim for refund under subtitle A of the Internal Revenue Code, or if the LITC charges more than a nominal fee for its services.

* * * * *

Par. 3. *Effective date*. This amendment is applicable on the date the 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 June 10, 2002, 8:45 a.m., and published in the issue of the Federal Register for June 11, 2002, 67 F.R. 39915)

Notice of Proposed Rulemaking and Notice of Public Hearing

Reporting of Gross Proceeds Payments to Attorneys

REG–126024–01

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 reporting of payments of gross proceeds to attorneys. The regulations reflect changes to the law made by the Taxpayer Relief Act of 1997 (1997 Act). The regulations will affect attorneys who receive payments of gross proceeds on behalf of their clients and certain payors (for example, defendants in lawsuits and their insurance companies and agents) that, in the course of their trades or businesses, make payments to these attorneys. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written and electronic comments must be received by August 15, 2002. Requests to speak (with outlines of topics to be discussed) at the public hearing scheduled for September 30, 2002, at 10 a.m., must be received by September 9, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG–126024–01), 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:ITA:RU (REG–126024–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically by submitting comments directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in the Auditorium on the Seventh Floor of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Nancy Rose (202) 622–4910; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett at (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 number 1545–1644.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB 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 the Income Tax Regulations (26 CFR Part 1) under sections 6041 and 6045 of the Internal Revenue Code (Code). These proposed amendments to the Income Tax Regulations would (a) revise existing §§ 1.6041–1 and 1.6041–3 and (b) add a new § 1.6045–5.

A new reporting requirement, section 6045(f), was added to the Code by section 1021 of the Taxpayer Relief Act of 1997 (1997–4 (Vol. 1) C.B. 1, 136). Section 6045(f) generally requires information reporting for payments of gross proceeds made in the course of a trade or business to attorneys in connection with legal services (whether or not the services are performed for the payor). No information return is required under section 6045(f) for the portion of any payment that is required to be reported under section 6041(a) (or that would be required to be reported under section 6041 but for the $600 limitation) or under section 6051. The 1997 Act also provides that the general exception in § 1.6041–3(q)(1) for reporting payments made to corporations does not apply to payments of attorneys' fees.

Proposed regulations under sections 6041 and 6045(f) were previously published in the **Federal Register** on May 21, 1999 (REG–105312–98, 1999–1 C.B. 1193 [64 FR 27730]) (the 1999 proposed regulations). Many individuals and organizations provided written comments on the 1999 proposed regulations. Several individuals spoke at a public hearing held on September 22, 1999.

After considering all of the comments, the IRS and the Treasury Department have decided to amend and repropose the regulations under sections 6041 and 6045(f), incorporating the guidance in the 1999 proposed regulations with some modifications. All comments received in connection with the 1999 proposed regulations will continue to be considered in

finalizing these reproposed regulations (the proposed regulations). The IRS and the Treasury Department welcome any additional comments from taxpayers on the issues discussed below or on other issues relating to section 6045(f).

Explanation of Revisions

Delivery Rule

Section 1.6045–5(b)(1) of the 1999 proposed regulations (the delivery rule) elicited numerous comments. The delivery rule required information reporting of payments delivered to a nonpayee attorney, if under the circumstances, it was reasonable for the payor to believe that the attorney received the check in connection with legal services. Most of the comments urged the IRS and the Treasury Department to eliminate the delivery rule for a variety of reasons.

First, commentators suggested that the benefits the IRS would derive from receiving information regarding payments of gross proceeds to nonpayee attorneys would be outweighed by the burdens payors would encounter in collecting and reporting that information. Several commentators stated that their automated information collection and processing systems cannot prepare returns for nonpayee recipients. Consequently, they would incur substantial costs to accommodate reporting to nonpayee attorneys, either by modifying those systems or by manually preparing information returns for nonpayee attorneys.

Second, commentators stated that the delivery rule creates the potential for unintentional noncompliance because the department of a payor's business that delivers checks to nonpayee attorneys is separate from, and may be in a different location from, the department that prepares the information returns. Due to this business structure, the reporting department may not receive the required information from the delivery department.

Other commentators stated that the delivery rule unnecessarily complicates the requirement to backup withhold on payments made to an attorney who does not provide a taxpayer identification number (TIN). Many commentators also argued that delivering a check to a nonpayee does not constitute "making a payment" to that person under section 6045(f) or other information reporting provisions of the Code.

Due to the substantial burdens that the delivery rule would impose on payors, the IRS and the Treasury Department have adopted the suggestion to eliminate it. Thus, the proposed regulations provide that a payment to an attorney, in the case of a payment by check, means a check on which the attorney is named as a sole, joint, or alternative payee.

Identity of the Payor

Several commentators suggested that the proposed regulations define the term "payor" under section 6045(f). Specifically, these commentators suggested that the section 6041(a) payor standard should also be used under section 6045(f), principally for three reasons. First, the language in both Code sections regarding who is required to report is virtually identical, that is, a person engaged in a trade or business and making payments in the course of that trade or business. Second, using different standards could lead to confusion. Third, commentators from the banking and mortgage lending industry were concerned that they would incur substantial costs of reporting payments made to lawyer-owned title insurance companies and settlement attorneys unless the regulations under section 6045(f) adopted the section 6041(a) payor standard.

The IRS and the Treasury Department agree that defining the term payor would be helpful. The proposed regulations define a payor as a person who makes a payment if that person is an obligor on the payment, or the obligor's insurer or guarantor. For example, a payor includes (a) a person who pays a settlement amount to an attorney of a client who has asserted a tort, contract, violation of law, or workers' compensation claim against that person; and (b) the person's insurer if the insurer pays the settlement amount to the attorney.

The IRS and the Treasury Department believe that the payor standards under sections 6041 and 6045(f) should not be identical because the nature and the purpose of the reporting requirements under each Code section are different. The legislative history of the 1997 Act, describing the law regarding information reporting of payments to attorneys before enactment of section 6045(f), states that if "the payment [to the attorney] is a gross amount and it is not known what portion is the attorney's fee, no reporting is required on any portion of the payment." H.R. Rep. No. 148, 105th Cong., 1st Sess. 474 (1997). The Committee Report then states that section 6045(f) "will have a positive impact on compliance with the tax laws by requiring additional information reporting." H.R. Rep. No. 148, at 474 (1997). A specific concern was that there was no reporting by payors (and underreporting by recipients) of payments of judgments and settlements made by insurance companies to attorneys that yielded large legal fees. See Department of the Treasury, *General Explanations of the Administration's Revenue Proposals* 86 (February 1997).

The additional reporting that Congress contemplated, and about which the Treasury Department was concerned, will not occur if the section 6041 payor standard is used under section 6045(f). Generally under section 6041, a person who makes a payment on behalf of a third person reports the payment only if the first person exercises management or oversight in connection with, or has a significant economic interest in, the payment. See Rev. Rul. 93–70, 1993–2 C.B. 294. Under the proposed section 6041 middleman regulations published in the **Federal Register** on October 17, 2000 (65 FR 61292), a defendant or its insurer that pays tort damages to a claimant's attorney generally does not exercise management or oversight in connection with, or have a significant economic interest in, the payment to the attorney. The preamble to those proposed regulations explains that neither the defendant nor the insurer is required to file an information return under section 6041(a) for the payment made to the attorney. 65 FR 61293–61294. If the section 6041 middleman rules were used under section 6045(f), the defendant and the insurer would not be required to report the payments to the attorney under section 6045(f) either. The large payments by insurers to attorneys in judgments and settlements would go unreported by any payor, as was the case prior to the enactment of section 6045(f). The IRS and the Treasury Department believe that Congress did not intend this result. Thus, the suggestion to use the

section 6041 payor standard for section 6045(f) has not been adopted.

Scope of the Section 6045(f)(2)(B) Exception

Section 6045(f)(2)(B) states that section 6045(f) "shall not apply to the portion of any payment that is required to be reported under section 6041(a) (or would be so required but for the $600 limitation contained therein) or section 6051." The use of different standards under sections 6041 and 6045(f) for determining who is required to file and furnish an information return affects the scope of the exception to reporting in section 6045(f)(2)(B). For example, assume that a defendant's insurer, to settle a claimant's lawsuit for taxable damages, wrote a check for $100,000 jointly to the claimant and the claimant's attorney and that the insurer knew that the attorney's fees were $40,000. Under section 6045(f), the insurer is required to report the $100,000 payment to the attorney. The exception in section 6045(f)(2)(B) does not apply because the insurer has no information reporting obligation under section 6041 with respect to the payment to the attorney.

Some commentators suggested a very broad reading of the exception to reporting contained in section 6045(f)(2)(B). Under the approach suggested by these commentators, this exception would apply if the payment to the attorney is subject to reporting under section 6041 or section 6051 by any person. For example, under this view, if a claimant in a lawsuit is required to report under section 6041 the portion of a damage award that his attorney retained as a contingent fee, then the defendant's insurance company, which paid those damages to the claimant's attorney, would not report the payment under section 6045(f). The IRS and the Treasury Department believe, however, that Congress intended the exception in section 6045(f)(2)(B) to provide relief only to the person who is required (or would be so required but for the dollar limitation) to report the payment to the attorney under section 6041 or section 6051. First, a payor is best able to determine whether it is required to report a payment based on its relationship to the payment rather than that of an unrelated (and possibly adversarial) third party. Second, requiring a payor to determine whether a third party is required to report a payment could introduce inconsistency into the reporting process if the payor and the third party disagree on whether the third party is required to report a payment under section 6041 or section 6051.

On a related matter, one commentator noted that some practitioners believe that if a payment (or portion of a payment) is reportable under section 6045(f), then under § 1.6041–1(a)(1)(ii) it is not subject to reporting under section 6041 with respect to another payee. This view contradicts Congress' purpose in enacting section 6045(f), which is to "have a positive impact on compliance with tax laws by requiring additional information reporting." H.R. Rep. No. 148, at 474 (1997). Therefore, § 1.6041–1(a)(1)(ii) has been clarified to provide explicitly that the exception applies to a payment with respect to which information returns are required under section 6041(a) and another Code section (*e.g.*, section 6045) for the same payee. For example, a person who pays $600 of taxable damages to a claimant and the claimant's attorney may be required to file an information return under section 6041 with respect to the claimant and another information return under section 6045(f) with respect to the claimant's attorney.

De Minimis Payments

Many commentators suggested that the statutory $600 annual threshold for reporting payments under section 6041 should also apply under section 6045(f). Many payors who are required to report payments under section 6045(f) also are required to report payments under section 6041. In many cases, payments under both Code sections are reported on Forms 1099–MISC. Commentators stressed that payors would incur substantial costs to report payments that aggregated less than $600 annually, because they would have to either modify their automated processing systems or manually prepare returns reporting these payments. They argued that this burden far outweighs any benefit to be derived from collecting information for the relatively few payments made to attorneys that do not aggregate at least $600 during a calendar year. In light of these circumstances, the proposed regulations adopt a $600 annual reporting threshold because such a threshold strikes a reasonable balance between the objectives of section 6045(f) and the potential burden of compliance.

Form 1099–MISC and Payee Statement

Most commentators approved of using Form 1099–MISC to report payments under section 6045(f) because their existing automated information processing systems are programmed to complete this form. However, a few commentators suggested that, because Form 1099–MISC is used to report income payments, it should not be used to report payments of gross proceeds. Some of these commentators also noted that some payors had improperly reported gross proceeds payments in an income box on Form 1099–MISC.

Beginning in 2001, the Form 1099–MISC was revised to add a separate and distinctly labeled box for reporting gross proceeds payments made to attorneys. Therefore, payments under section 6045(f) will continue to be reported on Form 1099–MISC. However, so that the IRS can easily change to another form if the need arises, the proposed regulations do not specify the form to be used.

Separate or Aggregate Reporting

Some commentators believed that, for each reportable payment under section 6045(f), payors should be required to file and furnish a separate Form 1099 listing the name of the attorney's client. These commentators were concerned that attorneys would have difficulty reconciling payee statements containing aggregate annual payments with their other records, an exercise that might be necessary if their income tax returns were examined by the IRS. However, other commentators asserted that requiring such detailed payee statements would impose an enormous burden on payors. These commentators urged that providing such detailed information should be voluntary, and noted that many payors provide such information to payees upon request. On balance, the IRS and the Treasury Department believe that the potential burden on payors that would result if separate payee statements were made mandatory outweighs the potential benefit of such statements to payees. Accordingly, under the proposed regulations, payors may file

either one Form 1099–MISC that aggregates annual payments or separate Forms 1099–MISC for each payment. However, further comments on this question are welcome.

Joint or Multiple Payees

Section 1.6045–5(b)(2)(i) of the 1999 proposed regulations provided that if more than one attorney is listed as a payee on a check, the information return is required to be filed with respect to the attorney who received the check (the payee-recipient rule). For some of the same reasons that the delivery rule was criticized, several commentators suggested that if more than one attorney's name is listed on a check, the payor should be required to issue an information return with respect to the first-listed attorney (the first-listed rule). In addition, one commentator suggested that where joint or multiple payees are listed on a check, the payor should be required to report with respect to each attorney listed as a payee on the check (the all-payee rule).

The IRS and the Treasury Department carefully considered whether the payee-recipient rule raises the same problems as the delivery rule and believe that it does not. Commentators' principal objection to the delivery rule was that their automated information reporting systems are designed to capture information about check payees, not mere addressees or deliverees. The payee-recipient rule, however, requires that the recipient of the check also be named as a payee and thus does not raise the same concerns as the delivery rule. The IRS and the Treasury Department considered and rejected the first-listed payee rule because it would result in no information reporting with respect to an attorney who receives the check and is not the first-listed payee attorney. Finally, the IRS and the Treasury Department considered and rejected the all-payee rule because, as between the two, the payee-recipient rule appears to be less burdensome for most payors. Therefore, the proposed regulations retain the payee-recipient rule. The IRS and the Treasury Department, however, request comments on the effectiveness of, and the relative burdens imposed by, each of these three approaches.

Exceptions for Certain Types of Payments

Many commentators suggested that the definition of the term legal services in § 1.6045–5(d)(2) of the 1999 proposed regulations was too broad. These commentators requested an exception to the section 6045(f) information reporting requirement in certain circumstances where they believed the specific payment bears little or no correlation to the taxable income of the attorney or the attorney's client. Specifically, they suggested exceptions to reporting for payments to payee attorneys who were acting as (i) settlement attorneys or title insurers in real estate transactions, (ii) executors or administrators of estates (for example, those receiving payments of life insurance proceeds), (iii) trustees of trusts (such as pension plans and bankruptcy estates), and (iv) administrators of qualified settlement funds described in § 1.468B–1.

Consistent with the language and purpose of section 6045(f), the IRS and the Treasury Department continue to believe that a broad definition of legal services is appropriate. However, it should be noted that other features of the proposed regulations, such as the elimination of the delivery rule, may provide a result equivalent to an exception in many cases. For example, the IRS and the Treasury Department understand that it is unusual for an attorney who is the executor or administrator of an estate to be named as the payee on a check. Similarly, in many bankruptcy situations the estate of the bankrupt, rather than the trustee, is the named payee. Further, under these proposed regulations, many payors will be able to avoid reporting under section 6045(f) simply by naming the attorney's client as payee on the check even if the check is delivered to the attorney's office. Finally, the proposed regulations provide that payments made to an attorney acting in the capacity as a settlement agent in connection with the closing of a real estate transaction are not subject to reporting under section 6045(f). The IRS and the Treasury Department believe that the flexibility provided by these rules should reduce the need for many of the requested exceptions from the term legal services. However, comments on additional exceptions where such flexibility is not practical are welcome.

The proposed regulations also provide a clearer and more objective standard for determining whether a payment made to a foreign attorney is subject to reporting under section 6045(f). Under the proposed regulations, a return of information is not required under section 6045(f) with respect to payments made to a nonresident alien individual, foreign partnership, or foreign corporation that does not engage in a trade or business in the United States and does not perform any labor or personal services in the United States. The proposed regulations provide that the rules provided in § 1.6041–4(a)(1) are used to determine whether a payment is subject to this exception. Thus, the payor makes this determination by obtaining from the payee a Form W–8, a Form W–9, or other documentation conforming in substance to those forms, or by relying on the presumptions provided under § 1.1441–1(b)(3).

Other commentators asked for exceptions for situations in which attorneys who, after collecting their fees for legal services rendered, continue to serve as mere clearinghouses or delivery conduits to their clients. For example, attorneys sometimes collect and disburse payments intact for: (1) a transient or homeless client; (2) a client whose address is intentionally not disclosed to the payee; or (3) a client who is entitled to recurring payments in satisfaction of the client's workers' compensation claim. In addition, sometimes a payor is required to make payments to third-party service providers through an attorney to monitor payor compliance, even though the attorney does not charge a separate fee for this service. The IRS and the Treasury Department have not adopted this suggested exception to the section 6045(f) reporting requirement, because it is too

burdensome to require a payor to determine whether any portion of a specific payment is being retained by the attorney as a fee.

Therefore, the proposed regulations adopt, with a minor clarification, the definition of the term legal services used in the 1999 proposed regulations. Under the proposed regulations, the term legal services means all services related to, or supportive of, the practice of law performed by, or under the supervision of, an attorney. Including services that are related to, or supportive of, the practice of law in the definition of legal services continues the broad definition in the 1999 proposed regulations. It also clarifies that payments to an attorney for services that are clearly unrelated to the practice of law are not subject to reporting under section 6045(f). For example, a payment to an individual for refurbishing an antique automobile is not subject to reporting under section 6045(f) merely because that individual is a tax lawyer.

Backup Withholding

Some commentators suggested either eliminating the requirement for a payor to backup withhold on a payment made to an attorney who does not furnish a TIN or, if such withholding is required, permitting the withheld amounts to be credited to the account of the attorney's client. The IRS and the Treasury Department believe that payments to attorneys for legal services are reportable payments under section 3406(b)(3)(C), and thus are subject to the backup withholding requirements. Further, the following statement in the legislative history of section 6045(f) shows that Congress specifically intended payments to attorneys that are reportable under section 6045(f) to be subject to backup withholding:

> Third, attorneys are required to promptly supply their TINs to persons required to file these information reports, pursuant to section 6109. Failure to do so could result in the attorney being subject to penalty under section 6723 and the payments being subject to backup withholding under section 3406.

H.R. Conf. Rep. No. 220, at 546 (1997). Accordingly, this suggestion has not been adopted in the proposed regulations. However, eliminating the delivery rule may alleviate many concerns regarding backup withholding on payments to attorneys who do not supply their TINs.

Revision of Examples

Several comments were received regarding the examples in § 1.6045–5(f) of the 1999 proposed regulations. Commentators suggested that *Example 1* be revised to clarify that the defendant in the lawsuit was the claimant's employer and that the amount disbursed by the defendant to the claimant's attorneys should be reduced to reflect payments of income and Federal Insurance Contributions Act tax withholdings. These revisions have been adopted.

Some commentators expressed concern that the examples imply that all damages in a lawsuit against an employer are back wages reportable under Forms W–2. *Example 1* has been clarified to explain that, under its particular facts, the damages received are taxable wages under existing legal principles. Further, the examples are not intended to state or imply any substantive conclusion on the tax treatment of any particular type of damage award.

Some commentators stated that the examples did not provide sufficient guidance on the reporting of damages under sections 6041 and 6051. The IRS and the Treasury Department understand taxpayers' interest in additional guidance in this area, due in part to significant changes in the law under section 104(a)(2). However, regulations under section 6045(f) are not the appropriate place to address legal issues involving concerns under sections 6041 and 6051. Thus, these proposed regulations address issues under sections 6041 and 6051 only to the extent they are integral or closely related to providing guidance regarding section 6045(f).

Finally, in response to numerous requests, the 1999 proposed regulations have been expanded to provide additional examples of required reporting.

Amendment to § 1.6041–3(q)

Section 1.6041–3(q) of the 1999 proposed regulations provided that payments to a corporation engaged in providing legal services did not qualify for the exception for reporting payments to corporations. These proposed regulations conform the language of section 1.6041–3(q) to that of section 1021(b) of the 1997 Act by providing that payments of attorneys' fees made to a corporation do not qualify for the exception for reporting payments to corporations under section 6041.

Effective Date of Proposed Regulations under Section 6045(f)

In response to several comments received concerning the amount of time needed to implement automated processing systems changes, the effective date of the regulations has been delayed. The regulations will apply to payments made during the first calendar year that begins at least two months after the date of publication of the final regulations in the **Federal Register.**

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in 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 economic impact on a substantial number of small entities. This certification is based on the facts that: (1) the time required to prepare and file a 2002 Form 1099–MISC is minimal (currently estimated at 16 minutes per form); and (2) it is not anticipated that, as a result of these regulations, small entities will have to prepare and file more than a few, at most, forms per year. 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 Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration

will be given to any written comments (a signed original and eight (8) copies) that are submitted timely (in the manner described in the **ADDRESSES** portion of this preamble) to the IRS. The IRS and the Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. Written comments on the proposed regulations are due by August 15, 2002.

A public hearing has been scheduled for September 30, 2002, beginning at 10 a.m. in the Auditorium on the Seventh Floor of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. 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 30 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** portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by September 9, 2002. 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 reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is A. Katharine Jacob Kiss, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In § 1.6041–1(a)(1)(ii), the first sentence is removed and three sentences are added in its place to read as follows:

§ 1.6041–1 Return of information as to payments of $600 or more.

(a) * * *

(1) * * *

(ii) The payments described in paragraphs (a)(1)(i)(A) and (B) of this section shall not include any payments of amounts with respect to which an information return is required by, or may be required under authority of, section 6042(a) (relating to dividends), section 6043(a)(2) (relating to distributions in liquidation), section 6044(a) (relating to patronage dividends), section 6045 (relating to brokers' transactions with customers), sections 6049(a)(1) and (2) (relating to interest), section 6050N(a) (relating to royalties), or section 6050P(a) or (b) (relating to cancellation of indebtedness) with respect to the same payee. For example, a person who pays $600 of taxable damages to a claimant and the claimant's attorney may be required to file an information return under section 6041 with respect to the claimant and another information return under section 6045(f) with respect to the claimant's attorney. In addition, notwithstanding anything in the preceding two sentences, payments to an attorney that are described in paragraph (a)(1)(i) of this section are reported under this section and not section 6045(f). For provisions relating to information reporting on payments to attorneys, see § 1.6045–5. * * *

* * * * *

Par. 3. Section 1.6041–3 is amended by revising the first sentence of paragraph (q)(1) to read as follows:

§ 1.6041–3 Payments for which no return of information is required under section 6041.

* * * * *

(q) * * *

(1) A corporation described in § 1.6049–4(c)(1)(ii)(A), except to a corporation for payments of attorneys' fees made after December 31, 1997, and except to a corporation engaged in providing medical and health care services or engaged in the billing and collecting of payments in respect to the providing of medical and health care services. * * *

* * * * *

Par. 4. Section 1.6045–5 is added to read as follows:

§ 1.6045–5 Information reporting on payments to attorneys.

(a) *Requirement of reporting*—(1) *In general*. Except as provided in paragraph (c) of this section, every payor engaged in a trade or business who, in the course of that trade or business, makes payments aggregating $600 or more during a calendar year to an attorney in connection with legal services (whether or not the services are performed for the payor) must file an information return for such payments. The information return must be filed on the form and in the manner required by the Commissioner. For the time and place of filing the form, see § 1.6041–6. For definitions of the terms under this section, see paragraph (d) of this section. The

requirements of this paragraph (a)(1) apply whether or not—

(i) A portion of a payment is kept by the attorney as compensation for legal services rendered; or

(ii) Other information returns are required with respect to some or all of a payment under other provisions of the Internal Revenue Code and the regulations thereunder.

(2) *Information required*. The information return required under paragraph (a)(1) of this section must include the following information—

(i) The name, address, and taxpayer identification number (TIN) (as defined in section 7701(a)) of the payor;

(ii) The name, address, and TIN of the payee attorney;

(iii) The amount of the payment or payments (as defined in paragraph (d)(5) of this section); and

(iv) Any other information required by the Commissioner.

(3) *Requirement to furnish statement*. A person required to file an information return under paragraph (a)(1) of this section must furnish to the attorney a written statement of the information required to be shown on the return. This requirement may be met by furnishing a copy of the return to the attorney. The written statement must be furnished to the attorney on or before January 31 of the year following the calendar year in which the payment was made.

(b) *Special rules*—(1) *Joint or multiple payees*—(i) *Check delivered to payee attorney*. If more than one attorney is listed as a payee on a check, an information return must be filed under paragraph (a)(1) of this section with respect to the payee attorney, if any, who received the check.

(ii) *Check delivered to nonpayee or to payee nonattorney*. If one or more than one attorney is listed as a payee on a check and the check is delivered to a person who is not a payee on the check, or to a payee who is not an attorney, an information return must be filed under paragraph (a)(1) of this section with respect to the first-listed payee attorney on the check.

(2) *Attorney required to report payments made to other attorneys*. If, due to the payment of a check, an information return is required to be filed under paragraph (b)(1) of this section, the attorney with respect to whom the information return is required to be filed (tier-one attorney) must file an information return, as required under this section, for any payment that the tier-one attorney makes to other attorneys with respect to that check, regardless of whether the tier-one attorney is a payor under paragraph (d)(3) of this section.

(c) *Exceptions*. Notwithstanding paragraphs (a) and (b) of this section, a return of information is not required under section 6045(f) with respect to the following payments—

(1) Payments of wages or other compensation paid to an attorney by the attorney's employer.

(2) Payments of compensation or profits paid or distributed to its partners by a partnership engaged in providing legal services.

(3) Payments of dividends or corporate earnings and profits paid to its shareholders by a corporation engaged in providing legal services.

(4) Payments made by a person to the extent that the person is required to report with respect to the same payee the payments or portions thereof under section 6041(a) and § 1.6041–1(a) (or would be required to so report the payments or portions thereof but for the dollar amount limitation contained in section 6041(a) and § 1.6041–1(a)).

(5) Payments made to a nonresident alien individual, foreign partnership, or foreign corporation that does not engage in a trade or business in the United States and does not perform any labor or personal services in the United States. For how a payor determines whether a payment is subject to this exception, see § 1.6041–4(a)(1).

(6) Payments made to an attorney in the attorney's capacity as the person responsible for closing a transaction within the meaning of § 1.6045–4(e)(3) for the sale or exchange of any present or future ownership interest in real estate described in § 1.6045–4(b)(2)(i) through (iv).

(d) *Definitions*. The following definitions apply for purposes of this section:

(1) *Attorney* means a person engaged in the practice of law, whether as a sole proprietor, partnership, corporation, or joint venture.

(2) *Legal services* means all services related to, or supportive of, the practice of law performed by, or under the supervision of, an attorney.

(3) *Payor* means a person who makes a payment if that person is an obligor on the payment, or the obligor's insurer or guarantor. For example, a payor includes a person who pays a settlement amount to an attorney of a client who has asserted a tort, contract, violation of law, or workers' compensation claim against that person and the person's insurer if the insurer pays the settlement amount to the attorney.

(4) *Payments to an attorney* in the case of a payment by check means a check on which the attorney is named as a sole, joint, or alternative payee.

(5) *Amount of the payment* in the case of a check means the amount of the check plus the amount required to be withheld from the payment under section 3406(a)(1), because a condition for withholding exists with respect to the attorney for whom an information return is required to be filed under paragraph (a)(1) of this section.

(e) *Attorney to furnish TIN*. A payor that is required to file an information return under this section must solicit a TIN from the attorney at or before the time the payor makes a payment to the attorney. Any attorney must furnish the TIN to the payor, but is not required to certify that the TIN is correct. See, however, paragraph (c)(5) of this section regarding payments to certain foreign attorneys. A payment for which a return of information is required under this section is subject to backup withholding under section 3406 and the regulations thereunder.

(f) *Examples*. The provisions of this section are illustrated by the following examples. The examples assume that P is not a payor with respect to A, the attorney, under section 6041. See section 6041 and the regulations thereunder for rules regarding whether P is required under section 6041 to file information returns with respect to C.

Example 1. One check—joint payees—taxable to claimant. Employee C, who sues employer P for back wages, is represented by attorney A. P settles the suit for $300,000 that represents taxable wages under existing legal principles and writes a settlement check payable jointly to C and A in the amount of $200,000, net of income and FICA tax withholding. P delivers the check to A. A retains $100,000 of

the payment and disburses the remaining $100,000 to C. P must file an information return with respect to A for $200,000 under paragraph (a)(1) of this section. P must also furnish an information return to C under section 6051 in the amount of $300,000.

Example 2. One check—joint payees—excludable to claimant. C, who sues corporation P for damages on account of personal physical injuries, is represented by attorney A. P settles the suit for a $600,000 damage payment that is excludable from C's gross income under section 104(a)(2). P writes the $600,000 settlement check payable jointly to C and A and delivers the check to A. A retains $240,000 of the payment as A's attorney's fees and remits the remaining $360,000 to C. P must file an information return with respect to A for $600,000 under paragraph (a)(1) of this section.

Example 3. Separate checks—taxable to claimant. C, a plaintiff in a suit for lost profits against corporation P, is represented by attorney A. P settles the suit for $300,000. A requests P to write two checks, one payable to A in the amount of $100,000 for A's attorney's fees and the other payable to C in the amount of $200,000. P writes the checks in accordance with A's instructions and delivers both checks to A. P must file an information return with respect to A for $100,000 under paragraph (a)(1) of this section.

Example 4. Check made payable to claimant, but delivered to nonpayee attorney. Corporation P, a defendant in a suit for damages knows that C, the plaintiff, has been represented by attorney A throughout the proceeding. P settles the suit for $500,000. Pursuant to a request by A, P writes the $500,000 settlement check payable solely to C and delivers it to A at A's office. P is not required to file an information return under paragraph (a)(1) of this section with respect to A, because there is no payment to an attorney within the meaning of paragraph (d)(4) of this section.

Example 5. Multiple attorneys listed as payees. Corporation P, a defendant, settles a lost profits suit brought by C, for $1,000,000 by paying a check naming C's attorneys, Y, A, and Z, as payees in that order. Y, A, and Z are not related parties. P delivers the payment to A's office. A deposits the check proceeds into a trust account and makes payments by separate checks to Y of $100,000 and to Z of $50,000, for their attorneys' fees. A also makes a payment by check of $550,000 to C. P must file an information return for $1,000,000 with respect to A under paragraphs (a)(1) and (b)(1)(i) of this section. A, in turn, must file information returns with respect to Y of $100,000 and to Z of $50,000 under paragraphs (a)(1) and (b)(2) of this section if A is not required to file information returns under section 6041 with respect to A's payments to Y and to Z.

Example 6. Amount of the payment—attorney does not provide TIN. Corporation P, a defendant, settles a suit brought by C for $1,000,000 of damages. C's attorney, A, did not furnish P with A's TIN. P is required to deduct and withhold tax from the $1,000,000 under section 3406(a)(1)(A) and paragraph (e) of this section. Therefore, P makes the payment by a $720,000 check naming C and C's attorney, A, as joint payees. P must also file an information return with respect to A under paragraph (a)(1) of this section in the amount of $1,000,000, as prescribed in paragraph (d)(5) of this section.

Example 7. Home mortgage lending transaction. (i) Individual P agrees to purchase a house that P will use solely as a residence. P obtains a loan from lender L to finance a portion of the cost of acquiring the house. L disburses loan proceeds of $325,000 to attorney A, who is the settlement agent, by a check naming A as the sole payee. A, in turn, writes checks from the loan proceeds and from other funds provided by P to the persons involved in the purchase of the house, including a check for $800 to attorney B, whom P hired to provide P with legal services relating to the closing.

(ii) P, not L, is the payor of the payment to A under paragraph (d)(3) of this section. P, however, is not required to file an information return with respect to A under paragraph (a)(1) of this section because the payment was not made in the course of P's trade or business. Even if P made the payment in the course of P's trade or business, P would not be required to file an information return under section 6045(f) with respect to A because P is excepted under paragraph (c)(6) of this section.

(iii) A is not required to file an information return under paragraph (a)(1) of this section with respect to the payment to B because A is not the payor as that term is defined under paragraph (d)(3) of this section. Also A is not required to file an information return under paragraph (b)(2) with respect to the payment to B because A was listed as sole payee on the check it received from P. See section 6041 and its regulations for whether A or L must file information returns under that section. See section 6045(e) and § 1.6045–4 for whether A is required to file an information return under that section.

Example 8. Business mortgage lending transaction. The facts are the same as in *Example 7* except that P buys real property that P will use in a trade or business. P, not L, is the payor of the payment to A under paragraph (d)(3) of this section. P, however, is not required to file an information return under section 6045(f) with respect to A because P is excepted under paragraph (c)(6) of this section. A is not required to file an information return under paragraphs (a) or (b)(2) of this section with respect to the payment to B. See section 6041 and its regulations for whether P or L must file information returns under that section. See sections 6041 and 6045(e) for rules regarding whether A is required to file information returns under those sections.

Example 9. Qualified settlement fund. Corporation P agrees to settle for $100,000,000 a class action lawsuit brought by attorney A on behalf of a claimant class. Pursuant to the settlement agreement and a preliminary order of approval by a court, A establishes a bank account in the name of Q Settlement Fund, which is a qualified settlement fund (QSF) under § 1.468B–1. A is also designated by the court as the administrator of the QSF. Corporation P writes a $100,000,000 check in 2003 to A, who deposits the check proceeds into the Q Settlement Fund. In 2004, the court approves an award of attorneys' fees of $35,000,000 for A. In 2004, Q Settlement Fund delivers a $35,000,000 check payable to A. P is required to file an information return under paragraph (a) of this section with respect to A for the year 2003 for the $100,000,000 payment it made to A. The Q Settlement Fund is required to file an information return under section 6041(a) and § 1.468B–2(l)(2) with respect to A for the year 2004 for the $35,000,000 payment it made to A.

Example 10. Bankruptcy trustee—wage garnishment. Individual C files for bankruptcy under Chapter XIII of the Bankruptcy Code, 11 U.S.C. sections 1301–1330. Pursuant to a wage garnishment order, C's employer, P, withholds $800 from C's earnings. P remits a check for $800 payable to A, an attorney who was appointed by the United States Bankruptcy Court to act as the trustee of C's bankruptcy estate. P is required to file an information return under section 6045(f) with respect to the $800 payment it made to A.

(g) *Cross reference to penalties.* See the following sections regarding penalties for failure to comply with the requirements of section 6045(f) and this section:

(1) Section 6721 for failure to file a correct information return.

(2) Section 6722 for failure to furnish a correct payee statement.

(3) Section 6723 for failure to comply with other information reporting requirements (including the requirement to furnish a TIN).

(4) Section 7203 for willful failure to supply information (including a taxpayer identification number).

(h) *Effective date.* The rules in this section apply to payments made during the first calendar year that begins at least two months after the date of publication of these regulations as final regulations in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on May 16, 2002, 8:45 a.m., and published in the issue of the Federal Register for May 17, 2002, 67 F.R. 35064)

New Revision of Publication 551, *Basis of Assets*

Announcement 2002–61

Publication 551, revised May 2002, is now available from the Internal Revenue Service. It replaces the December 2000 revision.

This publication provides information on determining your basis in property.

You can get a copy of this publication by calling 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available

on the IRS Internet web site at *www.irs.gov.*

New Revision of Publication 583, Starting a Business and Keeping Records

Announcement 2002–62

Publication 583, revised May 2002, is now available from the Internal Revenue Service. It replaces the December 2000 revision.

This publication provides basic federal tax and recordkeeping information for people who are starting a business.

You can get a copy of this publication by calling 1–800–TAX-FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. The publication is also available on the IRS Internet web site at *www.irs.gov.*

Request for Tax Accrual and Other Financial Audit Workpapers

Announcement 2002–63

The Internal Revenue Service is revising its policy concerning when it will request and, if necessary, summon tax accrual and other financial audit workpapers relating to the tax reserve for deferred tax liabilities and to footnotes disclosing contingent tax liabilities ("Tax Accrual Workpapers") appearing on audited financial statements. This limited expansion of the circumstances in which the Service will seek Tax Accrual Workpapers is necessary to allow the Service to fulfill its obligation to the public to curb abusive tax avoidance transactions and to ensure that taxpayers are in compliance with the tax laws. In all other respects, the Service's current policy regarding requests for Tax Accrual Workpapers will continue to apply.

The Service may request Tax Accrual Workpapers in the course of examining any return filed on or after July 1, 2002, that claims any tax benefit arising out of a transaction that the Service has determined to be a listed transaction at the time of the request within the meaning of Temp. Treas. Reg. § 1.6011–4T(b)(2) ("Listed Transaction"). (Temp. Treas. Reg § 1.6011–4T(b)(2) defines listed transactions to include substantially similar transactions.) If the Listed Transaction was disclosed under Temp. Treas. Reg. § 1.6011–4T, the Service will routinely request the Tax Accrual Workpapers pertaining only to the Listed Transaction. If the Listed Transaction was not disclosed, the Service will routinely request all Tax Accrual Workpapers. In addition, if the Service determines that tax benefits from multiple investments in Listed Transactions are claimed on a return, regardless of whether the Listed Transactions were disclosed, the Service, as a discretionary matter, will request all Tax Accrual Workpapers. Similarly, if, in connection with the examination of a return claiming tax benefits from a Listed Transaction that was disclosed, there are reported financial accounting irregularities, such as those requiring restatement of earnings, the Service, as a discretionary matter, will request all Tax Accrual Workpapers.

For a return filed prior to July 1, 2002, that claims any tax benefit arising out of a Listed Transaction, the Service may request Tax Accrual Workpapers pertaining to the Listed Transaction, if the taxpayer had an obligation to disclose the transaction under Temp. Treas. Reg. § 1.6011–4T, and failed to do so (1) on the return; (2) under Rev. Proc. 94–69, 1994–2 C.B. 804, if applicable; or (3) pursuant to Announcement 2002–2, 2002–2 I.R.B. 304 (Jan. 14, 2002).

The Supreme Court confirmed the Service's right to obtain Tax Accrual Workpapers under its summons authority. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984). Since Tax Accrual Workpapers are not generated in connection with seeking legal or tax advice, but are developed to evaluate a taxpayer's deferred or contingent tax liabilities in connection with a taxpayer's disclosure to third parties of the taxpayer's financial condition, Tax Accrual Workpapers are not privileged communications. Neither the attorney-client privilege nor the IRC § 7525 tax practitioner privilege (which is based upon, but is more limited than, the attorney-client privilege) protects Tax Accrual Workpapers from production upon proper request by an authorized examining agent. *See also* Treasury Department Circular 230, 31 C.F.R. § 10.20 (duty of practitioner to submit information upon a proper and lawful request by the IRS).

Despite the broad scope of authority recognized by the Supreme Court, the Service has historically acted with restraint, declining to request Tax Accrual Workpapers as a standard examination technique. The Service will continue to exercise its authority to request Tax Accrual Workpapers with restraint.

The Service will continue its current policy of requesting Tax Accrual Workpapers only in unusual circumstances (1) for any returns filed prior to July 1, 2002, other than those that claim any tax benefit arising out of a Listed Transaction that has not been disclosed as mentioned above, and (2) for any returns filed on or after July 1, 2002, other than those that claim any tax benefit arising out of a Listed Transaction as described above.

CONTACT INFORMATION

For further information regarding this announcement, contact George Bowden at 202–622–3400 (not a toll-free call).

Foundations Status of Certain Organizations

Announcement 2002–64

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section

509(a) of the Code) are now classified as private foundations:

21 Beechtree, Inc., Livingston, NJ
941-990 Leggett Avenue Housing Development Fund Corporation, Bronx, NY
Advocates for Adoption, Inc., New York, NY
Aegean Theatre Company, Inc., New York, NY
African-American Scholarship Foundation of Prince Geo County, Inc., Largo, MD
Ameraid, Inc., Brooklyn, NY
American Sports Academy, Inc., Temple Hills, MD
Amsong Foundation, New York, NY
Annapolis Chorale, Annapolis, MD
Artists Direct Chicago, Chicago, IL
Arts Academy of Bharata, Inc., Chesterfield, MO
Asian American Coalition of Staten Island, Inc., Staten Island, NY
Austin Area Rehabilitation Association, Austin, TX
Back Street Arts, Inc., New York, NY
Big Brothers of the National Capital Area Foundation, Inc., Silver Spring, MD
Boston A Cappella, Inc., Boston, MA
Boston Kids Science Foundation, Incorporated, Somerville, MA
Braille Revival League, Washington, DC
Breckenridge R-1 School District Foundation, Breckenridge, MO
Brighter Future Maternity Home, Inc., Cleveland, OH
Cama Beach Institute, Seattle, WA
Center for Design Innovation, New York, NY
Center for Global Education and Development, Inc., Boston, MA
Chesnut Knolls Aviation Foundation, Inc., London, KY
Christiana Rotary Club Foundation, Newark, DE
Classic Yacht Preservation, Inc., Eureka, CA
Coalition Empowering Families Affected by AIDS, St. Louis, MO
Coalition of Progressive Professionals, Cincinnati, OH
Codman Square Main Street, Inc., Dorchester, MA
Collaborations in Learning, Berkeley, CA
Common Sense Institute, Inc., New York, NY
Community Health and Education Services, Inc., Kansas City, KS
Community Partnership, Inc., Pawtucket, RI
Connecticut Elite, Inc., Hamden, CT
Connecticut Works, Inc., Mystic, CT
De Best Shared Housing, Inc., Baltimore, MD
Denver Police Latino A Officers Organization, Denver, CO
Dialogues Organization, Mineola, NY
Dovestreet, Inc., East Greenwich, RI
Economic Competitiveness Task Force, Des Moines, IA
Elizabethtown Historical Society, Elizabethtown, PA
Everett Youth Soccer, Inc., Everett, MA
Ezrs Cholm of Uta, Inc., Brooklyn, NY
Falmouth Interfaith Choir, Inc., Falmouth Barnstable, MA
Farmington Cooperative Child Care Center, Farmington, ME
Fellowship, Inc., Worcester, MA
Flight Technologies Museum, Big Lake, AK
Flushing Supportive Housing, Inc., Richmond Hill, NY
For Kids Only, Newport Beach, CA
Foss Avenue Economic Development Corporation, Flint, MI
Foundation for Colorectal Surgical Education, Seattle, WA
Foundation for Grieving Children, Culpeper, VA
Foundation for Salem Public Education, Inc., Salem, MA
Foundation of Miracles, Inc., Bel Air, MD
Friends of Belmont Track and Field, Inc., Belmont, MA
Friends of the Hockanum River Linear Park of Vernon, Inc., Vernon Rockville, CT
Friends of the Humanities Montgomery County, Inc., Rockville, MD
Full Armour Ministries, Inc., Washington, DC
Georgetown Apartments, Inc., Frederick, MD
Get Real Cooking, Inc., Wallingford, CT
Glass Institute for Basic Psychoanalytic Research, Inc., New York, NY
Gotham Group Dance, Inc., New York, NY
Greater Fort Dodge Area Ralph Bell Crusade, Fort Dodge, IA
Greater Springfield Science Fair Foundation, Inc., Springfield, MO
Green Acres Riding Stables, Inc., Atlanta, GA
Hands & Heart of New York, Inc., New York, NY
Harlem Advocate, Inc., New York, NY
Higgins Information Technology Fund, Peabody, MA
Hip, Incorporated, Pawtucket, RI
Hispanic American Womens Club of Long Island, Inc., Farmingdale, NY
HIV AIDS Task Force of Washington County, St. George, UT
Housing Education Resources, LTD., New York, NY
Houston Lesbian and Gay Community Center, Inc., Houston, TX
I.D.I. Inc., - Individuals Developing Independence, Bronx, NY
Institute for Art Research and Documentation, Madison, CT
Interfaith Volunteer Caregivers of Anne Arundel County, Inc., Annapolis, MD
Internet Users Society Niue, Medfield, MA
Jackson Avenue, Inc., Cranford, NJ
Joint School Activities, Inc., New York, NY
Kent County Foster Parent Association, Dover, DE
Kids International Enrichment Program, Inc., Hartford, CT
Kiwanis Heritage, Inc., Waukesha, WI
Knights of Columbus Scholarship Fund, White Plains, NY
Kung Mern Sern Tao Ru Der Association of Utah, Inc., Ogden, UT
Lanac Inc., - Latino American National Action Council, Elmhurst, NY
Laurel Renaissance, Inc., Laurel MD
Lawrenceville Club of New York, Inc., New York, NY
Lazarus Foundation, Inc., Yonkers, NY
Lifarm, Inc., New York, NY
Life's Choice, Inc., Randolph, MA
Link Institute, Redwood Shores, CA
Lions Club of Ossining Charities, Inc., Ossining, NY
Lions - Quest of NH, Inc., Andover, NH
Litchfield Continuing Care Retirement Corporation, Litchfield, CT
Long Island Development Corporation, Plainview, NY
Long Island Parent Advocates for Autistic Children, Inc., Roslyn Heights, NY
Louisiana Alliance for the Blind, Inc., Lake Charles, LA

Mad Dads of New York State, Inc., Brooklyn, NY
Maine State Teacher of the Year Association, Cornish, ME
Manhattan Virtuosi, Inc., New York, NY
Marshall Area Fine Arts Council, Marshall, MN
McMann Field Association, Bath, ME
MD/DC Chapter Eastern Region APPA: The Association of Higher Education Facilities Officers, Inc., Largo, MD
Medical Referral Agency, Inc., Brooklyn, NY
Mercy Transitional Care Services, Inc., Baltimore, MD
Meridian Women's Foundation, Inc., Jamaica Plain, MA
Metro Outreach Project, Inc., Atlanta, GA
Middleborough Downtown Partnership, Inc., Middleborough, PA
Miracle Lake Foundation, St. Louis, MO
Mogba-USA-Canada, Inc., Washington, DC
Monacacy Foundation, Inc., Frederick, MD
Mother Lode Productions, Inc., Baltimore, MD
Multicultural Mental Health Research Center, Incorporated, Framingham, MA
Music for Healing, Inc., Boston, MA
Ndigbo Development Foundation, Inc., New Orleans, LA
Neighborhood Community Action Center, Titusville, Fl
New Spirit II, Inc., Laurelton, NY
New York City Taekwondo Association, Inc., New York, NY
New York Sports United Benevolent Officials Alliance, Inc., Bronx, NY
New York Youth Ice Hockey League, Inc., Staten Island, NY
Noxid, Inc., Hollywood, CA
Nu B Ginnings Community Development Corporation, Brooklyn, NY
Old Brooklyn Montessori School, Cleveland, OH
Open House, Bothell, WA
Optimistic Youth Performing Arts Theatre, Inc., Lynn, MA
Parent Connection of the Sabis International Charter School, Springfield, MA
Park Avenue Thorpe Housing Development Fund Corporation, Bronx, NY
Partners for Living, Inc., Swansea, MA
Partners in Progress Resource Center, Inc., Baltimore, MD
Pelham Rotary Charities Fund, Pelham, NY
People About Changing Education, Inc., New York, NY
Pete and Lela Stavros Education Foundation, Oklahoma City, OK
PHI Foundation & Charitable Trust, Inc., New Haven, CT
Plainedge Educational Partnership, Inc., North Massapequa, NY
Pocumtuck Stewarts of the Land, Inc., S. Deerfield, MA
Pro Violino Foundation, Inc., Cambridge, MA
Project Youth Success, New York, NY
Provider-Maspik, Inc., Middleton, NY
Quaboag Youth Football Organization, Warren, MA
Quad Cities Minority AIDS Prevention Project, Inc., Davenport, IA
Real Options, Incorporated, N. Dartmouth, MA
Renaissance Drug & Alcohol Recovery House, Inc., Matteson, IL
Rhythm Rhyme Incorporated, Cheshire, Cheshire, MA
Rutland Township Community Consolidated School District No. 230, Ottawa, IL
Sacred Heart, Inc., Boston, MA
SAFE, Inc., -Substance Abuse Free Environment, Scarborough, ME
Samuel and Elizabeth Adams Letters of Correspondence Society, Brunswick, ME
Sandy Ridge Homes, Inc., Candor, NC
Sarah Dyer Barnes Parent Teachers Organization, Johnston, RI
Seated Man, Inc., New York, NY
Seven Hills Charter School, Inc., Worcester, MA
Smith College Class of 1995, New York, NY
Spinal Cord Research Foundation, Farmingville, NY
Stagedoor Theatre Company, Ltd., Waldorf, MD
Suffolk Association for the Education of Young Children, Commack, NY
SVM Productions, Inc., Ft. Washington, MD
Taney County Habilitation Rehabilitation Center for the, Branson, MO
Transformed by Grace, Evanston, IL
Utopia United, Inc., Orange, MA
Wakefield Music Boosters Association, Inc., Wakefield, MA
Water-Oak Crime Stoppers, Inc., Oakville, CT
Wentworth Corporation, Pawtucket, RI
West Tallahatchie County Consortium, Webb, MS
Wise-Up, Inc., Houston, TX
Woodridge Parent-Teacher Association PTA, Washington, DC
Zamorano Fine Arts Academy Educational Foundation, San Diego, CA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Definition of Terms

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

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

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

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

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

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

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

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

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

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

Abbreviations

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

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

Bulletin 2002–26

Announcements:

2002–59, 2002–26 I.R.B. *28*
2002–60, 2002–26 I.R.B. *28*

Proposed Regulations:

REG–248110–96, 2002–26 I.R.B. *19*
REG–106457–00, 2002–26 I.R.B. *23*
REG–122564–02, 2002–26 I.R.B. *25*
REG–123305–02, 2002–26 I.R.B. *26*

Revenue Procedures:

2002–44, 2002–26 I.R.B. *10*

Revenue Rulings:

2002–38, 2002–26 I.R.B. *4*

Treasury Decisions:

8997, 2002–26 I.R.B. *6*
8998, 2002–26 I.R.B. *1*

[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.

Finding List of Current Actions on Previously Published Items[1]

Bulletin 2002–26

Announcements:

98–99
Superseded by
Rev. Proc. 2002–44, 2002–26 I.R.B. *10*

2000–4
Modified by
Ann. 2002–60, 2002–26 I.R.B. *28*

2001–9
Superseded by
Rev. Proc. 2002–44, 2002–26 I.R.B. *10*

[1] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2002–1 through 2002–25 is in Internal Revenue Bulletin 2002–26, dated July 1, 2002.