

(c) \* \* \*

(6) For purposes of paragraph (c)(5) of this section, a transfer of assets will not be treated as resulting in a diversification of the transferors' interests if each transferor transfers a diversified portfolio of assets. For purposes of this paragraph, a portfolio of assets is diversified if it satisfies section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F), except that, in applying section 368(a)(2)(F)(iv), Government securities are included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

\* \* \* \* \*

**Margaret Milner Richardson,***Commissioner of Internal Revenue.*

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**26 CFR Part 1**

[PS-29-92]

RIN 1545-AQ64

**Diversification of Common Trust Funds****AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Notice of Proposed Rulemaking.

**SUMMARY:** This document proposes regulations relating to the diversification of common trust funds at the time of a combination or division. The proposed regulations will affect common trust funds and their participants.

**DATES:** Written comments and requests for a public hearing must be received by November 8, 1995.

**ADDRESSES:** Send submissions to: CC:DOM:CORP:T:R (PS-29-92), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (PS-29-92), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC.

**FOR FURTHER INFORMATION CONTACT:** Brian J. O'Connor, (202) 622-3060 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:****Background**

This document proposes amendments to the Income Tax Regulations (26 CFR part 1) under section 584 of the Internal Revenue Code of 1986 relating to common trust funds.

A common trust fund is an investment vehicle set up by a bank in the form of a state-law trust. The investors in a common trust fund, referred to as participants, are trusts and certain other accounts for which the bank acts as a fiduciary.

Section 584(b) provides that a common trust fund is not subject to taxation. Instead, each participant that invests in the common trust fund includes its proportionate share of the common trust fund's income or loss on its own return.

Under section 584(e), the contribution of property to a common trust fund is a taxable event to the contributing participant. This provision was added to section 584(e) by the Tax Reform Act of 1976 and was intended to prevent participants from using a common trust fund to diversify their portfolios tax-free. Accordingly, the legislative history to the 1976 amendment indicates that mergers or divisions of common trust funds will continue to be tax-free as long as the combining or dividing funds have portfolios that are diversified within the meaning of the corporate merger rules. S. Rep. No. 938, pt. 2, 94th Cong., 2d Sess. 48 (1976), 1976-3 (Vol. 3) C.B. 643, 690. The diversification test for corporate mergers, section 368(a)(2)(F)(ii), was enacted in 1976 as part of the same legislation.

Section 1.584-4(a), promulgated in 1984 and based on the 1976 amendment, provides that the transfer of a participating interest as a result of the combination of two or more common trust funds, or the division of a single common trust fund, is not considered an admission or a withdrawal if the combining, dividing, and resulting funds have diversified portfolios within the meaning of section 368(a)(2)(F)(ii).

Under section 368(a)(2)(F)(ii), a corporation has a diversified portfolio if not more than 25 percent of the value of its total assets is invested in the stock and securities of any one issuer and not more than 50 percent of the value of its total assets is invested in the stock and securities of five or fewer issuers. For purposes of the section 368(a)(2)(F)(ii) test, all members of a controlled group of corporations (within the meaning of section 1563(a)) shall be treated as one issuer. Also, a person holding stock in a regulated investment company, real estate investment trust, or other investment company (as defined by section 368(a)(2)(F)(iii)) that meets the requirements of section 368(a)(2)(F)(ii) shall be treated as holding its proportionate share of the assets held by the company. Section 368(a)(2)(F)(iv) provides that in determining total

assets, certain assets shall be excluded, including cash and cash items (including receivables), Government securities, and assets acquired to meet section 368(a)(2)(F)(ii) or to cease to be an investment company. Section 368(a)(2)(F)(v) provides that section 368(a)(2)(F) shall not apply if the stock of each investment company is owned substantially by the same persons in the same proportions. Section 368(a)(2)(F)(vii) defines securities for purposes of clauses (ii) and (iii) of section 368(a)(2)(F).

**Reasons for Change**

Excluding Government securities from a common trust fund's total assets pursuant to section 368(a)(2)(F)(iv) could inappropriately cause a fund with investments in Government securities to fail to be diversified under section 368(a)(2)(F)(ii). For example, if 95 percent of a common trust fund's assets are invested in Government securities and five percent are invested in the stock of corporation X, only five percent of the fund's total assets (that is, only the X stock) would be included in total assets in applying section 368(a)(2)(F)(ii). As a result, the X stock would be treated as constituting 100 percent of the common trust fund's assets and the fund would not satisfy the 25 and 50 percent test of section 368(a)(2)(F)(ii). Because excluding Government securities from a common trust fund's total assets could cause a fund with investments in Government securities to fail to be diversified under section 368(a)(2)(F)(ii), common trust funds might be discouraged from investing in Government securities.

**Explanation of Provisions**

Under the proposed amendment to § 1.584-4(a), the diversification test applied to a common trust fund at the time of a merger or division will continue to be section 368(a)(2)(F)(ii). However, the test is modified so that Government securities are now counted in determining a fund's total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

For purposes of § 1.584-4(a), relevant provisions of section 368(a)(2)(F) will apply to the section 368(a)(2)(F)(ii) test. Those provisions include the controlled group and look-through rules found in clause (ii) (members of a controlled group of corporations are considered as one issuer and persons holding stock in certain investment companies are treated as holding a proportionate share of the investment company's assets), the common ownership rule found in clause (v) (diversification will not be considered to occur if the interests in

the common trust funds transferred are held substantially by the same persons in the same proportions), and the definition of securities found in clause (vii) (the term securities includes investments constituting a security within the meaning of the Investment Company Act of 1940 (15 U.S.C. 80a-2(36)). The definition of total assets in section 368(a)(2)(F)(iv) will apply, except that, as stated above, Government securities will be included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii).

The proposed regulations contain the same diversification test as that in the proposed regulations under section 351(e) dealing with transfers to investment companies. Thus, these proposed regulations would ensure that a uniform diversification test is applied to common trust funds and similar investment entities.

The proposed regulations also update the regulations under section 584 to conform to changes in the law.

#### Proposed Effective Date

These regulations are proposed to apply to combinations and divisions of common trust funds consummated on or after the date of publication as final regulations in the **Federal Register**.

#### Special Analyses

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

#### Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying. A public hearing may be scheduled if requested in writing by a person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and

place for the hearing will be published in the **Federal Register**.

#### Drafting Information

The principal author of these regulations is Brian J. O'Connor, Office of Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Proposed Amendments to the Regulations

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

#### PART 1—INCOME TAXES

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

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

#### § 1.584-2 [Amended]

**Par. 2.** Section 1.584-2 is amended by:

1. Removing paragraph (b)(1).
2. Redesignating paragraph (b)(2) as paragraph (b).

**Par. 3.** Section 1.584-4 is amended by:

1. Removing paragraphs (a)(1) and (a)(2).
2. Revising the sixth sentence of paragraph (a).
3. Adding two sentences after the sixth sentence of paragraph (a).

The revision and additions read as follows:

#### § 1.584-4 Admission and withdrawal of participants in the common trust fund.

(a) \* \* \* When a participating interest is transferred by a bank, or by two or more banks that are members of the same affiliated group (within the meaning of section 1504), as a result of the combination of two or more common trust funds or the division of a single common trust fund, the transfer to the surviving or divided fund is not considered to be an admission or a withdrawal if the combining, dividing, and resulting common trust funds have diversified portfolios. For purposes of this paragraph, a common trust fund has a diversified portfolio if it satisfies section 368(a)(2)(F)(ii), applying the relevant provisions of section 368(a)(2)(F), except that, in applying section 368(a)(2)(F)(iv), Government securities are included in determining total assets, unless the Government securities are acquired to meet section 368(a)(2)(F)(ii). In addition, for a

transfer of a participating interest in a division of a common trust fund not to be considered an admission or withdrawal, each participant's pro rata interest in each of the resulting common trust funds must be substantially the same as was the participant's pro rata interest in the dividing fund.

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**Margaret Milner Richardson,**

*Commissioner of Internal Revenue.*

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#### Departmental Offices

#### 31 CFR Part 1

#### Privacy Act of 1974; Proposed Rule Exempting System of Records From Certain Provisions of the Privacy Act

**AGENCY:** Departmental Offices, Treasury.

**ACTION:** Proposed rule.

**SUMMARY:** In accordance with the requirements of the Privacy Act of 1974, as amended, 5 U.S.C. 552a, the Department of the Treasury gives notice of a proposed amendment of 31 CFR 1.36 to exempt the system of records entitled Integrated Data Retrieval System (IDRS) Security Files—Treasury/IRS 34.018 from certain provisions of the Privacy Act. The exemption is intended to comply with legal prohibitions against the disclosure of certain kinds of information and to protect certain information on individuals maintained in this system of records.

**DATES:** Comments must be received no later than September 11, 1995.

**ADDRESSES:** Please submit comments to the Director, Office of Disclosure, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. Comments will be made available for inspection and copying in the Freedom of Information Reading Room upon request.

**FOR FURTHER INFORMATION CONTACT:** Phyllis DePiazza, Chief, Privacy Act and Education Branch, Office of Disclosure, Internal Revenue Service at (202) 622-6240.

**SUPPLEMENTARY INFORMATION:** The Integrated Data Retrieval System (IDRS) Security Files is a computerized system which permits tax account access for the purposes of recording transactional information to tax accounts. The system is designed to identify potential unauthorized accesses to tax account information and to detect certain questionable accesses and/or patterns of access. Access to the system would