Internal Revenue

cumulative

bulletin

1997–2

July–December

Department of the Treasury
Internal Revenue Service

In This Issue

Mission of the Service

The purpose of the Internal Revenue Service is to collect the proper amount of tax revenue at the least cost; serve the public by continually improving the quality of our products and services; and perform in a manner warranting the highest degree of public confidence in our integrity, efficiency, and fairness.

Statement of Principles of Internal Revenue Tax Administration

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

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

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

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

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

Introduction

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

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

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

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

Cumulative Bulletin 1996–1 is a consolidation of all items of permanent nature published in the weekly Bulletins 1996–1 through 1996–26 for the period of January 1 through June 30, 1996.

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

Part I.—1986 Code.

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

Part II.—Treaties and Tax Legislation.

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

Part III.—Administrative, Procedural, and Miscellaneous.

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

Notice of Proposed Rulemaking.

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

Definition of Terms

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

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

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

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

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

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

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

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

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

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

Abbreviations

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

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

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Cumulative List of Actions Relating to Court Decisions Published in the Internal Revenue Bulletin From January 1, 1997 Through December 30, 1997

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

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

Prior to 1991, the Service published acquiescence or nonacquiescence only in certain regular Tax Court opinions. The Service has expanded its acquiescence program to include other civil tax cases where guidance is determined to be helpful. Accordingly, the Service now may acquiesce or nonacquiesce in the holdings of memorandum Tax Court opinions, as well as those of the United States District Courts, Claims Court, and Circuit Courts of Appeal. Regardless of the court deciding the case, the recommendation of any Action on Decision will b published in the Internal Revenue Bulletin.

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

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

The Commissioner ACQUIESCES in the following decisions:

The May Department Stores Co. v. United States,[1]
37 Fed. Cl. 680 (1996)

Pacific Enterprises and Subsidiaries v. Commissioner,[2]
101 T.C. 1 (1993)

Royal Caribbean Cruises, Ltd. v. United States,[3]
108 F.3d 290 (11th Cir. 1997)

Sun Microsystems, Inc. v. Commissioner,[4]
T.C.M. 1995–69

William R. Jackson v. Commissioner,[5]
108 T.C. 130 (1997)

The Commissioner does NOT ACQUIESCE in the following decisions:

Trans City Life Insurance Company v. Commissioner,[6]
108 T.C. 130 (1997)

Transwestern Pipeline Co. v. United States,[7]
639 F.2d 679 (Ct. Cl. 1980)

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[1]Acquiescence relating to whether interest accrued on the taxpayer's underpayments of tax for 1983 and 1984 from the due date of the first or third estimated tax payment for the next succeeding years.

[2]Acquiescence relating to whether the cost of recoverable cushion gas and recoverable line pack gas, the gas used to maintain adequate pressure in a gas storage facility and a pipeline, respectively, is properly treated as (i) merchandise and thus included in inventory; (ii) a depreciable capital asset; or (iii) a nondepreciable capital asset.

[3]Acquiescence relating to whether section 4471 of the Internal Revenue Code which imposes a one-time excise tax of $3 for each passenger who "embarks" or "disembarks" a commercial vessel in the United States, applies where the voyage begins and ends outside the United States, but make intermediate stops in the United States, where passengers temporarily leave the ship.

[4]Acquiescence relating to whether the spread income realized from a disqualifying disposition of stock purchased through the taxpayer's incentive stock option ("ISO") plan constitutes wages under section 41(b)(2)(D) in determining whether certain qualified research expenses qualify for the credit for increasing research activities under section 41.

[5]Acquiescence in result only relating to whether Termination Payments for an insurance company to a former insurance agent constitute net earnings from self-employment within the meaning of section 1402(a) of the Internal Revenue Code (the Code) so as to be subject to tax under the Self-Employment Contributions Act (SECA).

[6]Nonacquiescence relating to whether the Commissioner committed an abuse of discretion in determining that certain reinsurance agreements between unrelated parties had a "significant tax avoidance effect" within the meaning of Internal Revneue Code section 845(b).

[7]Nonacquiescence relating to whether the cost of recoverable line pack gas, the gas used to charge and operate an interstate natural gas pipeline system, is properly treated as (i) merchandise and thus included in inventory; (ii) a depreciable capital asset; or (iii) a nondepreciable capital asset.

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

Subtitle A.—Income Taxes
Chapter 1.—Normal Taxes and Surtaxes
Subchapter A.—Determination of Tax Liability
Part I.—Tax on Individuals

Section 1.—Tax Imposed

26 CFR 1.1–1: Income tax on individuals.

The Service provides adjusted tax tables for individuals, trusts, and estates for taxable years beginning in 1998 to reflect changes in the cost of living. Also adjusted is the amount of certain reductions allowed against the unearned income of minor children in computing the "kiddie tax," either on the child's return or, in the alternative, on a parent's return. The amounts used to determine whether a parent may elect to report the "kiddie tax" on the parent's return are also adjusted. See Rev. Proc. 97–57, page 584.

Part IV.—Credits Against Tax
Subchapter A.—Nonrefundable Personal Credits

Section 25A.—Hope and Lifetime Learning Credits

What information reporting requirements apply to educational institutions for 1998 under § 6050S of the Code, as added by the Taxpayer Relief Act of 1997, in connection with the Hope Scholarship Credit and the Lifetime Learning Credit. See Notice 97–73, page 335.

Subpart C.—Refundable Credits

Section 32.—Earned Income

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

The Service provides inflation adjustments to the limitations on the earned income tax credit for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Subpart D.—Business Related Credits

Section 38.—General Business Credit

Loan to community development corporation is eligible for general business credit. The full amount of the loan made to a community development corporation (CDC) is a "transfer of cash" to the CDC for purposes of the definition of a "qualified CDC contribution."

Rev. Rul. 97–51

ISSUE

What amount of a loan may a community development corporation (CDC) treat as a "transfer of cash" for purposes of the definition of a "qualified CDC contribution"?

FACTS

Bank wishes to lend money to *X*, a CDC, that *X* will use to provide employment and business opportunities for low-income residents in its operational area. In June 1994, the Secretary of Housing and Urban Development (HUD) designated *X* a "selected community development corporation" under § 13311 of the Omnibus Revenue Reconciliation Act of 1993, 1993–3 C.B. 144 (the Act). Bank and *X* have negotiated an agreement that Bank will lend *X* $2,000,000 on December 31, 1997, for 10 years at a stated rate of interest. Under the terms of the loan, X does not have to repay the loan before the end of 10 years.

LAW AND ANALYSIS

Section 13311 of the Act provides a business credit under § 38 of the Internal Revenue Code for a qualified CDC contribution made by a taxpayer to a CDC. A qualified CDC contribution is any transfer of cash (1) made to a CDC during the 5-year period beginning June 30, 1994, (2) that is available for use by the CDC for at least 10 years, (3) that the CDC uses to provide employment and business opportunities for low-income individuals who are residents of the operational area of the CDC, and (4) that the CDC designates as a qualified CDC contribution. The Secretary of HUD selects the 20 qualifying CDCs and determines whether those CDCs spend the money received appropriately.

A contributing taxpayer may claim an annual credit during a 10-year period equal to 5 percent of its contribution that is designated by the CDC as a qualified CDC contribution. The aggregate amount of contributions that a CDC can designate as eligible for the credit may not exceed $2,000,000. The credit period begins with the taxable year during which the taxpayer made the qualified CDC contribution.

A qualified contribution to a CDC need not be in the form of an outright gift. A qualified contribution may also be made in the form of a loan, the principal of which is to be returned to the lender taxpayer after the 10-year period. H.R. Rep. No. 2264, 103d Cong., 1st Sess. 801 n.196 (1993), 1993–3 C.B. 377.

In the present case, Bank is lending $2,000,000 to *X* for 10 years. To the extent of the amount of the loan designated by *X* as a qualified CDC contribution, Bank is eligible to claim the CDC credit.

HOLDING

The full amount of the loan made to a CDC is a "transfer of cash" to the CDC for purposes of the definition of a "qualified CDC contribution."

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 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period July through September

1997. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period July through September 1997.

Rev. Rul. 97–34

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

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) for dispositions of qualified low-income buildings or interests therein during the period July through September 1997.

TABLE 1
REV. RUL. 97–34
MONTHLY BOND FACTOR AMOUNTS FOR DISPOSITIONS EXPRESSED AS A PERCENTAGE OF TOTAL CREDITS

MONTH OF DISPOSITION	CALENDAR YEAR BUILDING PLACED IN SERVICE OR, IF SECTION 42(f)(1) ELECTION WAS MADE, THE SUCCEEDING CALENDAR YEAR										
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
JUL '97	78.33	80.65	83.19	86.15	89.61	93.54	97.58	101.48	105.30	109.33	112.52
AUG '97	78.11	80.43	82.96	85.92	89.36	93.27	97.30	101.18	105.01	109.06	112.52
SEP '97	77.90	80.21	82.74	85.68	89.12	93.01	97.03	100.90	104.73	108.81	112.52

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see the following revenue rulings: Rev. Rul. 90-60, 1990–2 C.B. 3, for dispositions occurring during calendar years 1987, 1988, and 1989; Rev. Rul. 90–88, 1990–2 C.B. 7, for dispositions occurring during calendar year 1990; Rev. Rul. 91–67, 1991–2 C.B. 13, for dispositions occurring during calendar year 1991; Rev. Rul. 92–101, 1992–2 C.B. 9, for dispositions occurring during calendar year 1992; Rev. Rul 93–83, 1993–2 C.B. 6, for dispositions occurring during calendar year 1993; Rev. Rul. 94–71, 1994–2 C.B. 4, for dispositions occurring during calendar year 1994; Rev. Rul. 95–83, 1995–2 C.B. 8, for dispositions occurring during calendar year 1995; Rev. Rul. 96–16, 1996–1 C.B. 3, for dispositions occurring during the period January through March 1996; Rev. Rul. 96–33, 1996–27 I.R.B. 4, for dispositions occurring during the period April through June 1996; Rev. Rul. 96–45, 1996–39 I.R.B. 5, for dispositions occurring during the period July through September 1996; Rev. Rul. 96–59, 1996–50 I.R.B. 4, for dispositions occurring during the period October through December 1996; Rev. Rul. 97–16, 1997–13 I.R.B. 4, for dispositions occurring during the period January through March 1997; and Rev. Rul. 97–25, 1997–23 I.R.B. 4, for dispositions occurring during the period April through June 1997.

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26 CFR 1.42–15: Available unit rule.

T.D. 8732

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Available Unit Rule

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations concerning the treatment of low-income housing units in a building that are occupied by individuals whose incomes increase above 140 percent of the income limitation applicable under section 42(g)(1). These regulations affect owners of those buildings who claim the low-income housing tax credit.

DATES: These regulations are effective September 26, 1997.

For dates of applicability of these regulations, see §1.42–15(i).

SUPPLEMENTARY INFORMATION:

Background

On May 30, 1996, the IRS published a notice of proposed rulemaking in the **Federal Register** (PS–29–95 at 61 F.R. 27036 [1997–1 C.B. 862]) proposing amendments to the Income Tax Regulations (26 CFR part 1) under section 42(g)(2)(D) of the Internal Revenue Code. A public hearing was scheduled for September 17, 1996, pursuant to a notice of public hearing published simultaneously with the notice of proposed rulemaking. However, the IRS received no requests to speak at the public hearing, and no public hearing was held. Written comments responding to the notice were received. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Revisions and Summary of Comments

The general rule in section 42(g)(2)-(D)(i) provides that if the income of an occupant of a low-income unit increases above the income limitation applicable under section 42(g)(1), the unit continues to be treated as a low-income unit. This general rule only applies if the occupant's income initially met the income limitation and the unit continues to be rent-restricted. Section 42(g)(2)(D)(ii), however, provides an exception to the general rule in section 42(g)(2)(D)(i). Under this exception, the unit ceases being treated as a low-income unit when two conditions occur. The first condition is that the occupant's income increases above 140 percent of the income limitation applicable under section 42(g)(1), or above 170 percent for a deep rent skewed project described in section 142(d)(4)(B) (applicable income limitation). When this occurs, the unit becomes an over-income unit. The second condition is that a new occupant, whose income exceeds the applicable income limitation (nonqualified resident), occupies any residential unit in the building of a comparable or smaller size (comparable unit).

Rules and Definitions

One commentator suggested that the available unit rule under the proposed regulations did not clearly indicate whether the aggregate income of all occupants of a unit is taken into account. Accordingly, the final regulations clarify that an over-income unit means a low-income unit in which the aggregate income of the occupants of the unit increases above 140 percent of the applicable income limitation under section 42(g)(1), or above 170 percent of the applicable income limitation for deep rent skewed projects described in section 142(d)(4)(B).

Commentators requested that the final regulations specify whether a comparable unit is measured by floor space or number of bedrooms. The final regulations provide that a comparable unit must be measured by the same method the taxpayer used to determine qualified basis for the credit year in which the comparable unit became available.

Some commentators stated that the provision in the proposed regulations that all available comparable units (not just the "next available" unit) must be rented to qualified residents to continue treating an over-income unit as a low-income unit is inconsistent with the title of section 42(g)(2)(D)(ii). Although the title of that provision uses the term next available unit, the text of the rule provides that if any available comparable unit is occupied by a nonqualified resident, the over-income unit ceases to be treated as a low-income unit. This means that if a building has more than one over-income unit, renting any available comparable unit (a comparably sized or smaller unit) to a qualified resident preserves the status of all over-income units as low-income units. Similarly, if any available comparable unit is rented to a nonqualified resident, all over-income units for which the available unit was a comparable unit lose their status as low-income units; thus, comparably sized or larger over-income units would lose their status as low-income units. In operation, this means that the owner must continue to rent any available comparable unit to a qualified resident until the percentage of low-income units in a building (excluding the over-income units) is equal to the percentage of low-income units on which the credit is based. At that point, failure to maintain the over-income units as low-income units has no immediate significance. (However, the failure to maintain an over-income unit as a low-income unit may affect the owner's decision of whether or not to rent a particular available unit at market rate at a later time.) Consequently, the final regulations provide that all available comparable units in the building, not only the next available comparable unit, must be rented to qualified residents to retain the low-income status of the over-income units.

Application of Rules on a Building by Building Basis

The proposed regulations provide that in a project containing more than one low-income building, the available unit rule applies separately to each building. Some commentators suggested that the regulations should permit residents of over-income units to move to available units in different buildings within the same low-income housing project without violating the available unit rule. However, because the requirements under section 42 must be satisfied on a building by building basis, the final regulations provide that the available unit rule only permits a current resident to move to another unit within the same building of a low-income housing project.

In addition, in response to requests from several commentators, the final regulations make clear that when a current resident moves to a different unit within the same low-income building, the units exchange status. (See example 2 of §1.42–15(g) of the proposed regulations and §1.42–15(h) of the final regulations.) Thus, the newly occupied unit adopts the status of the vacated unit, and the vacated unit assumes the status the newly occupied unit had immediately prior to its occupancy by the qualifying residents.

Timing Issues

The methods of committing rental units to tenants varies in different jurisdictions. However, it is a common rental practice to have some form of preliminary reservation for a unit prior to the date on which a lease is signed or the unit is occupied. Thus, several commentators have requested clarification that once a unit is reserved for a prospective tenant, it is no longer treated as available for purposes of the available unit rule. Accordingly, the final regulations provide that a unit is not available for purposes of the available unit rule when the unit is no longer available for rent due to a reservation that is binding under local law.

Finally, financing arrangements using obligations that purport to be exempt facility bonds under section 142 must meet the requirements of sections 103 and 141 through 150 for interest on the obligations to be excluded from gross income under section 103(a). The requirements under section 142(d) may differ from those under section 42. Accordingly, the final regulations provide that the rules under the final regulations are not intended as an interpretation of the applicable rules under section 142.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that

section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.42-15 is also issued under 26 U.S.C. 42(n); * * *

Par. 2. Section 1.42-15 is added to read as follows:

§1.42–15 Available unit rule.

(a) *Definitions.* The following definitions apply to this section:

Applicable income limitation means the limitation applicable under section 42(g)(1) or, for deep rent skewed projects described in section 142(d)(4)(B), 40 percent of area median gross income.

Available unit rule means the rule in section 42(g)(2)(D)(ii).

Comparable unit means a residential unit in a low-income building that is comparably sized or smaller than an over-income unit or, for deep rent skewed projects described in section 142(d)(4)(B), any low-income unit. For purposes of determining whether a residential unit is comparably sized, a comparable unit must be measured by the same method used to determine qualified basis for the credit year in which the comparable unit became available.

Current resident means a person who is living in the low-income building.

Low-income unit is defined by section 42(i)(3)(A).

Nonqualified resident means a new occupant or occupants whose aggregate income exceeds the applicable income limitation.

Over-income unit means a low-income unit in which the aggregate income of the occupants of the unit increases above 140 percent of the applicable income limitation under section 42(g)(1), or above 170 percent of the applicable income limitation for deep rent skewed projects described in section 142(d)(4)(B).

Qualified resident means an occupant either whose aggregate income (combined with the income of all other occupants of the unit) does not exceed the applicable income limitation and who is otherwise a low-income resident under section 42, or who is a current resident.

(b) *General section 42(g)(2)(D)(i) rule.* Except as provided in paragraph (c) of this section, notwithstanding an increase in the income of the occupants of a low-income unit above the applicable income limitation, if the income of the occupants initially met the applicable income limitation, and the unit continues to be rent-restricted—

(1) The unit continues to be treated as a low-income unit; and

(2) The unit continues to be included in the numerator and the denominator of the ratio used to determine whether a project satisfies the applicable minimum set-aside requirement of section 42(g)(1).

(c) *Exception.* A unit ceases to be treated as a low-income unit if it becomes an over-income unit and a nonqualified resident occupies any comparable unit that is available or that subsequently becomes available in the same low-income building. In other words, the owner of a low-income building must rent to qualified residents all comparable units that are available or that subsequently become available in the same building to continue treating the over-income unit as a low-income unit. Once the percentage of low-income units in a building (excluding the over-income units) equals the percentage of low-income units on which the credit is based, failure to maintain the over-income units as low-income units has no immediate significance. The failure to maintain the over-income units as low-income units, however, may affect the decision of whether or not to rent a particular available unit at market rate at a later time. A unit is not available for purposes of the available unit rule when the unit is no longer available for rent due to contractual arrangements that are binding under local law (for example, a unit is not available if it is subject to a preliminary reservation that is binding on the owner under local law prior to the date a lease is signed or the unit is occupied).

(d) *Effect of current resident moving within building.* When a current resident moves to a different unit within the building, the newly occupied unit adopts the status of the vacated unit. Thus, if a current resident, whose income exceeds the applicable income limitation, moves from an over-income unit to a vacant unit in the same building, the newly occupied unit is treated as an over-income unit. The vacated unit assumes the status the newly occupied unit had immediately before it was occupied by the current resident.

(e) *Available unit rule applies separately to each building in a project.* In a project containing more than one low-income building, the available unit rule applies separately to each building.

(f) *Result of noncompliance with available unit rule.* If any comparable unit that is available or that subsequently becomes available is rented to a nonqualified resident, all over-income units for which the available unit was a comparable unit within the same building lose their status as low-income units; thus, comparably sized or larger over-income units would lose their status as low-income units.

(g) *Relationship to tax-exempt bond provisions.* Financing arrangements that purport to be exempt-facility bonds under section 142 must meet the requirements of sections 103 and 141 through 150 for interest on the obligations to be excluded from gross income under section 103(a). This section is not intended as an interpretation under section 142.

(h) *Examples.* The following examples illustrate this section:

Example 1. This example illustrates noncompliance with the available unit rule in a low-income building containing three over-income units. On January 1, 1998, a qualified low-income housing project, consisting of one building containing ten identically sized residential units, received a housing credit dollar amount allocation from a state housing credit agency for five low-income units. By the close of 1998, the first year of the credit period, the project satisfied the minimum set-aside requirement of section 42(g)(1)(B). Units 1, 2, 3, 4, and 5 were occupied by individuals whose incomes

did not exceed the income limitation applicable under section 42(g)(1) and were otherwise low-income residents under section 42. Units 6, 7, 8, and 9 were occupied by market-rate tenants. Unit 10 was vacant. To avoid recapture of credit, the project owner must maintain five of the units as low-income units. On November 1, 1999, the certificates of annual income state that annual incomes of the individuals in Units 1, 2, and 3 increased above 140 percent of the income limitation applicable under section 42(g)(1), causing those units to become over-income units. On November 30, 1999, Units 8 and 9 became vacant. On December 1, 1999, the project owner rented Units 8 and 9 to qualified residents who were not current residents at rates meeting the rent restriction requirements of section 42(g)(2). On December 31, 1999, the project owner rented Unit 10 to a market-rate tenant. Because Unit 10, an available comparable unit, was leased to a market-rate tenant, Units 1, 2, and 3 ceased to be treated as low-income units. On that date, Units 4, 5, 8, and 9 were the only remaining low-income units. Because the project owner did not maintain five of the residential units as low-income units, the qualified basis in the building is reduced, and credit must be recaptured. If the project owner had rented Unit 10 to a qualified resident who was not a current resident, eight of the units would be low-income units. At that time, Units 1, 2, and 3, the over-income units, could be rented to market-rate tenants because the building would still contain five low-income units.

Example 2. This example illustrates the provisions of paragraph (d) of this section. A low-income project consists of one six-floor building. The residential units in the building are identically sized. The building contains two over-income units on the sixth floor and two vacant units on the first floor. The project owner, desiring to maintain the over-income units as low-income units, wants to rent the available units to qualified residents. J, a resident of one of the over-income units, wishes to occupy a unit on the first floor. J's income has recently increased above the applicable income limitation. The project owner permits J to move into one of the units on the first floor. Despite J's income exceeding the applicable income limitation, J is a qualified resident under the available unit rule because J is a current resident of the building. The unit newly occupied by J becomes an over-income unit under the available unit rule. The unit vacated by J assumes the status the newly occupied unit had immediately before J occupied the unit. The over-income units in the building continue to be treated as low-income units.

(i) *Effective date.* This section applies to leases entered into or renewed on and after September 26, 1997.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved August 28, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 25, 1997, 8:45 a.m., and published in the issue of the Federal Register for September 26, 1997, 62 F.R. 50503)

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26 CFR 1.42–16: Eligible basis reduced by federal grants.

T.D. 8731

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Section 42(d)(5) Federal Grants

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations with respect to the low-income housing tax credit relating to the application of section 42(d)(5) to certain rental assistance programs under section 42(g)(2)(B)(i). The regulations clarify that certain types of federal rental assistance payments do not result in a reduction in the eligible basis of a low-income housing building. DATES: These regulations are effective September 26, 1997.

For date of applicability for these regulations, see §1.42–16(d).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations (T.D. 8713 [1997–14 I.R.B. 4]) and a notice of proposed rulemaking cross-referencing the temporary regulations were published in the **Federal Register** for January 27, 1997 (62 F.R. 3792, 3848 [REG–254394–96 I.R.B. 14]). Those regulations provide that certain federal rental assistance payments made to the owner of a building on behalf of low-income tenants are not federal grants with respect to a building or its operation that require a reduction in the building's eligible basis under section 42(d)(5) of the Internal Revenue Code (Code). These payments include rental assistance payments made under section 8 of the United States Housing Act of 1937 (Act) (42 U.S.C. 1437f), certain payments made under section 9 of the Act, and payments made under such other programs or methods of rental assistance as may be designated in the **Federal Register** or the Internal Revenue Bulletin. The notice of proposed rulemaking indicated that comments would be considered on those areas addressed in the temporary regulations. Written comments responding to the notice of proposed rulemaking were received. There was no request for a public hearing, and no public hearing was held. After consideration of all the written comments, the proposed regulations have been adopted, without change, by this Treasury decision.

Summary of Comments

One commenter suggested that the final regulations provide additional guidance for state agencies to use in determining whether similar programs beyond those described in the regulations should be considered grants that cause a reduction in a building's eligible basis under section 42(d)(5) of the Code. The final regulations do not adopt this suggestion. The scope of this regulation is limited to specified rental assistance payments that are not grants requiring a reduction in a building's eligible basis and any additional payments the Secretary may designate in the future.

Another commenter suggested that §1.42–16(c)(3) should be deleted if it is intended to impose conditions beyond the restrictions under section 9 of the Act, because the IRS is improperly infringing upon the Department of Housing and Urban Development's (HUD) authority to provide subsidies under section 9. The final regulations do not adopt this suggestion. Section 1.42–16 does not interpret HUD's authority for paying subsidies under section 9; it describes the extent to which section 9 payments may be made without a reduction in a building's eligible basis under section 42(d)(5) of the Code. The conditions imposed on section 9 payments in §1.42–16(c)(3) serve to differentiate section 9 assistance for operating expenses that function in a manner similar to rental assistance payments under section 8 of the Act from section 9 assistance that is applied to uses more closely associated with operational expenses requiring a reduction in a building's eligible basis under section 42(d)(5).

This commenter also suggested that if §1.42–16(c)(3) were to be retained, it

should be clarified to provide that actual operating costs be determined by HUD and/or the appropriate public housing agency. The commenter reasons that HUD is already making this determination in the context of deciding the proper amount of assistance to make under section 9 of the Act, and that precedent already exists for allowing HUD to make certain interpretations relating to the section 42 program. The final regulations do not adopt this suggestion. The IRS and Treasury believe they should retain the ability to determine what costs are appropriately characterized as operating costs that require a reduction in a building's eligible basis under section 42(d)(5) of the Code.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for §1.42–16T and adding an entry in numerical order to read as follows:

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

Section 1.42–16 also issued under 26 U.S.C. 42(n); * * *

Par. 2. Section 1.42–16 is added to read as follows:

§1.42–16 Eligible basis reduced by federal grants.

(a) *In general.* If, during any taxable year of the compliance period (described in section 42(i)(1)), a grant is made with respect to any building or the operation thereof and any portion of the grant is funded with federal funds (whether or not includible in gross income), the eligible basis of the building for the taxable year and all succeeding taxable years is reduced by the portion of the grant that is so funded.

(b) *Grants do not include certain rental assistance payments.* A federal rental assistance payment made to a building owner on behalf or in respect of a tenant is not a grant made with respect to a building or its operation if the payment is made pursuant to—

(1) Section 8 of the United States Housing Act of 1937;

(2) A qualifying program of rental assistance administered under section 9 of the United States Housing Act of 1937; or

(3) A program or method of rental assistance as the Secretary may designate by publication in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

(c) *Qualifying rental assistance program.* For purposes of paragraph (b)(2) of this section, payments are made pursuant to a qualifying rental assistance program administered under section 9 of the United States Housing Act of 1937 to the extent that the payments—

(1) Are made to a building owner pursuant to a contract with a public housing authority with respect to units the owner has agreed to maintain as public housing units (PH-units) in the building;

(2) Are made with respect to units occupied by public housing tenants, provided that, for this purpose, units may be considered occupied during periods of short term vacancy (not to exceed 60 days); and

(3) Do not exceed the difference between the rents received from a building's PH-unit tenants and a pro rata portion of the building's actual operating costs that are reasonably allocable to the PH-units (based on square footage, number of bedrooms, or similar objective criteria), and provided that, for this purpose, operating costs do not include any development costs of a building (including developer's fees) or the principal or interest of any debt incurred with respect to any part of the building.

(d) *Effective date.* This section is effective September 26, 1997.

§1.42–16T [Removed]

Par. 3. Section 1.42–16T is removed.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved August 26, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on September 25, 1997, 8:45 a.m., and published in the issue of the Federal Register for September 26, 1997, 62 F.R. 50502)

Part VI.—Alternative Minimum Tax

Section 55.—Alternative Minimum Tax Imposed

How does § 1(h), as amended by the Taxpayer Relief Act of 1997, coordinate with the alternative minimum tax provisions. See Notice 97–59, page 309.

Subchapter B.—Computation of Taxable Income

Part I.—Definition of Gross Income, Adjusted Gross Income, Taxable Income, Etc.

Section 61.—Gross Income Defined

26 CFR 1.61–21: Taxation of fringe benefits.

Fringe benefits aircraft valuation formula. For purposes of section 1.61–21(g) of the regulations, relating to the rule for valuing non-commercial flights on employer-provided aircraft, the Standard Industry Fare Level, cents-per-mile rates and terminal charges in effect for the second half of 1997 are set forth.

Rev. Rul. 97-33

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

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

Period During Which the Flight Is Taken	*Terminal Charge*	*SIFL Mileage Rates*
7/1/97-12/31/97	$31.72	Up to 500 miles = $.1735 per mile 501-1500 miles = $.1323 per mile Over 1500 miles = $.1272 per mile

Section 62.—Adjusted Gross Income Defined

26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.

Optional rules are provided under which an employee of a federal government agency who is reimbursed for ordinary and necessary business expenses relating to travel, entertainment, gifts, or listed property (such as an employee's automobile) may make an adequate accounting to the employer to substantiate those expenses by submitting only an account book, diary, log, etc., without submitting documentary evidence such as receipts. See Rev. Proc. 97–45 page 499.

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26 CFR 1.62–2: Reimbursements and other expense allowance arrangements.

Rules under which a reimbursement or other expense allowance arrangement for the cost of operating an automobile for business purposes will satisfy the requirements of section 62(c) of the Code as to business connection, substantiation, and returning amounts in excess of expenses. See Rev. Proc. 97–58, page 587.

Rules are set forth under which a reimbursement or other expense allowance arrangement for the cost of lodging, meals, and incidental expenses or meal and incidental expenses incurred by an employee while traveling away from home will satisfy the requirements of § 62(c) of the Code as to substantiation of the amount of expenses. See Rev. Proc. 97–59, page 594.

Section 63.—Taxable Income Defined

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

The Service provides inflation adjustments to the standard deduction amounts (including the limitation in the case of certain dependents, and the additional standard deduction for the aged or blind) for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Section 68.—Overall Limitation on Itemized Deductions

The Service provides inflation adjustments to the overall limitation on itemized deductions for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Part II.—Items Specifically Included in Gross Income

Section 72.—Annuities; Certain Proceeds of Endowment and Life Insurance Contracts

Does the 10 percent additional tax on early withdrawals from individual retirement accounts apply to early withdrawals used to pay qualified higher education expenses? See Notice 97–60, page 310.

Part III.—Items Specifically Excluded From Gross Income

Section 104. — Compensation for Injuries or Sickness

Ct.D. 2061

SUPREME COURT OF THE UNITED STATES

No. 95–966*

O'GILVIE ET AL., MINORS *v.* UNITED STATES

519 U.S. ___

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

*December 10, 1996**

Syllabus

Petitioners, the husband and two children of a woman who died of toxic shock syndrome, received a jury award of $1,525,000 actual damages and $10 million punitive damages in a tort suit based on Kansas law against the maker of the product that caused decedent's death. They paid federal income tax insofar as

* Together with No. 95–977, *O'Gilvie* v. *United States*, also on certiorari to the same court.

the award's proceeds represented punitive damages, but immediately sought a refund. Procedurally speaking, this litigation represents the consolidation of two cases brought in the same Federal District Court: the husband's suit against the Government for a refund, and the Government's suit against the children to recover the refund that the Government had made to the children earlier. The District Court found for petitioners under 26 U.S.C. §104(a)(2), which, as it read in 1988, excluded from "gross income," the *"amount of any damages received . . . on account of personal injuries or sickness."* (Emphasis added.) The court held on the merits that the italicized language includes punitive damages, thereby excluding such damages from gross income. The Tenth Circuit reversed, holding that the exclusionary provision does not cover punitive damages.

Held:

1. Petitioners' punitive damages were not received *"on account of"* personal injuries; hence the gross-income-exclusion provision does not apply and the damages are taxable. Pp. 2–11.

(a) Although the phrase "on account of" does not unambiguously define itself, several factors prompt this Court to agree with the Government when it interprets the exclusionary provision to apply to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries, and not to punitive damages that do not compensate injury, but are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence. For one thing, the Government's interpretation gives the phrase "on account of" a meaning consistent with the dictionary definition. More important, in *Commissioner* v. *Schleier*, 515 U.S. ____, this Court came close to resolving the statute's ambiguity in the Government's favor when it said that the statute covers pain and suffering damages, medical expenses, and lost wages in an ordinary tort case because they are "designed to compensate . . . victims" *id.*, at ____, n. 5, but does not apply to elements of damages that are "punitive in nature," *id.*, at . The Government's reading also is more faithful to the statutory provision's history and basic tax-related purpose of excluding compensatory damages that restore a victim's lost, nontaxable "capital." Petitioners suggest no very good reason *why* Congress might have wanted the exclusion to have covered these punitive damages, which are not a substitute for any normally untaxed personal (or financial) quality, good, or "asset" and do not compensate for any kind of loss. Pp. 2–8.

(b) Petitioners' three arguments to the contrary—that certain words or phrases in the original, or current, version of the statute work in their favor; that the exclusion of punitive damages from gross income may be justified by Congress' desire to be generous to tort victims and to avoid such administrative problems as separating punitive from compensatory portions of a global settlement or determining the extent to which a punitive damages award is itself intended to compensate; and that their position is supported by a 1989 statutory amendment that specifically says that the gross income exclusion does not apply to any punitive damages in connection with a case not involving physical injury or sickness—are not sufficiently persuasive to overcome the Government's interpretation. Pp. 8–11.

2. Petitioners' two case-specific procedural arguments—that the Government's lawsuit was untimely and that its original notice of appeal was filed a few days late—are rejected. Pp. 12–14.

66 F. 3d 1550, affirmed.

BREYER, J., delivered the opinion of the Court, in which REHNQUIST, C. J., and STEVENS, KENNEDY, SOUTER, and GINSBURG, JJ., joined. SCALIA, J., filed a dissenting opinion, in which O'CONNOR and THOMAS, JJ., joined.

* * * * *

SUPREME COURT
OF THE UNITED STATES

Nos. 95–966 AND 95–977

KEVIN M. O'GILVIE AND
STEPHANIE L. O'GILVIE,
MINORS, PETITIONERS

95-966 *v.*

UNITED STATES

KELLY M. O'GILVIE, PETITIONER

95-977 *v.*

UNITED STATES

ON WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

[December 10, 1996]

JUSTICE BRYER delivered the opinion of the Court.

Internal Revenue Code §104(a)(2), as it read in 1988, excluded from "gross income," the

> "amount of any *damages received* (whether *by suit* or agreement and whether as lump sums or as periodic payments) *on account of personal injuries or sickness."* 26 U.S.C. §104 (a)(2) (1988 ed.) (emphasis added).

The issue before us is whether this provision applies to (and thereby makes nontaxable) punitive damages received by a plaintiff in a tort suit for personal injuries. We conclude that the punitive damages received here were not received *"on account of"* personal injuries; hence the provision does not apply and the damages are taxable.

I

Petitioners in this litigation are the husband and two children of Betty O'Gilvie, who died in 1983 of toxic shock syndrome. Her husband, Kelly, brought a tort suit (on his own behalf and that of her estate) based on Kansas law against the maker of the product that caused Betty O'Gilvie's death. Eventually, he and the two children received the net proceeds of a jury award of $1,525,000 actual damages and $10 million punitive damages. Insofar as the proceeds represented punitive damages, petitioners paid income tax on the proceeds but immediately sought a refund.

The litigation before us concerns petitioners' legal entitlement to that refund. Procedurally speaking, the litigation represents the consolidation of two cases brought in the same Federal District Court: Kelly's suit against the Government for a refund, and the Government's suit against the children to recover the refund that the Government had made to the children earlier. 26 U.S.C. §7405(b) (authorizing suits by the United States to recover refunds erroneously made). The Federal District Court held on the merits that the statutory phrase "damages . . . on account of personal injury or sickness," includes punitive damages, thereby excluding punitive damages from gross income and entitling Kelly to obtain, and the children to keep, their refund. The

Court of Appeals for the Tenth Circuit, however, reversed the District Court. Along with the Fourth, Ninth and Federal Circuits, it held that the exclusionary provision does not cover punitive damages. Because the Sixth Circuit has held the contrary, the Circuits are divided about the proper interpretation of the provision. We granted certiorari to resolve this conflict.

II

Petitioners received the punitive damages at issue here "by suit,"—indeed "by" an ordinary "suit" for "personal injuries." Contrast *United States* v. *Burke*, 504 U.S. 229 (1992) (§104(a)(2) exclusion not applicable to backpay awarded under Title VII of the Civil Rights Act of 1964 because the claim was not based upon "'tort or tort type rights,'" *id.*, at 233); *Commissioner* v. *Schleier*, 515 U.S. ____ (1995) (alternative holding) (Age Discrimination in Employment Act of 1967 (ADEA) claim is similar to Title VII claim in *Burke* in this respect). These legal circumstances bring those damages within the gross-income-exclusion provision, however, only if the petitioners also "received" those damages *"on account of"* the "personal injuries." And the phrase "on account of" does not unambiguously define itself.

On one linguistic interpretation of those words, that of petitioners, they require no more than a "but-for" connection between "any" damages and a lawsuit for personal injuries. They would thereby bring virtually all personal injury lawsuit damages within the scope of the provision, since: "but for the personal injury, there would be no lawsuit, and but for the lawsuit, there would be no damages."

On the Government's alternative interpretation, however, those words impose a stronger causal connection, making the provision applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries. To put the matter more specifically, they would make the section inapplicable to punitive damages, where those damages

> "'are not compensation for injury [but] [i]nstead . . . are private fines levied by civil juries to punish reprehensible conduct and to deter its future occurrence.'" *Electrical Workers* v. *Foust*, 442 U.S. 42, 48 (1979), quoting *Gertz* v. *Robert Welch, Inc.*, 418 U.S. 323, 350 (1974) (footnote omitted).

The Government says that such damages were not "received . . . on account of" the personal injuries, but rather were awarded "on account of" a defendant's reprehensible conduct and the jury's need to punish and to deter it. Hence, despite some historical uncertainty about the matter, see Rev. Rul. 75–45, 1975–1 Cum. Bull. 47, revoked by Rev. Rul. 84–108, 1984–2 Cum. Bull. 32, the Government now concludes that these punitive damages fall outside the statute's coverage.

We agree with the Government's interpretation of the statute. For one thing, its interpretation gives the phrase "on account of" a meaning consistent with the dictionary definition. See, *e.g.*, Webster's Third New International Dictionary 13 (1981) ("for the sake of: by reason of: because of").

More important, in *Schleier, supra*, we came close to resolving the statute's ambiguity in the Government's favor. That case did not involve damages received in an ordinary tort suit; it involved liquidated damages and backpay received in a settlement of a lawsuit charging a violation of the Age Discrimination in Employment Act. Nonetheless, in deciding one of the issues there presented (whether the provision now before us covered ADEA liquidated damages), we contrasted the elements of an ordinary tort recovery with ADEA liquidated damages. We said that pain and suffering damages, medical expenses, and lost wages in an ordinary tort case are covered by the statute and hence excluded from income

> "not simply because the taxpayer received a tort settlement, but rather because each element . . . satisfies the requirement . . . that the damages were received 'on account of personal injuries or sickness.'" *Id.*, at ____ (slip op., at 6–7).

In holding that ADEA liquidated damages are not covered, we said that they are not "designed to compensate ADEA victims," *id.*, at ____, n. 5 (slip op., at 9, n. 5); instead, they are "'punitive in nature,'" *id.*, at ____ (slip op., at 8) (quoting *Trans World Airlines, Inc.* v. *Thurston*, 469 U.S. 111, 125 (1985)).

Applying the same reasoning here would lead to the conclusion that the punitive damages are not covered because they are an element of damages not "designed to compensate . . . victims," *Schleier*, 515 U.S., at ____ (slip op., at 9, n. 5); rather they are "'punitive in nature.'" *Ibid.* Although we gave other reasons for our holding in *Schleier* as well, we explicitly labeled this reason an "independent" ground in support of our decision, *id.*, at ____ (slip op., at 11). We cannot accept petitioners' claim that it was simply a dictum.

We also find the Government's reading more faithful to the history of the statutory provision as well as the basic tax-related purpose that the history reveals. That history begins in approximately 1918. At that time, this Court had recently decided several cases based on the principle that a restoration of capital was not income; hence it fell outside the definition of "income" upon which the law imposed a tax. *E.g.*, *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179, 187 (1918); *Southern Pacific Co.* v. *Lowe*, 247 U.S. 330, 335 (1918). The Attorney General then advised the Secretary of the Treasury that proceeds of an accident insurance policy should be treated as nontaxable because they primarily

> "substitute . . . capital which is the source of *future* periodical income . . . merely tak[ing] the place of capital in human ability which was destroyed by the accident. They are therefore [nontaxable] 'capital' as distinguished from 'income' receipts." 31 Op. Atty. Gen. 304, 308 (1918).

The Treasury Department added that

> "upon similar principles . . . an amount received by an individual as the result of a suit or compromise for personal injuries sustained by him through accident is not income [that is] taxable . . . ." T. D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

Soon thereafter, Congress enacted the first predecessor of the provision before us. That provision excluded from income

> "[a]mounts received, through accident or health insurance or under workmen's compensation acts, as compensation for personal injuries or sickness, plus the amount of any damages received whether by suit or agreement on account of such injuries or sick-

ness." Revenue Act of 1918, ch. 18, §213(b)(6), 40 Stat. 1066.

The provision is similar to the cited materials from the Attorney General and the Secretary of the Treasury in language and structure, all of which suggests that Congress sought, in enacting the statute, to codify the Treasury's basic approach. A contemporaneous House Report, insofar as relevant, confirms this similarity of approach, for it says:

> "Under the present law it is doubtful whether amounts received through accident or health insurance, or under workmen's compensation acts, as compensation for personal injury or sickness, and damages received on account of such injuries or sickness, are required to be included in gross income. The proposed bill provides that such amounts shall not be included in gross income." H. R. Rep. No. 767, pp. 9–10 (1918).

This history and the approach it reflects suggest there is no strong reason for trying to interpret the statute's language to reach beyond those damages that, making up for a loss, seek to make a victim whole, or, speaking very loosely, "return the victim's personal or financial capital."

We concede that the original provision's language does go beyond what one might expect a purely tax-policy-related "human capital" rationale to justify. That is because the language excludes from taxation not only those damages that aim to substitute for a victim's physical or personal well-being—personal assets that the Government does not tax and would not have taxed had the victim not lost them. It also excludes from taxation those damages that substitute, say, for lost wages, which would have been taxed had the victim earned them. To that extent, the provision can make the compensated taxpayer better off from a tax perspective than had the personal injury not taken place.

But to say this is not to support cutting the statute totally free from its original moorings in victim loss. The statute's failure to separate those compensatory elements of damages (or accident insurance proceeds) one from the other does not change its original focus upon damages that restore a loss, that seek to make a victim whole, with a tax-equality objective providing an important part of, even if not the entirety of, the statute's rationale. All this is to say that the Government's interpretation of the current provision (the wording of which has not changed significantly from the original) is more consistent than is petitioners' with the statute's original focus.

Finally, we have asked *why* Congress might have wanted the exclusion to have covered these punitive damages, and we have found no very good answer. Those damages are not a substitute for any normally untaxed personal (or financial) quality, good, or "asset." They do not compensate for any kind of loss. The statute's language does not require, or strongly suggest, their exclusion from income. And we can find no evidence that congressional generosity or concern for administrative convenience stretched beyond the bounds of an interpretation that would distinguish compensatory from noncompensatory damages.

Of course, as we have just said, from the perspective of tax policy one might argue that noncompensatory punitive damages and, for example, compensatory lost wages are much the same thing. That is, in both instances, exclusion from gross income provides the taxpayer with a windfall. This circumstance alone, however, does not argue strongly for an interpretation that covers punitive damages, for coverage of compensatory damages has both language and history in its favor to a degree that coverage of noncompensatory punitive damages does not. Moreover, this policy argument assumes that coverage of lost wages is something of an anomaly; if so, that circumstance would not justify the extension of the anomaly or the creation of another. See Wolfman, Current Issues of Federal Tax Policy, 16 U. Ark. Little Rock L. J. 543, 549–550 (1994) ("[T]o build upon" what is, from a tax policy perspective, the less easily explained portion "of the otherwise rational exemption for personal injury," simply "does not make sense").

Petitioners make three sorts of arguments to the contrary. First, they emphasize certain words or phrases in the original, or current, provision that work in their favor. For example, they stress the word "any" in the phrase "any damages." And they note that in both original and current versions Congress referred to certain amounts of money received (from workmen's compensation, for example) as "amounts received . . . as compensation," while here they refer only to "damages received" without adding the limiting phrase "as compensation." 26 U.S.C. §104(a); Revenue Act of 1918, §213(b)(6), 40 Stat. 1066. They add that in the original version, the words "on account of personal injuries" might have referred to, and modified, the kind of lawsuit, not the kind of damages. And they find support for this view in the second sentence of the Treasury Regulation first adopted in 1958 which says:

> "The term 'damages received (whether by suit or agreement' means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." 26 CFR §1.104–1(c) (1996).

These arguments, however, show only that one can reasonably read the statute's language in different ways—the very assumption upon which our analysis rests. They do not overcome our interpretation of the provision in *Schleier,* nor do they change the provision's history. The help that the Treasury Regulation's second sentence gives the petitioners is offset by its *first* sentence, which says that the exclusion applies to damages received "on account of personal injuries or sickness," and which we have held sets forth an independent requirement. *Schleier,* 515 U.S., at ____ (slip op., at 14). See Appendix, *infra,* at 16.

Second, petitioners argue that to some extent the purposes that might have led Congress to exclude, say, lost wages from income would also have led Congress to exclude punitive damages, for doing so is both generous to victims and avoids such administrative problems as separating punitive from compensatory portions of a global settlement or determining the extent to which a punitive damages award is itself intended to compensate.

Our problem with these arguments is one of degree. Tax generosity presumably has its limits. The administrative problem of distinguishing punitive from compensatory elements is likely to be less serious than, say, distinguishing among the compensatory elements of a settlement (which difficulty might account for the statute's

treatment of, say, lost wages). Cf. *supra* p. 8. And, of course, the problem of identifying the elements of an ostensibly punitive award does not exist where, as here, relevant state law makes clear that the damages at issue are not at all compensatory, but entirely punitive. *Brewer* v. *Home-Stake Production Co.,* 200 Kan. 96, 100, 434 P. 2d 828, 831 (1967) ("[E]xemplary damages are not regarded as compensatory in any degree"); accord, *Smith* v. *Printup,* 254 Kan. 315, 866 P. 2d 985 (1993); *Folks* v. *Kansas Power & Light Co.,* 243 Kan. 57, 755 P. 2d 1319 (1988); *Nordstrom* v. *Miller,* 227 Kan. 59, 605 P. 2d 545 (1980).

Third, petitioners rely upon a later enacted law. In 1989, Congress amended the law so that it now specifically says the personal injury exclusion from gross income

> "shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." 26 U.S.C. §104(a) (1994).

Why, petitioners ask, would Congress have enacted this amendment removing punitive damages (in nonphysical injury cases) unless Congress believed that, in the amendment's absence, punitive damages did fall within the provision's coverage?

The short answer to this question is that Congress might simply have thought that the then-current law about the provision's treatment of punitive damages—in cases of physical and nonphysical injuries—was unclear, that it wanted to clarify the matter in respect to nonphysical injuries, but it wanted to leave the law where it found it in respect to physical injuries. The fact that the law was indeed uncertain at the time supports this view. Compare Rev. Rul. 84–108, 1984–2 Cum. Bull. 32, with *e.g., Roemer* v. *Commissioner,* 716 F. 2d 693 (CA9 1983); *Miller* v. *Commissioner,* 93 T. C. 330 (1989), rev'd 914 F. 2d 586 (CA4 1990).

The 1989 amendment's legislative history, insofar as relevant, offers further support. The amendment grew out of the Senate's refusal to agree to a House bill that would have made all damages in nonphysical personal injury cases taxable. The Senate was willing to specify only that the Government could tax punitive damages in such cases. Compare H. R. Rep. No. 101–247, p. 1355 (1989), with H. R. Conf. Rep. No. 101–386, pp. 622–623 (1989). Congress' primary focus, in other words, was upon what to do about nonphysical personal injuries, not upon the provision's coverage of punitive damages under pre-existing law.

We add that, in any event, the view of a later Congress cannot control the interpretation of an earlier enacted statute. *United States* v. *Price,* 361 U.S. 304 (1960); *Higgins* v. *Smith,* 308 U.S. 473 (1940). But cf. *Burke,* 504 U.S., at 235, n. 6 (including a passing reference to the 1989 amendment, in dicta, as support for a view somewhat like that of petitioners).

(Although neither party has argued that it is relevant, we note in passing that §1605 of the Small Business Job Protection Act of 1996, Pub. L. 104–188, 110 Stat. 1838, explicitly excepts most punitive damages from the exclusion provided by §104(a)(2). Because it is of prospective application, the section does not apply here. The Conference Report on the new law says that "[n]o inference is intended" as to the proper interpretation of section 104(a)(2) prior to amendment. H. R. Conf. Rep. No. 104–737, p. 301 (1996).)

The upshot is that we do not find petitioners' arguments sufficiently persuasive. And, for the reasons set out above, *supra,* at 3–8, we agree with the Government's interpretation of the statute.

III

Petitioners have raised two further issues, specific to the procedural posture of this litigation. First, the O'Gilvie children point out that the Government had initially accepted their claim for a refund and wrote those checks on July 6, 1990. The Government later changed its mind and, on July 9, 1992, two years plus three days later, filed suit against them seeking the return of a refund erroneously made. 26 U.S.C. §7405(b) (authorizing a "civil action brought in the name of the United States" to recover any "portion of a tax . . . which has been erroneously refunded"). They add that the relevant statute of limitations specifies that recovery of the refund "shall be allowed only if such suit is begun within 2 years after the making of such refund." §6532(b).

The children concede that they *received* the refund checks on July 9, 1990, and they agree that if the limitation period runs from the date of receipt—if, as the Government argues, that is the date of the "making of" the refund—the Government's suit was timely. But the children say that the refund was made on, and the limitations period runs from, the date the Government *mailed* the checks (presumably July 6, 7, or 8) in which case the Government brought this suit one or two or three days too late.

In our view, the Government is correct in its claim that its lawsuit was timely. The language of the statute admits of both interpretations. But the law ordinarily provides that an action to recover mistaken payments of money "accrues upon the receipt of payment," *New Bedford* v. *Lloyd Investment Associates, Inc.,* 363 Mass. 112, 119, 292 N. E. 2d 688, 692 (1973); accord *Sizemore* v. *E. T. Barwick Industries, Inc.,* 225 Tenn. 226, 233, 465 S. W. 2d 873, 876 (1971) ("'the time of making the . . . payment . . . was the date of actual receipt'"), unless, as in some States and in some cases, it accrues upon the still later date of the mistake's discovery, see Allen & Lamkin, When Statute of Limitations Begins to Run Against Action to Recover Money Paid By Mistake, 79 A.L.R. 3d 754, 766–769 (1977). We are not aware of any good reason why Congress would have intended a different result where the nature of the claim is so similar to a traditional action for money paid by mistake—an action the roots of which can be found in the old common-law claim of "assumpsit" or "money had and received." *New Bedford, supra,* at 118. The lower courts and commentators have reached a similar conclusion. *United States* v. *Carter,* 906 F. 2d 1375 (CA9 1990); *Akers* v. *United States,* 541 F. Supp. 65, 67 (M. D. Tenn. 1981); *United States* v. *Woodmansee,* 388 F. Supp. 36, 46 (N. D. Cal. 1975), rev'd on other grounds, 578 F. 2d 1302 (CA9 1978); 14 J. Mertens Law of Federal Income Taxation §54A.69 (1995); Kafka & Cavanagh, Litigation of Federal Civil Tax Controversies §20.03, p. 20–15 (2d ed. 1995). That conclusion is consistent with dicta in an earlier case from this Court, *United States* v. *Wurts,* 303 U.S. 414, 417–418 (1938), as well as with this Court's normal practice of construing ambiguous statutes of limitations in Government action in the Government's favor. *E.g., Badaracco* v. *Commissioner,* 464 U.S. 386, 391 (1984).

We concede the children's argument that a "date of mailing" interpretation produces marginally greater certainty, for such a rule normally would refer the court to the postmark to establish the date. But there is no indication that a "date of receipt" rule has proved difficult to administer in ordinary state or common-law actions for money paid erroneously. The date the check clears, after all, sets an outer bound.

Second, Kelly O'Gilvie says that the Court of Appeals should not have considered the Government's original appeal from the District Court's judgment in his favor because, in his view, the Government filed its notice of appeal a few days too late. The Court of Appeals describes the circumstances underlying this case-specific issue in its opinion. We agree with its determination of the matter for the reasons it has there set forth.

The judgment of the Court of Appeals is

affirmed.

APPENDIX
TO OPINION OF THE COURT

Section 104(a), in 1988, read as follows:

"Compensation for injuries or sickness

"(a) In general.—Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

"(1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;

"(2) the amount of any damages received (whether by suite or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness;

"(3) amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);

"(4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980; and

"(5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a violent attack which the Secretary of State determines to be a terrorist attack and which occurred while such individual was an employee of the United States engaged in the performance of hisofficial duties outside the United States." 26 U.S.C. §104 (1988 ed.).

In 1989, §104(a) was amended, adding, among other things, the following language:

"Paragraph (2) shall not apply to any punitive damages in connection with a case not involving physical injury or physical sickness." 26 U. S. C. §104(a) (1994).

Treasury Regulation §1.104-1(c) provides:

"Section 104(a)(2) excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness. The term 'damages received (whether by suit or agreement)' means an amount received (other than workmen's compensation) through prosecution of a legal suit or action based upon tort or tort type rights, or through a settlement agreement entered into in lieu of such prosecution." 26 CFR §1.104-1(c) (1996).

JUSTICE SCALIA, with whom JUSTICE O'CONNOR and JUSTICE THOMAS join, dissenting.

Section 104(a)(2), as it stood at the time relevant to these cases, provided an exclusion from income for "any damages received . . . on account of personal injuries or sickness." 26 U.S.C. §104(a)(2) (1988 ed.). The Court is of the view that this phrase, in isolation, is just as susceptible of a meaning that includes only compensatory damages as it is of a broader meaning that includes punitive damages as well. *Ante,* at 3–4. I do not agree. The Court greatly understates the connection between an award of punitive damages and the personal injury complained of, describing it as nothing more than "but for" causality, *ante,* at 3. It seems to me that the personal injury is as proximate a cause of the punitive damages as it is of the compensatory damages; in both cases it is the *reason* the damages are awarded. That is *why* punitive damages are called *damages.* To be sure, punitive damages require intentional, blameworthy conduct, which can be said to be a coequal reason they are awarded. But negligent (or intentional) conduct occupies the same role of coequal causality with regard to compensatory damages. Both types of damages are "received on account of" the personal injury.

The nub of the matter, it seems to me, is this: If one were to be asked, by a lawyer from another legal system, "What damages can be received on account of personal injuries in the United States?" surely the correct answer would be "Compensatory damages and punitive damages —the former to compensate for the inflicting of the personal injuries, and the latter to punish for the inflicting of them." If, as the Court asserts, the phrase "damages received on account of personal injuries" *can* be used to refer only to the former category, that is only because people sometimes *can* be imprecise. The notion that Congress carefully and precisely used the phrase "damages received on account of personal injuries" to segregate out *compensatory* damages seems to me entirely fanciful. That is neither the exact nor the ordinary meaning of the phrase, and hence not the one that the statute should be understood to intend.

What I think to be the fair meaning of the phrase in isolation becomes even clearer when the phrase is considered in its statutory context. The Court proceeds too quickly from its erroneous premise of ambiguity to analysis of the history and policy behind §104(a)(2). *Ante,* at 5–8. Ambiguity in isolation, even if it existed, would not end the textual inquiry. Statutory construction, we have said, is a "holistic endeavor." *United Sav. Assn. of Tex.* v. *Timbers of Inwood Forest Associates, Ltd.,* 484 U.S. 365, 371 (1988). "A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme." *Ibid.*

Section 104(a)(2) appears immediately after another provision, §104(a)(1), which parallels §104(a)(2) in several respects

but does not use the critical phrase "on account of":

> "(a) [G]ross income does not include—
> "(1) amounts received under workmen's compensation acts *as compensation for* personal injuries or sickness;
> "(2) the amount of any damages received . . . *on account of* personal injuries or sickness." (Emphasis added.)

Although §104(a)(1) excludes amounts received "as compensation for" personal injuries or sickness, while §104(a)(2) excludes amounts received "on account of" personal injuries or sickness, the Court reads the two phrases to mean precisely the same thing. That is not sound textual interpretation. "[W]hen the legislature uses certain language in one part of the statute and different language in another, the court assumes different meanings were intended." 2A N. Singer, Sutherland on Statutory Construction §46.07 (5th ed. 1992 and Supp. 1996). See, *e.g., Russello* v. *United States,* 464 U.S. 16, 23 (1983). This principle of construction has its limits, of course: Use of different terminology in differing contexts might have little significance. But here the contrasting phrases appear in adjoining provisions that address precisely the same subject matter and that even have identical grammatical structure.

The contrast between the two usages is even more striking in the original statute that enacted them. The Revenue Act of 1918 combined subsections (a)(1) and (a)(2) of §104, together with (a)(3) (which provides an exclusion from income for amounts received through accident or health insurance for personal injuries or sickness), into a single subsection, which provided:

> "'Gross income' . . . [d]oes not include . . .:
> "(6) Amounts received, through accident or health insurance or under workmen's compensation acts, *as compensation for* personal injuries or sickness, plus the amount of any damages received . . . *on account of* such injuries or sickness." §213(b)(6) of the Revenue Act of 1918, 40 Stat. 1065–66 (emphasis added).

The contrast between the first exclusion and the second could not be more clear. Had Congress intended the latter provision to cover only damages received "as compensation for" personal injuries or sickness, it could have written "amounts received, through accident or health insurance, under workmen's compensation acts, or in damages, as compensation for personal injuries or sickness." Instead, it tacked on an additional phrase "plus the amount of, etc." with no apparent purpose except to make clear that not *only* compensatory damages were covered by the exclusion.

The Court maintains, however, that the Government's reading of §104(a)(2) is "more faithful to [its] history." *Ante,* at 5. The "history" to which the Court refers is not statutory history of the sort just discussed—prior enactments approved by earlier Congresses and revised or amended by later ones to produce the current text. Indeed, it is not "history" from within even a small portion of Congress, since the House Committee Report the Court cites, standing by itself, is uninformative, saying only that "[u]nder the present law it is doubtful whether . . . damages received on account of [personal] injuries or sickness are required to be included in gross income." H. R. Rep. No. 767, 65th Cong., 2d Sess., 9–10 (1918). The Court makes this snippet of legislative history relevant by citing as pertinent an antecedent Treasury Department decision, which concludes on the basis of recent judicial decisions that amounts received from prosecution or compromise of a personal-injury suit are not taxable *because they are a return of capital. Ante,* at 5–6 (citing T. D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918)).

One might expect the Court to conclude from this that the Members of Congress (on the unrealistic assumption that they knew about the Executive-Branch opinion) meant the statutory language to cover only return of capital, the source of the "doubt" to which the Committee Report referred. But of course the Court cannot draw that logical conclusion, since even if it is applied only to compensatory damages the statute obviously and undeniably covers *more* than mere return of "human capital," namely, reimbursement for lost income, which would be a large proportion (indeed perhaps the majority) of any damages award. The Court concedes this is so, but asserts that this inconsistency is not enough "to support cutting the statute totally free from its original moorings," *ante,* at 7, by which I assume it means the Treasury Decision, however erroneous it might have been as to the "capital" nature of compensatory damages. But the Treasury Decision was no more explicitly limited to compensatory damages than is the statute before us. It exempted from taxation "an amount received by an individual as the result of a suit or compromise for personal injuries." T. D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918). The Court's entire thesis of taxability rests upon the proposition that this Treasury Decision, which overlooked the obvious fact that "an amount received . . . as the result of a suit or compromise for personal injuries" almost always includes compensation for lost future income, did *not* overlook the obvious fact that such an amount sometimes includes "smart-money."

So, to trace the Court's reasoning: The statute must exclude punitive damages because the Committee Report must have had in mind a 1918 Treasury Decision, whose text no more supports exclusion of punitive damages than does the text of the statute itself, but which must have *meant* to exclude punitive damages since it was based on the "return-of-capital" theory, though, inconsistently with that theory, it did *not* exclude the much more common category of compensation for lost income. Congress supposedly knew all of this, and a reasonably diligent lawyer could figure it out by mistrusting the inclusive language of the statute, consulting the Committee Report, surmising that the Treasury Decision of 1918 underlay that Report, mistrusting the inclusive language of the Treasury Decision, and discerning that Treasury *could* have overlooked lost-income compensatories, but could *not* have overlooked punitives. I think not. The sure and proper guide, it seems to me, is the language of the statute, inclusive by nature and doubly inclusive by contrast with surrounding provisions.

The Court poses the question, *ante,* at 7, *"why* Congress might have wanted the exclusion [in §104(a)(2)] to have covered . . . punitive damages." If an answer is needed (and the text being as clear as it is, I think it is not), surely it suffices to surmise that Congress was following the Treasury Decision, which had inadvertently embraced punitive damages just as

it had inadvertently embraced future-income compensatory damages. Or if some reason free of human error must be found, I see nothing wrong with what the Court itself suggests but rejects out of hand: Excluding punitive as well as compensatory damages from gross income "avoids such administrative problems as separating punitive from compensatory portions of a global settlement." *Ante,* at 9. How substantial that particular problem is is suggested by the statistics which show that 73 percent of tort cases in state court are disposed of by settlement, and between 92 and 99 percent of tort cases in federal court are disposed of by either settlement or some other means (such as summary judgment) prior to trial. See B. Ostrom & N. Kauder, Examining the Work of State Courts, 1994, p. 34 (1996); Administrative Office of the United States, L. Mecham, Judicial Business of the United States Courts: 1995 Report of the Director 162–164. What is at issue, of course, is not just imposing on the parties the necessity of allocating the settlement between compensatory and punitive damages (with the concomitant suggestion of intentional wrongdoing that any allocation to punitive damages entails), but also imposing on the Internal Revenue Service the necessity of reviewing that allocation, since there would always be strong incentive to inflate the tax-free compensatory portion. The Court's only response to the suggestion that this is an adequate reason (if one is required) for including punitive damages in the exemption is that "[t]he administrative problem of distinguishing punitive from compensatory elements is likely to be less serious than, say, distinguishing among the compensatory elements of a settlement." *Ante,* at 9–10. Perhaps so; and it may also be more simple than splitting the atom; but that in no way refutes the point that it is complicated *enough* to explain the inclusion of punitive damages in an exemption that has already abandoned the purity of a "return-of-capital" rationale.

The remaining argument offered by the Court is that our decision in *Commissioner* v. *Schleier,* 515 U. S. ____ (1995), came "close to resolving"—in the Government's favor—the question whether §104(a)(2) permits the exclusion of punitive damages. *Ante,* at 4. I disagree. In *Schleier* we were faced with the question whether backpay and liquidated damages under the Age Discrimination in Employment Act of 1967 (ADEA) were "damages received . . . on account of personal injuries or sickness" for purposes of §104(a)(2)'s exclusion. As the dissent accurately observed, 515 U. S., at ____ (slip op., at 6) (opinion of O'CONNOR, J.), "the key to the Court's analysis" was the determination that an ADEA cause of action did not necessarily entail "personal injury or sickness," so that the damages awarded for that cause of action could hardly be awarded "on account of personal injuries or sickness." See *id.,* at ____ (slip op., at 7). In the case at hand, we said, "respondent's unlawful termination may have caused some psychological or 'personal' injury comparable to the intangible pain and suffering caused by an automobile accident," but "it is clear that no part of respondent's recovery of back wages is attributable to that injury." *Ibid.* The respondent countered that at least "the liquidated damages portion of his settlement" could be linked to that psychological injury. *Ibid.* And it was in response to *that* argument that we made the statement which the Court seek. to press into service for today's opinion. ADEA liquidated damages, we said, were punitive in nature, rather than compensatory. *Id.,* at ____, and n. 5 (slip op., at 8–9, and n. 5).

The Court recites this statement as though the point of it was that punitive damages could not be received "on account of" personal injuries, whereas in fact the point was quite different: Since the damages were punishment for the conduct that gave rise to the (non-personal-injury) cause of action, they could not be "linked to" the incidental psychological injury. In the present cases, of course, there is no question that a personal injury occurred and that this personal injury is what entitled petitioners to compensatory and punitive damages. We neither decided nor intimated in *Schleier* whether punitive damages that are indisputably "linked to" personal injuries or sickness are received "on account of" such injuries or sickness. Indeed, it would have been odd for us to resolve that question (or even come "close to resolving" it) without any discussion of the numerous considerations of text, history and policy highlighted by today's opinion. If one were to search our opinions for a dictum bearing upon the present issue, much closer is the statement in *United States* v. *Burke,* 504 U.S. 229 (1992), that a statute confers "tort or tort type rights" (qualifying a plaintiff's recovery for the §104(a)(2) exemption) if it entitles the plaintiff to "a jury trial at which 'both equitable and legal relief, including compensatory and, under certain circumstances, punitive damages' may be awarded." *Id.,* at 240 (quoting *Johnson* v. *Railway Express Agency, Inc.,* 421 U.S. 454, 460 (1975)).

But all of this is really by the way. Because the statutory text unambiguously covers punitive damages that are awarded on account of personal injuries, I conclude that petitioners were entitled to deduct the amounts at issue here. This makes it unnecessary for me to reach the question, discussed *ante,* at 12–13, whether the government's refund action against the O'Gilvie children was commenced within the two-year period specified by 26 U.S.C. §6532(b). I note, however, that the Court's resolution of these cases also does not demand that this issue be addressed, except to the extent of rejecting the proposition that the statutory period begins to run with the mailing of a refund check. So long as that is not the trigger, there is no need to decide whether the proper trigger is receipt of the check or some later event, such as the check's clearance.

For the reasons stated, I respectfully dissent from the judgment of the Court.

Section 125.—Cafeteria Plans

26 CFR 1.125–4T: Permitted election changes (temporary).

T.D. 8738

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1
Tax Treatment of Cafeteria Plans

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Temporary regulations

SUMMARY: This document contains temporary regulations that clarify the cir-

cumstances under which an employer may permit a cafeteria plan participant to revoke an existing election and make a new election during a period of coverage. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the REG–243025–96, page 626.

DATES: These regulations are effective on December 31, 1998.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 125. These temporary regulations provide guidance relating to the circumstances under which a cafeteria plan participant may revoke an existing election and make a new election during a period of coverage.

Explanation of Provisions

A "cafeteria plan" under section 125 allows an employee to choose between cash and certain nontaxable benefits, such as accident or health coverage. Section 125 generally permits the employee to choose the nontaxable benefit (rather than the available cash) without the employee having to include the available cash in gross income. The temporary regulations:

- Permit a cafeteria plan to allow an employee, during a plan year, to change his or her health coverage election to conform with the new special enrollment rights provided under the Health Insurance Portability and Accountability Act of 1996 (HIPAA), and
- Permit a cafeteria plan to allow a change in coverage election for a variety of other changes in status.

These regulations are designed to provide clear, administrable guidelines for determining when changes can be made in cafeteria plan elections during a plan year.

These regulations are effective for plan years beginning after December 31, 1998. However, taxpayers may rely on the guidance in the temporary regulations (or on the existing proposed regulations) for prior periods.

Summary

Section 125 generally provides that an employee in a cafeteria plan will not have an amount included in gross income solely because the employee may choose among two or more benefits consisting of cash and "qualified benefits." A qualified benefit generally is any benefit that is excludable from gross income because of an express provision of the Code, including coverage under an employer-provided accident or health plan under sections 105 and 106, group-term life insurance under section 79, elective contributions under a qualified cash or deferred arrangement within the meaning of section 401(k), dependent care assistance under section 129, and adoption assistance under section 137.[1] Under §§1.125–1 and 1.125–2 of the existing proposed regulations,[2] an employee is permitted to make an election between cash and qualified benefits before the beginning of the period of coverage (which generally is the plan year of the cafeteria plan); changes in the election during the plan year are permitted only in limited circumstances.

The temporary regulations clarify the circumstances under which a cafeteria plan may permit an employee to change his or her cafeteria plan election with respect to accident or health coverage or group-term life insurance coverage during the plan year. Proposed regulations are also being published that cross-reference these temporary regulations, and that replace the change in family status provisions in Q&A–6 of proposed §1.125–2 with respect to accident or health plans and group-term life insurance.

HIPAA Special Enrollment Rules.

The temporary regulations conform the cafeteria plan rules to the new special enrollment rights provided under HIPAA (which generally require group health plans to permit individuals to be enrolled for coverage following the loss of other health coverage, or if a person becomes the spouse or dependent of an employee through birth, marriage, adoption, or placement for adoption).[3] Under the regulations, if an employee has a right to enroll in an employer's group health plan or to add coverage for a family member under HIPAA, the employee can make a conforming election under the cafeteria plan. This allows required contributions for such health coverage to be paid on a pre-tax basis.

Changes in Status.

The temporary regulations include rules for other events, called "changes in status," under which a cafeteria plan may allow an employee to change his or her election during the plan year. The events that constitute changes in status under the regulations are changes in legal marital status, number of dependents, employment status, work schedule, and residence or worksite, and cases where the dependent satisfies or ceases to satisfy the requirements for unmarried dependents.

The regulations permit a cafeteria plan to allow a change of election during the plan year if a change in status occurs that affects eligibility for coverage and the election change corresponds with the effect on eligibility. For example, if under the terms of an accident or health plan a child of an employee loses eligibility for coverage upon graduation from college, the cafeteria plan may allow the employee to cease payment for the child's coverage when the child graduates and coverage ceases.

Certain of these changes in status (marriage, birth, adoption, and placement for adoption) overlap with the special enrollment events under HIPAA. The regulations include examples that clarify the relationship between HIPAA's special enrollment rights and these change in status rules. In addition, if a change in status occurs that entitles an employee or family member to "COBRA" continuation coverage (or coverage under a similar State program) with respect to the employer's plan, the regulations permit payments for the continuation coverage to be made on a pre-tax basis under a cafeteria plan.

[1]The following are not qualified benefits: products advertised, marketed, or offered as long-term care insurance; medical savings accounts under section 106(b); qualified scholarships under section 117; educational assistance programs under section 127; and fringe benefits under section 132.

[2]Published as proposed rules at 49 FR 19321 (May 7, 1984) and 54 FR 9460 (March 7, 1989), respectively.

[3]See section 9801(f). Similar provisions are set forth in section 701(f) of the Employee Retirement Income Security Act of 1974 (ERISA), and section 2701(f) of the Public Health Service Act. Regulations under these provisions are set forth in Treas. Reg. §54.9801–6T; 29 C.F.R. §2590.701–6; and 45 C.F.R. §146.117.

Other Events.

The regulations allow a corresponding cafeteria plan change if a plan receives a court order, such as a qualified medical child support order under section 609 of ERISA. In addition, if an employee, spouse, or dependent becomes entitled to Medicare or Medicaid, a cafeteria plan can permit a corresponding election change.

Elective Contributions Under a Qualified Cash or Deferred Arrangement.

The temporary regulations, in provisions similar to those of the existing proposed regulations (proposed §1.125–2(f)), make clear that the rules of section 401(k) and (m), rather than the rules in these temporary regulations (which apply to other qualified benefits), govern changes in elections under a qualified cash or deferred arrangement (within the meaning of section 401(k)) or with respect to employee after-tax contributions subject to section 401(m).

Scope of Temporary Regulations and Reliance on Proposed Regulations.

The temporary regulations do not address certain provisions concerning cafeteria plan election changes that are included in the existing proposed regulations. Guidance on these provisions is reserved at paragraphs (f)–(i) of the temporary regulations.

For example, future guidance under the significant cost change provision (reserved at paragraph (g) of the temporary regulations), rather than the change in status rules, would determine whether an employee who switches from full-time to part-time employment and who remains eligible under the employer's health plan could make an election change if the part-time employee is required to pay significantly higher amounts for the coverage. The temporary regulations also reserve guidance with respect to provisions set forth in the existing proposed regulations that permit an election change in the case of a significant change in coverage (which includes a significant change in the health coverage of the employee or spouse attributable to the spouse's employment[4]). Other matters not addressed in the temporary regulations include the application of the cafeteria plan election change rules to qualified benefits other than accident or health coverage and group-term life insurance coverage (for example, dependent care assistance programs), and special rules concerning changes in elections by employees taking leave under the Family and Medical Leave Act of 1993 (Public Law 103-3)[5]. Pending further guidance, taxpayers can continue to rely on the existing proposed regulations[6] concerning these and other matters not addressed in the temporary regulations.[7]

The temporary regulations are effective for plan years beginning after December 31, 1998. Prior to that date, however, taxpayers can rely on the guidance provided in the temporary regulations (as well as on the guidance provided in the existing proposed regulations that relates to matters addressed in the temporary regulations) in order to comply with the provisions of section 125.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. §1.125–4T is added to read as follows:

§1.125–4T Permitted election changes (temporary).

(a) *Election changes.* A cafeteria plan may permit an employee to revoke an election during a period of coverage and to make a new election only as provided in paragraphs (b) through (i) of this section. See paragraph (j) of this section for special provisions relating to qualified cash or deferred arrangements.

(b) *Special enrollment rights.* A cafeteria plan may permit an employee to revoke an election for accident or health coverage during a period of coverage and make a new election that corresponds with the special enrollment rights provided in section 9801(f), whether or not the change in election is permitted under paragraph (c) of this section.

(c) *Changes in status for accident or health coverage and group-term life.* (1) *In general.* A cafeteria plan may permit an employee to revoke an election for accident or health coverage or group-term life insurance coverage during a period of coverage and make a new election for the remaining portion of the period if, under the facts and circumstances—

(i) A change in status occurs; and

(ii) The election change satisfies the consistency requirement in paragraph (c)(3) of this section (consistency rule for accident or health coverage) or (c)(4) of this section (consistency rule for group-term life insurance coverage).

(2) *Change in status events.* The following events are changes in status for purposes of this paragraph (c):

(i) *Legal marital status.* Events that change an employee's legal marital status, including marriage, death of spouse, divorce, legal separation, or annulment;

(ii) *Number of dependents.* Events that change an employee's number of dependents (as defined in section 152), including birth, adoption, placement for adoption (as defined in regulations under section 9801), or death of a dependent;

(iii) *Employment status.* A termination or commencement of employment by the employee, spouse, or dependent;

[4]See the second-to-last sentence in Q&A-6(c) of proposed §1.125–2.

[5]See §1.125–3, published as a proposed rule at 60 FR 66229 (December 21, 1995).

[6]See also §1.125–2T, published at 51 FR 4312 (January 29, 1986), which describes benefits that may be offered under a cafeteria plan.

[7]See the preambles to proposed §§1.125–1 and 1.125–2 and Q&A-8 of proposed §1.125–3.

(iv) *Work schedule.* A reduction or increase in hours of employment by the employee, spouse, or dependent, including a switch between part-time and full-time, a strike or lockout, or commencement or return from an unpaid leave of absence;

(v) *Dependent satisfies or ceases to satisfy the requirements for unmarried dependents.* An event that causes an employee's dependent to satisfy or cease to satisfy the requirements for coverage due to attainment of age, student status, or any similar circumstance as provided in the accident or health plan under which the employee receives coverage; and

(vi) *Residence or Worksite.* A change in the place of residence or work of the employee, spouse, or dependent.

(3) *Consistency rule for accident or health coverage.* (i) *General rule.* (A) An employee s revocation of a cafeteria plan election during a period of coverage and new election for the remaining portion of the period (referred to below as an "election change") is consistent with a change in status if, and only if —

(1) The change in status results in the employee, spouse, or dependent gaining or losing eligibility for accident or health coverage under either the cafeteria plan or an accident or health plan of the spouse's or dependent's employer; and

(2) The election change corresponds with that gain or loss of coverage.

(B) A change in status results in an employee, spouse, or dependent gaining (or losing) eligibility for coverage under a plan only if the individual becomes eligible (or ineligible) to participate in the plan. A cafeteria plan may treat an individual as gaining (or losing) eligibility for coverage if the individual becomes eligible (or ineligible) for a particular benefit package option under a plan (e.g., a change in status results in an individual becoming eligible for a managed care option or an indemnity option). If, as a result of a change in status, the individual gains eligibility for elective coverage under a plan of the spouse's or dependent's employer, the consistency rule of this paragraph (c)(3)(i) is satisfied only if the individual elects the coverage under the spouse's or dependent's employer. See the Examples in paragraph (k) of this section for illustrations of the consistency rule.

(ii) *Exception for COBRA.* Notwithstanding paragraph (c)(3)(i) of this section, if the employee, spouse, or dependent becomes eligible for continuation coverage under the employer's group health plan as provided in section 4980B or any similar State law, the employee may elect to increase payments under the employer's cafeteria plan in order to pay for the continuation coverage.

(4) *Consistency rule for group-term life insurance coverage.* Except as provided in this paragraph (c)(4), the provisions of paragraph (c)(3)(i) of this section apply to group-term life insurance coverage. In the case of marriage, birth, adoption, or placement for adoption, a cafeteria plan can allow an election change to increase (but not to reduce) the amount of the employee's life insurance coverage. In the case of divorce, legal separation, annulment, or death of a spouse or dependent, a cafeteria plan may allow an election change to reduce (but not to increase) the amount of the employee s life insurance coverage.

(d) *Judgment, decree, or order.* This paragraph (d) applies to a judgment, decree, or order ("order") resulting from a divorce, legal separation, annulment, or change in legal custody (including a qualified medical child support order defined in section 609 of the Employee Retirement Income Security Act of 1974) that requires accident or health coverage for an employee's child. Notwithstanding the provisions of paragraph (c) of this section, a cafeteria plan may—

(1) Change the employee s election to provide coverage for the child if the order requires coverage under the employee's plan; or

(2) Permit the employee to make an election change to cancel coverage for the child if the order requires the former spouse to provide coverage.

(e) *Entitlement to Medicare or Medicaid.* If an employee, spouse, or dependent who is enrolled in an accident or health plan of the employer becomes entitled to coverage (i.e., enrolled) under Part A or Part B of Title XVIII of the Social Security Act (Medicare) or Title XIX of the Social Security Act (Medicaid), other than coverage consisting solely of benefits under section 1928 of the Social Security Act (the program for distribution of pediatric vaccines), a cafeteria plan may permit the employee to make an election change to cancel coverage of that employee, spouse or dependent under the accident or health plan.

(f) *Changes in status for other qualified benefits.* [Reserved].

(g) *Significant coverage or cost changes.* [Reserved].

(1) *Employer's plan.* [Reserved].

(2) *Plan of spouse's or dependent's employer.* [Reserved].

(h) *Cessation of required contributions.* [Reserved].

(i) *Special requirements concerning the Family and Medical Leave Act.* [Reserved].

(j) *Elective contributions under a qualified cash or deferred arrangement.* The provisions of this section do not apply with respect to elective contributions under a qualified cash or deferred arrangement (within the meaning of section 401(k)) or employee contributions subject to section 401(m). Thus, a cafeteria plan may permit an employee to modify or revoke elections in accordance with sections 401(k) and 401(m) and the regulations thereunder.

(k) *Examples.* The following examples illustrate the rules of this section. In each case involving an accident or health plan, assume that the plan is subject to section 9801(f) (providing for special enrollment rights under certain group health plans).

Example 1. (i) Employer M provides health coverage for its employees under which employees may elect either employee-only coverage or family coverage. M also maintains a calendar year cafeteria plan under which qualified benefits, including health coverage, are funded through salary reduction. M's employee, A, elects employee-only health coverage before the beginning of the calendar year. During the year, A adopts a child, C. Within 30 days thereafter, A wants to revoke A's election for employee-only health coverage and obtain family health coverage, as of the date of C's adoption. A satisfies the conditions for special enrollment of an employee with a new dependent under section 9801(f)(2), so that A may enroll in family coverage under M's accident or health plan in order to provide coverage for C, effective as of the date of C's adoption.

(ii) In this *Example 1,* M's cafeteria plan may permit A to change the employee s salary reduction election to family coverage for salary not yet currently available. The increased salary reduction could reflect the cost of family coverage from the date of adoption. (The adoption of C is also a change in status, and the election of family coverage is consistent with that change in status. Thus, under the change in status provisions of paragraph (c) of this section, M's cafeteria plan could permit A to elect family coverage prospectively in order to cover C for the remaining portion of the coverage period.)

Example 2. (i) The employer plans and permissible coverage are the same as in *Example 1.* Before the beginning of the calendar year, Employee A elects employee-only health coverage under M's cafeteria plan. A marries B during the plan year. B's employer, N, offers health coverage to N's employees, and, prior to the marriage, B had elected employee-only coverage. A wants to revoke the election for employee-only coverage, and is considering electing family health coverage under M's plan or obtaining family health coverage under N's plan.

(ii) In this *Example 2,* A's marriage to B is a change in status. Two possible election changes by A would be consistent with the change in status: to cover A and B by electing family health coverage under M's plan, or to cancel coverage under M's plan (with B electing family health coverage under N's plan in order to cover A and B). Thus, M's cafeteria plan may permit A to make either change in election. (M's cafeteria plan could also permit A to change A's salary reduction election to reflect the change to family coverage under M's group health plan in accordance with paragraph (b) of this section because the marriage would also create special enrollment rights under section 9801(f), pursuant to which an election of family coverage under M's plan would be required to be effective no later than the first day of the first calendar month beginning after the completed request for enrollment is received by the plan.)

Example 3. (i) Employee G, a single parent, elects family health coverage under a calendar year cafeteria plan maintained by Employer O. G and G's 21-year old child, H, are covered under O's health plan. During the year, H graduates from college. Under the terms of the health plan, dependents over the age of 19 must be full-time students to receive coverage. G wants to revoke G's election for family health coverage and obtain employee-only coverage under O's cafeteria plan.

(ii) In this *Example 3,* H's loss of eligibility for coverage under the terms of the health plan is a change in status. A revocation of G s election for family coverage and new election of employee-only coverage is consistent with the change in status. Thus, O's cafeteria plan may permit G to elect employee-only coverage.

Example 4. (i) Employee J is married to K and they have one child, S. A calendar year cafeteria plan maintained by Employer P allows employees to elect no health coverage, employee-only coverage, employee-plus-one-dependent coverage, or family coverage. Under the plan, before the beginning of the calendar year, J elects family health coverage for J, K, and S. J and K divorce during the year and, under the terms of P s accident or health plan, K loses eligibility for P's health coverage. S does not lose eligibility for health coverage under P s plan upon the divorce. J now wants to revoke J's election under the cafeteria plan and elect no coverage.

(ii) In this *Example 4,* the divorce is a change in status. A change in the cafeteria plan election to cancel health coverage for K is consistent with that change in status. However, the divorce does not affect J's or S's eligibility for health coverage. Therefore, an election change to cancel J's or S's health coverage is not consistent with the change in status. The cafeteria plan, however, may permit J to elect employee-plus-one-dependent health coverage.

Example 5. (i) The facts are the same as *Example 4,* except that, before the beginning of the year, Employee J elected employee-only health coverage (rather than family coverage). Pursuant to J's divorce agreement with K, P's health plan receives a qualified medical child support order (as defined in section 609 of the Employee Retirement Income Security Act) during the plan year. The order requires P's health plan to cover S.

(ii) In this *Example 5,* P's cafeteria plan may change J's election from employee-only health coverage to employee-plus-one-dependent coverage in order to cover S.

Example 6. (i) Before the beginning of the coverage period, Employee L elects to participate in a cafeteria plan maintained by L's Employer, Q. However, in order to change the election during the coverage period so as to cancel coverage, and by prior understanding with Q, L terminates employment and resumes employment one week later.

(ii) In this *Example 6,* under the facts and circumstances, in which a principal purpose of the termination of employment was to alter the election and reinstatement of employment was understood at the time of termination, L does not have a change in status. However, L's termination of employment would constitute a change in status, permitting a cancellation of coverage during the period of unemployment, if L's original cafeteria plan election was reinstated upon resumption of employment (for example, because of a cafeteria plan provision requiring an employee who resumes employment within 30 days, without any other intervening event that would permit a change in election, to return to the election in effect prior to termination of employment).

Example 7. (i) Employer R maintains a calendar year cafeteria plan under which full-time employees may elect coverage under one of three benefit package options provided under an accident or health plan: an indemnity option or either of two HMO options for employees that work in the respective service areas of the two HMOs. Employee T, who works in the service area of HMO #1, elects the HMO #1 option. During the year, T is transferred to another work location which is outside the HMO #1 service area and inside the HMO #2 service area.

(ii) In this *Example 7,* the transfer is a change in status and, under the consistency rule, the cafeteria plan may permit T to make an election change to either the indemnity option or HMO #2, or to cancel accident or health coverage.

Example 8. (i) A calendar year cafeteria plan maintained by Employer S allows employees to elect coverage under an accident or health plan providing indemnity coverage and under a flexible spending arrangement (FSA). Prior to the beginning of the calendar year, Employee U elects employee-only indemnity coverage, and coverage under the FSA for up to $600 of reimbursements for the year to be funded by salary reduction contributions of $600 during the year. U's spouse, V, has employee-only coverage under an accident or health plan maintained by V's employer. During the year, V terminates employment and loses coverage under that plan. U now wants to elect family coverage under S's accident or health plan and increase U's FSA election.

(ii) In this *Example 8,* V's termination of employment is a change in status. The cafeteria plan may permit U to elect family coverage under S's accident or health plan, and to increase U's FSA coverage.

Example 9. (i) Employer T provides group-term life insurance coverage as described under section 79. Under T's plan, an employee may elect life insurance coverage in an amount up to the lesser of his or her salary or $50,000. T also maintains a calendar year cafeteria plan under which qualified benefits, including the group-term life insurance coverage, are funded through salary reduction. Before the beginning of the calendar year, Employee W elects $10,000 of life insurance coverage, with W's spouse, X, as the beneficiary. During the year, a child is placed for adoption with W and X. W wants to increase W's election for life insurance coverage to $50,000 (without changing the designation of X as the beneficiary).

(ii) In this *Example 9,* the placement of a child for adoption with W is a change in status. The increase in coverage is consistent with the change in status. Thus, W's cafeteria plan may permit W to increase W's life insurance coverage.

(l) *Effective Date.* This section is applicable for plan years beginning after December 31, 1998.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Donald C. Lubick,
Assistant Secretary of the Treasury.

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Section 126.—Certain Cost-Sharing Payments

26 CFR 16A.126–1: Certain cost-sharing payments—In general (Temporary).

Certain cost-sharing payments. The Wetlands Reserve Program, the Environmental Quality Incentives Program, and the Wildlife Habitat Incentives Program are substantially similar to the type of programs described in section 126(a)(1) through (8) of the Code so that cost-share payments made under such programs and in connection with small watersheds are within the scope of section 126(a)(9) and, thereby, cost-share payments received under the programs are eligible for exclusion from gross income to the extent permitted by section 126.

Rev. Rul. 97–55

ISSUE

Are the Wetlands Reserve Program, the Environmental Quality Incentives Pro-

gram, and the Wildlife Habitat Incentives Program substantially similar to the type of programs described in § 126(a)(1) through (8) of the Internal Revenue Code so that cost-share payments made under such programs and in connection with small watersheds are within the scope of § 126(a)(9) and, thereby, cost-share payments received under the programs are eligible for exclusion from gross income to the extent permitted by § 126?

FACTS

The Wetlands Reserve Program (WRP), authorized by Title XII of the Food Security Act of 1985, Pub. L. No. 99–198, 99 Stat. 1504, reauthorized by the Federal Agriculture Improvement and Reform Act of 1996 (the 1996 Farm Act), Pub. L. No. 104–127, 110 Stat. 995, is a voluntary wetlands conservation program to restore and protect wetlands on private property. Landowners who participate in the WRP may sell a conservation easement or enter into a restoration cost-share agreement with the Department of Agriculture to restore and protect wetlands. Under a restoration cost-share agreement, a landowner agrees to undertake approved conservation-related improvements on the property in return for a cost-share payment, generally between 75 and 100 percent of the costs for restoring the wetland. A conservation easement and a restoration cost-share agreement may be combined in one agreement with the Department of Agriculture but separate payments are made for the easement and for the cost-share agreement.

The 1996 Farm Act also establishes the Environmental Quality Incentives Program (EQIP) and the Wildlife Habitat Incentives Program (WHIP). EQIP and WHIP are administered by the Department of Agriculture. EQIP combines the functions of the Agricultural Conservation Program (ACP), the Great Plains Conservation Program (GPCP), the Water Quality Incentives Program (WQIP), and the Colorado River Basin Salinity Control Program (CRBSCP). ACP and GPCP are programs enumerated in § 126(a)(1) through (8) and the Commissioner determined in § 16A.126–1(d)(1)(D) that CRBSCP was within the scope of § 126(a)(9). WQIP was funded through and administered under ACP.

WHIP was established to help participants develop habitat for upland wildlife, wetland wildlife, threatened and endangered species, fish, and other types of wildlife. Under WHIP, landowners enter into wildlife habitat development cost-share contracts for a minimum of 10 years.

The Secretary of Agriculture has made the requisite determinations under § 126(b)(1)(A) that cost-share payments made under WRP, EQIP, and WHIP are primarily for purposes of conservation.

LAW AND ANALYSIS

Under § 126(a), gross income does not include the excludable portion of payments made to taxpayers by federal and state governments for a share of the cost of improvements to property under certain conservation programs set forth in § 126(a)(1) through (8). Under § 126-(a)(9), programs affecting small watersheds are eligible for § 126 treatment if they are administered by the Secretary of Agriculture and are determined by the Secretary of the Treasury or the Secretary's delegate to be substantially similar to the type of programs described in § 126(a)(1) through (8). Even if the Secretary of the Treasury determines that a particular program is within the scope of § 126(a)(9), not all cost-share payments under such program will qualify for the exclusion under § 126. In addition to the determination requirement, the specific project must be with respect to a small watershed and then only the "excludable portion" of any payment can qualify for exclusion. See §§ 126(b)(1), 16A.126–1(b)(5) and 16A.126–1(d)(3) for the definitions of "excludable portion" and "small watershed."

HOLDING

The Commissioner has determined that WRP, EQIP, and WHIP are substantially similar to the type of programs described in § 126(a)(1) through (8) so that cost-share payments made under such programs and in connection with small watersheds are within the scope of § 126(a)(9) and, thereby, cost-share payments received under the programs are eligible for exclusion from gross income to the extent permitted by § 126. See § 16A.126–1 to determine what portion, if any, of the cost-share payments are excludable from gross income under § 126.

Section 127.—Educational Assistance Programs

What conditions apply to the extension of tax-free treatment of employer-provided educational assistance under the Taxpayer Relief Act of 1997? See Notice 97–60, page 310.

Section 132.—Certain Fringe Benefits

The Service provides inflation adjustments to the limitation on the exclusion of income for a qualified transportation fringe for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

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

The Service provides an inflation adjustment to the limitation on the exclusion of income from United States savings bonds for taxpayers who pay qualified higher education expenses for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Part V.—Deductions for Personal Exemptions

Section 151.—Allowance of Deductions for Personal Exemptions

26 CFR 1.151–4: Amount of deduction for each exemption under section 151.

The Service provides inflation adjustments to the personal exemption and to the threshold amounts of adjusted gross income above which the exemption amount phases out for taxable years beginning in 1998. See Rev.Proc. 97–57, page 584.

Part VI.—Itemized Deductions for Individuals and Corporations

Section 162.—Trade or Business Expenses

What procedures must a lawyer, handling cases on a contingent fee basis, use to obtain automatic consent of the Commissioner to change its method of accounting for advances paid to clients. See Rev. Proc. 97–37, page 455.

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

Optional rules are provided under which an employee of a federal government agency who is reim-

bursed for ordinary and necessary business expenses relating to travel, entertainment, gifts, or listed property (such as an employee's automobile) may make an adequate accounting to the employer to substantiate those expenses by submitting only an account book, diary, log, etc., without submitting documentary evidence such as receipts. See Rev. Proc. 97–45 page 499.

Rules are set forth for substantiating the amount of a deduction or expense for business use of an automobile that most nearly represents current costs. See Rev. Proc. 97–58, page 587.

Rules are set forth for substantiating the amount of a deduction or expense for lodging, meals, and incidental expenses or meal and incidental expenses incurred while traveling away from home that most nearly represents current costs. See Rev. Proc. 97–59, page 594.

Section 165.—Losses

26 CFR 1.165–2: Obsolescence of nondepreciable property.

When may a taxpayer deduct a loss arising from the obsolescence of a package design. See Rev. Proc. 97–35, page 448.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for package design costs. See Rev. Proc. 97–37, page 455.

Section 166.—Bad Debts

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change from the § 585 reserve method of accounting to the § 166 specific charge-off method. See Rev. Proc. 97–37, page 455.

Section 167.—Depreciation

26 CFR 1.167(a) –1: Depreciation in general.

The cost of recoverable line pack gas or cushion gas is not depreciable, and the cost of nonrecoverable line pack gas or cushion gas is depreciable. See Rev. Rul. 97–54, page 23.

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26 CFR 1.167(a)–3: Intangibles.

How may a taxpayer recover the costs of creating a package design. See Rev. Proc. 97–35, page 448.

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26 CFR 1.167(e)–1: Change in method.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for depreciation. See Rev. Proc. 97–37, page 455.

Section 168.—Accelerated Cost Recovery System

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for depreciation. See Rev. Proc. 97–37, page 455.

Retail motor fuels outlet. A retail motor fuels outlet is 15-year property for depreciation purposes whether or not the taxpayer-owner is the operator of the motor fuels business.

Rev. Rul. 97–29

ISSUE

If taxpayer is the owner, but not the operator, of a retail motor fuels outlet, is the outlet 15-year property for depreciation purposes under § 168(e)(3)(E) of the Internal Revenue Code?

FACTS

A retail motor fuels outlet may be owned by one entity and operated by another entity. Often, the owner of the property leases the property to an operator. In addition, businesses other than the motor fuels business may operate in the same building. For example, an outlet building may contain a restaurant or video arcade. These businesses may be owned and operated by different taxpayers that make payments to the owner of the outlet building or to a sublessor.

LAW AND ANALYSIS

Section 1120 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755 (1996) (the Act), amended § 168(e)(3)(E) to provide that 15-year property includes any § 1250 property that is a retail motor fuels outlet whether or not food or other convenience items are sold at the outlet. The legislative history of the Act provides that property will qualify as a retail motor fuels outlet if 50 percent or more of the gross revenues generated from the property are derived from petroleum sales, or 50 percent or more of the floor space in the property is devoted to petroleum marketing sales. A motor fuels outlet of 1400 square feet or less qualifies as a retail motor fuels outlet under the Act without application of either 50 percent test. S. Rep. No. 281, 104th Cong., 2d Sess. 14–16 (1996).

Section 168(e)(3)(E) provides that any § 1250 property that qualifies as a retail motor fuels outlet is 15-year property. There is no distinction between an owner of a retail motor fuels outlet that also operates the motor fuels business and an owner that does not operate the motor fuels business. Accordingly, § 1250 property the use of which meets the definition of a retail motor fuels outlet is treated as 15-year property for depreciation purposes whether or not the owner is the operator. In applying the 50-percent gross revenues test to determine if the property qualifies as a retail motor fuels outlet, the owner of an outlet building must aggregate the gross revenues of all businesses operated in the outlet building whether or not such businesses are operated by the owner.

HOLDING

A retail motor fuels outlet is 15-year property for depreciation purposes under § 168(e)(3)(E) whether or not the taxpayer-owner is the operator of the motor fuels business.

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

26 CFR 1.170A–1: Charitable, etc., contributions and gifts; allowance of deduction.

What are the rules for the deductibility, under § 162 or 170, of unreimbursed travel and other out-of-pocket expenses incurred by a member of a federal advisory committee while performing services without compensation for the federal government as a member of that committee? See Rev. Proc. 97–52, page 527.

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

The Service provides inflation adjustments to the "insubstantial benefit" guidelines for calendar year 1998. Under the guidelines, a charitable contribution is fully deductible even though the contributor receives "insubstantial benefits" from the charity. See Rev. Proc. 97–57, page 584.

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26 CFR 1.170A–1: Charitable, etc., contributions and gifts; allowance of deduction.

Rules are set forth for substantiating the amount of a deduction or expense for charitable use of an automobile. See Rev. Proc. 97–58, page 587.

Section 197.—Amortization of Goodwill and Certain Other Intangibles

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for amortization. See Rev. Proc. 97–37, page 455.

Part VII.—Additional Itemized Deductions for Individuals

Section 213.—Medical, Dental, Etc., Expenses

The Service provides an inflation adjustment to the limitation on the amount of eligible long-term care premiums includible in the term "medical care" for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

26 CFR 1.213–1: Medical, dental, etc., expenses.

Rules are set forth for substantiating the amount of a deduction or expense for use of an automobile to obtain medical services. See Rev. Proc. 97–58, page 587.

Section 217.—Moving Expenses

26 CFR 1.217–2: Moving expenses.

Rules are set forth for substantiating the amount of a deduction or expense for use of an automobile as part of a move. See Rev. Proc. 97–58, page 587.

Section 220.—Medical Savings Accounts

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 221.—Interest on Education Loans

What are the rules for deducting interest on education loans under section 221, added by the Taxpayer Relief Act of 1997? See Notice 97–60, page 310.

Part IX.—Items Not Deductible

Section 263.—Capital Expenditures

26 CFR 1.263(a)–1: Capital expenditures; in genral.

The cost of recoverable and nonrecoverable line pack gas or cushion gas is a capital expenditure. See Rev. Rul. 97–54, page 23.

26 CFR 1.263(a)–1: Capital expenditures; in general.
(Also sections 167, 168, 471; 1.167(a)–1, 1.471–1.)

Line pack gas; cushion gas. The cost of recoverable line pack gas or cushion gas is a capital expenditure and is not depreciable. The cost of nonrecoverable line pack gas or cushion gas is a capital expenditure and is depreciable.

Rev. Rul. 97–54

ISSUES

(1) Is the cost of "line pack gas" or "cushion gas" a capital expenditure under § 263 of the Internal Revenue Code or an amount that is included in inventory under § 471?

(2) If the cost of "line pack gas" or "cushion gas" is a capital expenditure under § 263, is that cost depreciable under §§ 167 and 168?

FACTS

"Line pack gas" is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas through a pipeline. "Cushion gas" is the minimum volume of natural gas necessary to provide the pressure to facilitate the flow of gas from a storage reservoir to a pipeline. Recoverable line pack gas and recoverable cushion gas will be available for sale or other use upon the abandonment of the pipeline or storage reservoir, respectively. Unrecoverable line pack gas and unrecoverable cushion gas will not be available for sale or other use upon the abandonment of the pipeline or storage reservoir, but will become obsolete with that abandonment.

LAW AND ANALYSIS

Section 263(a) provides that no deduction shall be allowed for amounts paid out for permanent improvements or betterments made to increase the value of any property or estate.

Section 1.263(a)–2 of the Income Tax Regulations provides that a "capital expenditure" includes the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the tax year.

Section 167(a) provides that there shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property used in a trade or business or held for the production of income.

Generally, for tangible property, the depreciation deduction under § 167(a) is determined under § 168 by using the applicable depreciation method, the applicable recovery period, and the applicable convention.

Section 471 provides that whenever, in the opinion of the Secretary, the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by that taxpayer, on the basis the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Section 1.471–1 provides that in order to reflect income correctly, inventories at the beginning and end of each tax year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. Inventories should include all finished and partly finished goods and, in the case of raw materials and supplies, only those that have been acquired for sale or that will physically become a part of merchandise intended for sale.

Rev. Rul. 68–620, 1968–2 C.B. 199, *amplified* by Rev. Rul. 78–352, 1978–2 C.B. 168, holds that line pack gas is merchandise in transit that is intended to be sold to customers and therefore must be included in the inventory of the taxpayer.

Rev. Rul. 75–233, 1975–1 C.B. 95, holds that the cost of unrecoverable cushion gas is a capital expenditure under § 263, which is recoverable through an annual depreciation deduction under § 167.

With respect to both line pack gas and cushion gas, several court decisions have considered the capital expenditure-versus-inventory issue, as well as the depreciation issue. In *Pacific Enterprises v. Commissioner*, 101 T.C. 1 (1993), the United States Tax Court held that the costs of line pack gas and cushion gas are capital expenditures. *Accord Transwestern Pipeline Co. v. United States*, 639 F.2d 679 (Ct.Cl. 1980), regarding line pack gas; *Arkla, Inc. v. United States*, 765

F.2d 487 (5th Cir. 1985), regarding cushion gas. The United States Court of Appeals for the Fifth Circuit in *Arkla* further held that recoverable cushion gas was not subject to depreciation because it was not subject to exhaustion, wear, tear, or obsolescence. *Accord Washington Energy Co. v. United States*, 94 F.3d 1557 (Fed. Cir. 1996). The Fifth Circuit in *Arkla* distinguished unrecoverable cushion gas as being subject to depreciation because that gas will become obsolete along with the storage facility. *Accord* Rev. Rul. 75–233. Finally, in *Arkla, Inc. v. United States*, 37 F.3d 621 (Fed. Cir. 1994), the United States Court of Appeals for the Federal Circuit held that line pack gas and cushion gas are treated the same for purposes of depreciation. *Accord Washington Energy Co. v. United States*, 94 F.3d 1557.

Line pack gas or cushion gas is recoverable if it will be available for sale or other use upon abandonment of a pipeline or storage reservoir. *See Arkla, Inc. v. United States*, 765 F.2d at 490. The Service will treat line pack gas or cushion gas as being available for sale or other use to the extent that such gas will be recovered from an abandoned pipeline or storage reservoir pursuant to a plan, a requirement of law, or economic feasibility, whichever method projects the greatest actual recovery of such gas.

The Service will follow the court decisions cited in this revenue ruling to the extent they hold that the cost of line pack gas or cushion gas is a capital expenditure, the cost of recoverable line pack gas or recoverable cushion gas is not depreciable, and the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable.

HOLDINGS

(1) The cost of line pack gas or cushion gas is a capital expenditure under § 263.

(2) The cost of recoverable line pack gas or recoverable cushion gas is not depreciable, but the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable under §§ 167 and 168. The Service will treat line pack gas or cushion gas as recoverable to the extent that such gas will be recovered from an abandoned pipeline or storage reservoir pursuant to a plan, a requirement of law, or economic feasibility, whichever method projects the greatest actual recovery of such gas.

APPLICATION

Any change in a taxpayer's treatment of the costs of line pack gas or cushion gas to conform with this revenue ruling is a change in method of accounting to which the provisions of §§ 446 and 481 and the regulations thereunder apply. A taxpayer wanting to change its method of accounting for the cost of line pack gas or cushion gas to conform with this revenue ruling must follow the automatic change in accounting method provisions of Rev. Proc. 97–37, 1997–33 I.R.B. 18.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 68–620 and Rev. Rul. 78–352 are revoked. Rev. Rul. 75–233 is superseded. Rev. Proc. 97–37 is amplified to include this change in the Appendix.

PROSPECTIVE APPLICATION

The Service will not require a taxpayer to change its method of accounting to comply with the holding that the cost of line pack gas or recoverable cushion gas is a capital expenditure for any taxable year beginning before December 29, 1997. In addition, the Service will not require a taxpayer to change its method of accounting to comply with the holding for determining the amount of recoverable line pack gas or recoverable cushion gas for any taxable year beginning before December 29, 1997, provided the method used by the taxpayer projects recoverable line pack gas or recoverable cushion gas in an amount equal to or greater than an amount that would be projected using an economic feasibility of recovery standard.

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26 CFR 1.263(a)–2: Examples of capital expenditures.

Must the costs of creating a package design be capitalized. See Rev. Proc. 97–35, page 448.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for package design costs. See Rev. Proc. 97–37, page 455.

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

26 CFR §1.263A–1: Uniform capitalization of costs.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting. See Rev. Proc. 97–37, page 455.

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26 CFR 1.263A–2: Rules relating to property produced by the taxpayer.

Are the costs incurred in connection with the development and design of product packages subject to the rules under section 263A. See Rev. Proc. 97–35, page 448.

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26 CFR 1.263A–7: Changing a method of accounting under section 263A.

T.D. 8728

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Procedure for Changing a Method of Accounting under Section 263A

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the requirements for changing a method of accounting for costs subject to section 263A. The regulations provide guidance regarding changes in method of accounting for costs incurred in producing property and acquiring property for resale. The regulations affect taxpayers changing their method of accounting for costs subject to section 263A.

DATES: These regulations are effective August 5, 1997.

SUPPLEMENTARY INFORMATION:

Background

On March 30, 1987 and August 7, 1987, temporary regulations under section 263A were published in the **Federal Register** (T.D. 8131, 52 F.R. 10052 [1987–1 C.B. 98] and T.D. 8148, 52 F.R. 29375 [1987–2 C.B. 70]), and cross-referenced to notices of proposed rulemaking published in the **Federal Register** on the same date (52 F.R. 10118 [LR–168–86, 1987–1 C.B. 808]and 52 F.R. 29391 [LR–37–87, 1987–2 C.B. 1054]). The temporary regulations contain rules for

taxpayers changing their method of accounting to comply with the capitalization rules of section 263A. A public hearing on these temporary and proposed regulations was held on December 7, 1987.

On August 9, 1993, final regulations under section 263A were published in the **Federal Register** (T.D. 8482, 58 F.R. 42198 [1993 C.B. 77]). These final regulations did not address the accounting method provisions in the 1987 temporary regulations, which continued in effect. On August 5, 1994, final and temporary regulations were published in the **Federal Register** (T.D. 8559, 59 F.R. 39958 [1994–2 C.B. 32]). These final regulations address "pick and pack costs" and other expenses. The August 5, 1994 temporary regulations renumbered the accounting method provisions in the 1987 temporary regulations from §1.263A–1T(e) to §1.263A–7T.

This document adopts, with modifications, §1.263A–7T as final regulations.

Explanation of Provisions

In 1987, the IRS and the Treasury Department issued temporary regulations that provide guidance to taxpayers changing their method of accounting to comply with the capitalization rules of section 263A. The regulations provide automatic consent for taxpayers required to change their method of accounting for the first taxable year section 263A was effective.

Subsequent to promulgation of the 1987 temporary regulations, the IRS and the Treasury Department issued various revenue procedures that set forth rules and procedures applicable to certain changes in method of accounting for costs subject to section 263A for which taxpayers can obtain automatic consent. These revenue procedures provide automatic consent to change the method of accounting in years other than the first taxable year section 263A was effective. Where automatic consent is not available by revenue procedure, taxpayers can obtain the Commissioner's consent to change a method of accounting for costs subject to section 263A under Rev. Proc. 97–27 (1997–21 I.R.B. 10).

Rev. Proc. 97–27 and the automatic change revenue procedures describe how a change in method of accounting may be effected, but they do not describe how inventory and other property on hand at the beginning of the year of change should be revalued. These final regulations provide guidance regarding how taxpayers must revalue property in connection with a change in method of accounting for costs subject to section 263A. The revaluation rules for inventory are substantially similar to the revaluation rules contained in the 1987 temporary regulations. Section 1.263A–7(c) provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Section 1.263A–7(d) provides guidance regarding how non-inventory property on hand at the beginning of the year of change must be revalued.

The regulations also provide certain rules that apply to changes in method of accounting for costs subject to section 263A, in addition to the rules and procedures that apply under the applicable revenue procedures. See, §1.263A–7(b).

In addition, the regulations clarify whether certain changes are changes in method of accounting under section 263A and therefore are within the scope of the regulations. For example, a change from one permissible capitalization method, such as the simplified resale method in former §1.263A–1T(d)(4), to another permissible capitalization method, such as the simplified resale method in §1.263A-3(d), is a change in method of accounting under section 263A and is therefore within the scope of the regulations. See §1.263A–7(a)(5).

The final regulations delete certain provisions of §1.263A–7T that were primarily applicable to accounting method changes made in 1987. For example, the final regulations do not incorporate provisions such as §1.263A–7T(e)(2), which provide automatic consent to make the change in method of accounting for the first taxable year section 263A was effective, and §1.263A–7T(e)(7)(iii), (iv) and (v) and §1.263A–7T(e)(8), which provide special rules for adjusting the revaluation factor for costs attributable to different methods of accounting for depreciation (including cost recovery) and differences in the percentage of fixed indirect production costs that were expensed by taxpayers using the practical capacity concept.

Certain Administrative Guidance

The final regulations incorporate the provisions of Notice 88–23 (1988–1 C.B. 490) (ordering rules for accounting method changes), and sections IV (A) (guidance regarding deferred intercompany exchanges) and IV (B) (permission to elect a new base year for taxpayers using the last-in, first-out (LIFO) inventory method) of Notice 88-86 (1988–2 C.B. 401). These notices or portions thereof are withdrawn for taxable years to which this Treasury decision applies.

Effect on Other Documents

The following publications are obsolete as of August 5, 1997:

Notice 88–23 (1988–1 C.B. 490).

Notice 88–86 (1988–2 C.B. 401), sections IV (A) and IV (B).

Public Comments

The IRS and the Treasury Department received a number of comments in response to the 1987 temporary and proposed regulations. Most of the comments received in response to the temporary regulations issued in March 1987 were considered in connection with the temporary regulations issued in August 1987. In general, those comments are not discussed again here.

REVALUING BEGINNING INVENTORY—THE 3-YEAR AVERAGE METHOD

A. Extending availability of the method

Under the temporary regulations, taxpayers using the dollar-value LIFO inventory method were permitted to use a 3-year average method for revaluing their beginning inventory in the year they changed their method of accounting to comply with section 263A. Several commentators suggested that taxpayers other than those on the dollar-value LIFO inventory method should also be permitted to use this 3-year average method for revaluing beginning inventory in the year of change. Specifically, commentators suggested that the 3-year average method be made available to taxpayers using the specific goods LIFO inventory method. Another suggestion was that taxpayers using the first-in, first-out (FIFO) inventory method should be permitted to use the 3-year average method even though those taxpayers may have sufficient information to revalue their inventory under the facts and circumstances method.

The final regulations do not adopt these suggestions. The House and Senate Reports to the Tax Reform Act of 1986 indicate Congress intended that taxpayers generally revalue their inventory in the year of change using the facts and circumstances method. Because Congress realized that dollar-value LIFO taxpayers may not have the data needed to use the facts and circumstances method, it suggested two other revaluation methods that could be used in conjunction with, or in lieu of, the facts and circumstances method. The 3-year average method was one of those other methods. H.R. Rep. No. 426, 99th Cong., 1st Sess. 633–637 (1985), 1986–3 (Vol. 2) C.B. 633–637 and S. Rep. No. 313, 99th Cong., 2nd Sess. 147–152 (1986), 1986–3 (Vol. 3) C.B. 147–152. The IRS and the Treasury Department believe that limiting the 3-year average method to dollar-value LIFO taxpayers is more consistent with legislative history which expresses Congress' concern that dollar-value LIFO taxpayers may have particular problems in revaluing inventory. H.R. Rep. No. 426, 633, 1986–3 (Vol. 2) C.B. 633 and S. Rep. No. 313, 147, 1986–3 (Vol.3) C.B. 147.

B. Altering the mechanics of the method

One commentator suggested that taxpayers be permitted to revalue items or costs included in beginning inventory in the year of change by using data from the year of change instead of data from the prior three years, and calculate a section 481(a) adjustment accordingly. This commentator further suggested that three years after the year of change, the taxpayer would recompute the section 481(a) adjustment using data from the three new years to test its original adjustment under section 481(a). If the new adjustment were larger than the original adjustment by a substantial amount, the taxpayer would be required to amend its federal income tax returns. The final regulations do not adopt this suggestion. Requiring taxpayers to compute two adjustments under section 481(a) would unnecessarily complicate application of the 3-year average method.

Another commentator suggested that some taxpayers be permitted to revalue items or costs included in beginning inventory in the year of change by using data from the immediately preceding year rather than the prior three years. This proposal to use only the prior year's data would be limited to taxpayers that can show they have not had a significant change in costs over the preceding three years. This suggested modification to the 3-year average method was not adopted. The suggested modification would not substantially simplify the process of revaluing beginning inventory because taxpayers would be required to determine whether their costs significantly changed during the preceding three-year period.

C. Limiting costs subject to revaluation

One commentator suggested that LIFO layers should be revalued only if the items of inventory comprising those layers are still in existence in the year of change. This suggestion was not adopted. However, the final regulations continue the rule in the temporary regulations that taxpayers may adjust the revaluation factor (under either the 3-year average method or the weighted average method) to the extent they can show that additional section 263A costs included in the calculation of the revaluation factor were not incurred in the prior years in which the LIFO layers were accumulated.

D. New base year

Under the 3-year average method, taxpayers generally are required to establish a new base year. Several commentators commented that requiring link-chain LIFO taxpayers to establish a new base year is costly and pointless and suggested that these taxpayers be excluded from the general requirement that all dollar-value LIFO taxpayers establish a new base year. The IRS and the Treasury Department did not adopt this suggestion. If a new base year is not established, the current-year index, determined under the taxpayer's new method of accounting, would be multiplied by the prior-year cumulative index, determined under the taxpayer's former method of accounting, and could distort the taxpayer's LIFO inventory valuation. This distortion is eliminated when the taxpayer establishes a new base year and establishes a new index. Accordingly, the final regulations provide that all dollar-value LIFO taxpayers (whether using double extension or link-chain) should generally establish a new base year when they use the 3-year average method to revalue their inventories under section 263A.

Commentators also suggested that taxpayers using the 3-year average method and either the simplified production method or the simplified resale method be allowed, but not required, to establish a new base year. Section IV (B) of Notice 88-86 permits these taxpayers to choose whether to establish a new base year. This rule is incorporated into the final regulations.

One commentator noted that the example in the 1987 temporary regulations illustrating the 3-year average method did not use the current year revaluation factor in computing the updated base year cost of inventory. The example has been revised to use the current year revaluation factor.

REVALUING BEGINNING INVENTORY—FACTS AND CIRCUMSTANCES METHOD

One commentator suggested that specific rules or guidelines be adopted to clarify what is a reasonable estimate or procedure for revaluing beginning inventory in connection with a change in method of accounting. This suggestion was not adopted. What is a reasonable estimate or procedure must be decided on a case-by-case basis in light of all applicable facts and circumstances. The final regulations continue the provision in the temporary regulations that permissible estimates and procedures include using information from a more recent period to estimate the amount and nature of inventory costs applicable to earlier periods, and using information with respect to comparable items of inventory to estimate the costs associated with other items of inventory.

NEW BASE YEAR WHEN THE 3-YEAR AVERAGE METHOD IS NOT USED

Several commentators suggested that dollar-value LIFO taxpayers not using the 3-year average method to revalue beginning inventory be permitted to update their base year if they so choose. Section IV (B) of Notice 88–86 permits these taxpayers to establish a new base year. The final regulations adopt this rule.

SCOPE OF ACCOUNTING METHOD CHANGE

Several commentators suggested that the regulations should allow taxpayers to change from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in connection with changing their method of accounting for costs under section 263A without obtaining the Commissioner's consent. Generally, taxpayers must secure the Commissioner's consent before effecting a change in method of accounting under section 446(e) unless this requirement is specifically waived. The IRS and the Treasury Department do not believe an exception from this general rule is warranted for changes from the specific goods LIFO inventory method to the dollar-value LIFO inventory method except to the extent permitted by §1.472–8(f)(1).

Several commentators also suggested that taxpayers that change their method of accounting for costs subject to section 263A be permitted to make additional changes in their methods of accounting in future tax years under section 263A without obtaining additional consents from the Commissioner. The IRS and the Treasury Department have issued various revenue procedures that provide automatic consent procedures for taxpayers to change their method of accounting for costs under section 263A.

One commentator suggested that the regulations provide that when making the change from the full absorption rules of §1.471–11 to the uniform capitalization rules of section 263A, taxpayers may cease taking into account any costs not treated as inventoriable under section 263A that may have been erroneously inventoried under prior law. The temporary regulations issued in August 1987 and the final regulations permit this result. In revaluing beginning inventory to include additional section 263A costs, taxpayers may cease capitalizing costs that had been capitalized but are not required to be capitalized under section 263A.

AUDIT PROTECTION

Several commentators noted that taxpayers should be guaranteed audit protection for costs or items that are part of a change in method of accounting under section 263A. The IRS' long-standing administrative position is that if a taxpayer files an application to change its method of accounting in accordance with the applicable administrative guidance, for example, Rev. Proc. 97–27, an examining agent may not later propose that the taxpayer change its method of accounting for the same item for a taxable year prior to the year of change.

ORDERING RULES

One commentator suggested that overall accounting method changes (for example, the cash receipts and disbursements method to an accrual method) should be implemented prior to any change in method of accounting for costs under section 263A. The temporary regulations generally provide that a change in method of accounting for costs under section 263A is deemed to occur prior to any other change in method of accounting effected during the year of change. The final regulations continue that general rule with four modifications. Taxpayers that are discontinuing the LIFO inventory method may make that change prior to a change in method of accounting under section 263A. Additionally, taxpayers that are changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method may make that change prior to a change in method of accounting under section 263A. Also, taxpayers that are changing their overall method of accounting from the cash method to an accrual method must make the change to an accrual method prior to a change in method of accounting under section 263A. Finally, taxpayers that are changing their method of accounting for depreciation when any portion of the depreciation is subject to section 263A must make the method change for depreciation prior to a change in method of accounting under section 263A.

COST ALLOCATION METHOD

Several commentators suggested that the regulations be clarified to provide that a taxpayer must use the same cost allocation method to restate its beginning inventory and to value its ongoing inventory. The final regulations clarify this point. Inventory on hand at the beginning of the year of change is revalued as if the taxpayer's new method had applied to all prior periods. The same cost allocation method must be used both retroactively (for purposes of restating beginning inventory) and prospectively (for purposes of the current year and all subsequent years, unless the taxpayer seeks specific consent from the Commissioner to change this method of accounting).

INTERCOMPANY ITEMS

One commentator suggested that taxpayers be given automatic consent to discontinue filing consolidated federal income tax returns so that they could avoid the need to revalue the amount of intercompany items resulting from the sale or exchange of inventory property in intercompany transactions. The regulations do not adopt this suggestion. Generally, taxpayers must secure the Commissioner's consent before discontinuing the filing of consolidated tax returns. The IRS and the Treasury Department do not think an exception from this general rule is warranted in this situation.

Effective Date

These regulations are effective for taxable years beginning on or after August 5, 1997.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Small Business Administration for comment on their impact on small business.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.263A–0 is amended by revising the introductory text and adding entries for §1.263A–7 to read as follows:

§1.263A–0 Outline of regulations under section 263A.

This section lists the paragraphs in §§1.263A–1 through 1.263A–3 and §1.263A–7 through 1.263A-15.

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§1.263A–7 Changing a method of accounting under section 263A.

(a) Introduction.
(1) Purpose.
(2) Taxpayers that adopt a method of accounting under section 263A.
(3) Taxpayers that change a method of accounting under section 263A.
(4) Effective date.
(5) Definition of change in method of accounting.
(b) Rules applicable to a change in method of accounting.
(1) General rules.
(2) Special rules.
(i) Ordering rules when multiple changes in method of accounting occur in the year of change.
(A) In general.
(B) Exceptions to the general ordering rule.
(*1*) Change from the LIFO inventory method.
(*2*) Change from the specific goods LIFO inventory method.
(*3*) Change in overall method of accounting.
(*4*) Change in method of accounting for depreciation.
(ii) Adjustment required by section 481(a).
(iii) Base year.
(A) Need for a new base year.
(*1*) Facts and circumstances revaluation method used.
(*2*) 3-year average method used.
(*i*) Simplified method not used.
(*ii*) Simplified method used.
(B) Computing a new base year.
(c) Inventory
(1) Need for adjustments.
(2) Revaluing beginning inventory.
(i) In general.
(ii) Methods to revalue inventory.
(iii) Facts and circumstances revaluation method.
(A) In general.
(B) Exception.
(C) Estimates and procedures allowed.
(D) Use by dollar-value LIFO taxpayers.
(E) Examples.
(iv) Weighted average method.
(A) In general.
(B) Weighted average method for FIFO taxpayers.
(*1*) In general.
(*2*) Example.
(C) Weighted average method for specific goods LIFO taxpayers.
(*1*) In general.
(*2*) Example.
(D) Adjustments to inventory costs from prior years.
(v) 3-year average method.
(A) In general.
(B) Consecutive year requirement.
(C) Example.
(D) Short taxable years.
(E) Adjustments to inventory costs from prior years.
(*1*) General rule.
(*2*) Examples of costs eligible for restatement adjustment procedure.
(F) Restatement adjustment procedure.
(*1*) In general.
(*2*) Examples of restatement adjustment procedure.
(3) Intercompany items.
(i) Revaluing intercompany transactions.
(ii) Example.
(iii) Availability of revaluation methods.
(4) Anti-abuse rule.
(i) In general.
(ii) Deemed avoidance of this section.
(A) Scope.
(B) General rule.
(iii) Election to use transferor's LIFO layers.
(iv) Tax avoidance intent not required.
(v) Related corporation.
(d) Non-inventory property.
(1) Need for adjustments.
(2) Revaluing property.

§1.263A–1 [Amended]

Par. 3. Section 1.263A–1 is amended by removing "1.263A–7T (e) generally" from the last sentence in paragraph (a)(2)(i) and replacing it with "1.263A–7".

Par. 4. Section 1.263A–7 is added to read as follows:

§1.263A–7 Changing a method of accounting under section 263A.

(a) *Introduction*—(1) *Purpose.* These regulations provide guidance to taxpayers changing their methods of accounting for costs subject to section 263A. The principal purpose of these regulations is to provide guidance regarding how taxpayers are to revalue property on hand at the beginning of the taxable year in which they change their method of accounting for costs subject to section 263A. Paragraph (c) of this section provides guidance regarding how items or costs included in beginning inventory in the year of change must be revalued. Paragraph (d) of this section provides guidance regarding how non-inventory property should be revalued in the year of change.

(2) *Taxpayers that adopt a method of accounting under section 263A.* Taxpayers may adopt a method of accounting for costs subject to section 263A in the first taxable year in which they engage in resale or production activities. For purposes of this section, the adoption of a method of accounting has the same meaning as provided in §1.446–1(e)(1). Taxpayers are not subject to the provisions of these regulations to the extent they adopt, as opposed to change, a method of accounting.

(3) *Taxpayers that change a method of accounting under section 263A.* Taxpayers changing their method of accounting for costs subject to section 263A are subject to the revaluation and other provisions of this section. Taxpayers subject to these regulations include, but are not limited to—

(i) Resellers of personal property whose average annual gross receipts for the immediately preceding 3-year period (or lesser period if the taxpayer was not in existence for the three preceding taxable years) exceed $10,000,000 where the taxpayer was not subject to section 263A in the prior taxable year;

(ii) Resellers of real or personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A;

(iii) Producers of real or tangible personal property that are using a method that fails to comply with section 263A and desire to change to a method of accounting that complies with section 263A; and

(iv) Resellers and producers that desire to change from one permissible method of accounting for costs subject to section 263A to another permissible method.

(4) *Effective date.* The provisions of this section are effective for taxable years beginning on or after August 5, 1997. For taxable years beginning before August 5, 1997, the rules of §1.263A–7T contained in the 26 CFR part 1 edition revised as of April 1, 1997, as modified by other administrative guidance, will apply.

(5) *Definition of change in method of accounting.* For purposes of this section, a change in method of accounting has the same meaning as provided in §1.446–1(e)(2)(ii). Changes in method of accounting for costs subject to section 263A include changes to methods required or permitted by section 263A and the regulations thereunder. Changes in method of accounting may be described in the preceding sentence irrespective of whether the taxpayer's previous method of accounting resulted in the capitalization of more (or fewer) costs than the costs required to be capitalized under section 263A and the regulations thereunder, and irrespective of whether the taxpayer's previous method of accounting was a permissible method under the law in effect when the method was being used. However, changes in method of accounting for costs subject to section 263A do not include changes relating to factors other than those described therein. For example, a change in method of accounting for costs subject to section 263A does not include a change from one inventory identification method to another inventory identification method, such as a change from the last-in, first-out (LIFO) method to the first-in, first-out (FIFO) method, or vice versa, or a change from one inventory valuation method to another inventory valuation method under section 471, such as a change from valuing inventory at cost to valuing the inventory at cost or market, whichever is lower, or vice versa. In addition, a change in method of accounting for costs subject to section 263A does not include a change within the LIFO inventory method, such as a change from the double extension method to the link-chain method, or a change in the method used for determining the number of pools. Further, a change from the modified resale method set forth in Notice 89-67 (1989–1 C.B. 723), see §601.601(d)(2) of this chapter, to the simplified resale method set forth in §1.263A–3(d) is not a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is therefore not subject to the provisions of this section. However, a change from the simplified resale method set forth in former §1.263A–1T(d)(4) to the simplified resale method set forth in §1.263A–3(d) is a change in method of accounting within the meaning of §1.446–1(e)(2)(ii) and is subject to the provisions of this section.

(b) *Rules applicable to a change in method of accounting*—(1) *General rules.* All changes in method of accounting for costs subject to section 263A are subject to the rules and procedures provided by the Code, regulations, and administrative procedures applicable to such changes. The Internal Revenue Service has issued specific revenue procedures that govern certain accounting method changes for costs subject to section 263A. Where a specific revenue procedure is not applicable, changes in method of accounting for costs subject to section 263A are subject to the same rules and procedures that govern other accounting method changes. See Rev. Proc. 97–27 (1997–21 I.R.B. 10) and §601.601(d)(2) of this chapter.

(2) *Special rules*—(i) *Ordering rules when multiple changes in method of accounting occur in the year of change.*

(A) *In general.* A change in method of accounting for costs subject to section 263A is generally deemed to occur (including the computation of the adjustment under section 481(a)) before any other change in method of accounting is deemed to occur for that same taxable year.

(B) *Exceptions to the general ordering rule—(1) Change from the LIFO inventory method.* In the case of a taxpayer that is discontinuing its use of the LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the LIFO method may be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(*2*) *Change from the specific goods LIFO inventory method.* In the case of a taxpayer that is changing from the specific goods LIFO inventory method to the dollar-value LIFO inventory method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the change from the specific goods LIFO inventory method may be made before the change in method of accounting under section 263A is made.

(*3*) *Change in overall method of accounting.* In the case of a taxpayer that is changing its overall method of accounting from the cash receipts and disbursements method to an accrual method in the same taxable year it is changing its method of accounting for costs subject to section 263A, the taxpayer must change to an accrual method for capitalizable costs (see §1.263A–1(c)(2)(ii)) before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(*4*) *Change in method of accounting for depreciation.* In the case of a taxpayer that is changing its method of accounting for depreciation in the same taxable year it is changing its method of accounting for costs subject to section 263A and any portion of the depreciation is subject to section 263A, the change in method of accounting for depreciation must be made before the change in method of accounting (and the computation of the corresponding adjustment under section 481(a)) under section 263A is made.

(ii) *Adjustment required by section 481(a).* In the case of any taxpayer required or permitted to change its method of accounting for any taxable year under section 263A and the regulations thereunder, the change will be treated as initiated by the taxpayer for purposes of the adjustment required by section 481(a). The adjustment required by section 481(a) is to be taken into account in computing taxable income over a period not to exceed 4 taxable years.

(iii) *Base year*—(A) *Need for a new base year.* Certain dollar-value LIFO tax-

payers (whether using double extension or link-chain) must establish a new base year when they revalue their inventories under section 263A.

(*1*) *Facts and circumstances revaluation method used.* A dollar-value LIFO taxpayer that uses the facts and circumstances revaluation method is permitted, but not required, to establish a new base year.

(*2*) *3-year average method used—*(*i*) *Simplified method not used.* A dollar-value LIFO taxpayer using the 3-year average method but not the simplified production method or the simplified resale method to revalue its inventory is required to establish a new base year.

(*ii*) *Simplified method used.* A dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year.

(B) *Computing a new base year.* For purposes of determining future indexes, the year of change becomes the new base year (that is, the index at the beginning of the year of change generally must be 1.00) and all costs are restated in new base year costs for purposes of extending such costs in future years. However, when a new base year is established, costs associated with old layers retain their separate identity within the base year, with such layers being restated in terms of the new base year index. For example, for purposes of determining whether a particular layer has been invaded, each layer must retain its separate identity. Thus, if a decrement in an inventory pool occurs, layers accumulated in more recent years must be viewed as invaded first, in order of priority.

(c) *Inventory*—(1) *Need for adjustments.* When a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer generally must, in computing its taxable income for the year of change, take into account the adjustments required by section 481(a). The adjustments required by section 481(a) relate to revaluations of inventory property, whether the taxpayer produces the inventory or acquires it for resale. See paragraph (d) of this section in regard to the adjustments required by section 481(a) that relate to non-inventory property.

(2) *Revaluing beginning inventory*—(i) *In general.* If a taxpayer changes its method of accounting for costs subject to section 263A, the taxpayer must revalue the items or costs included in its beginning inventory in the year of change as if the new method (that is, the method to which the taxpayer is changing) had been in effect during all prior years. In revaluing inventory costs under this procedure, all of the capitalization provisions of section 263A and the regulations thereunder apply to all inventory costs accumulated in prior years. The necessity to revalue beginning inventory as if these capitalization rules had been in effect for all prior years includes, for example, the revaluation of costs or layers incurred in taxable years preceding the transition period to the full absorption method of inventory costing as described in §1.471–11(e), regardless of whether a taxpayer employed a cut-off method under those regulations. The difference between the inventory as originally valued using the former method (that is, the method from which the taxpayer is changing) and the inventory as revalued using the new method is equal to the amount of the adjustment required under section 481(a).

(ii) *Methods to revalue inventory.* There are three methods available to revalue inventory. The first method, the facts and circumstances revaluation method, may be used by all taxpayers. Under this method, a taxpayer determines the direct and indirect costs that must be assigned to each item of inventory based on all the facts and circumstances. This method is described in paragraph (c)(2)(iii) of this section. The second method, the weighted average method, is available only in certain situations to taxpayers using the FIFO inventory method or the specific goods LIFO inventory method. This method is described in paragraph (c)(2)(iv) of this section. The third method, the 3-year average method, is available to all taxpayers using the dollar-value LIFO inventory method of accounting. This method is described in paragraph (c)(2)(v) of this section. The weighted average method and the 3-year average method revalue inventory through processes of estimation and extrapolation, rather than based on the facts and circumstances of a particular year's data. All three methods are available regardless of whether the taxpayer elects to use a simplified method to capitalize costs under section 263A.

(iii) *Facts and circumstances revaluation method*—(A) *In general.* Under the facts and circumstances revaluation method, a taxpayer generally is required to revalue inventories by applying the capitalization rules of section 263A and the regulations thereunder to the production and resale activities of the taxpayer, with the same degree of specificity as required of inventory manufacturers under the law immediately prior to the effective date of the Tax Reform Act of 1986 (Public Law 99–514, 100 Stat. 2085, 1986–3 C.B. (Vol. 1)). Thus, for example, with respect to any prior year that is relevant in determining the total amount of the revalued balance as of the beginning of the year of change, the taxpayer must analyze the production and resale data for that particular year and apply the rules and principles of section 263A and the regulations thereunder to determine the appropriate revalued inventory costs. However, under the facts and circumstances revaluation method, a taxpayer may utilize reasonable estimates and procedures in valuing inventory costs if—

(*1*) The taxpayer lacks, and is not able to reconstruct from its books and records, actual financial and accounting data which is required to apply the capitalization rules of section 263A and the regulations thereunder to the relevant facts and circumstances surrounding a particular item of inventory or cost; and

(*2*) The total amounts of costs for which reasonable estimates and procedures are employed are not significant in comparison to the total restated value (including costs previously capitalized under the taxpayer's former method) of the items or costs for the period in question.

(B) *Exception.* A taxpayer that is not able to comply with the requirement of paragraph (c)(2)(iii)(A)(*2*) of this section because of the existence of a significant amount of costs that would require the use of estimates and procedures must revalue its inventories under the procedures provided in paragraph (c)(2)(iv) or (v) of this section.

(C) *Estimates and procedures allowed.* The estimates and procedures of this paragraph (c)(2)(iii) include—

(*1*) The use of available information from more recent years to estimate the amount and nature of inventory costs applicable to earlier years; and

(*2*) The use of available information with respect to comparable items of inventory produced or acquired during the same year in order to estimate the costs associated with other items of inventory.

(D) *Use by dollar-value LIFO taxpayers.* Generally, a dollar-value LIFO taxpayer must recompute its LIFO inventory for each taxable year that the LIFO inventory method was used.

(E) *Examples.* The provisions of this paragraph (c)(2)(iii) are illustrated by the following three examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in all three examples is 1997. The examples read as follows:

Example 1. Taxpayer X lacks information for the years 1993 and earlier, regarding the amount of costs incurred in transporting finished goods from X's factory to X's warehouse and in storing those goods at the warehouse until their sale to customers. X determines that, for 1994 and subsequent years, these transportation and storage costs constitute 4 percent of the total costs of comparable goods under X's method of accounting for such years. Under this paragraph (c)(2)(iii), X may assume that transportation and storage costs for the years 1993 and earlier constitute 4 percent of the total costs of such goods.

Example 2. Assume the same facts as in *Example 1*, except that for the year 1993 and earlier, X used a different method of accounting for inventory costs whereunder significantly fewer costs were capitalized than amounts capitalized in later years. Thus, the application of transportation and storage based on a percentage of costs for 1994 and later years would not constitute a reasonable estimate for use in earlier years. X may use the information from 1994 and later years, if appropriate adjustments are made to reflect the differences in inventory costs for the applicable years, including, for example—

(i) Increasing the percentage of costs that are intended to represent transportation and storage costs to reflect the aggregate differences in capitalized amounts under the two methods of accounting; or

(ii) Taking the absolute dollar amount of transportation and storage costs for comparable goods in inventory and applying that amount (adjusted for changes in general price levels, where appropriate) to goods associated with 1993 and prior periods.

Example 3. Taxpayer Z lacks information for certain years with respect to factory administrative costs, subject to capitalization under section 263A and the regulations thereunder, incurred in the production of inventory in factory A. Z does have sufficient information to determine factory administrative costs with respect to production of inventory in factory B, wherein inventory items were produced during the same years as factory A. Z may use the information from factory B to determine the appropriate amount of factory administrative costs to capitalize as inventory costs for comparable items produced in factory A during the same years.

(iv) *Weighted average method*—(A) *In general.* A taxpayer using the FIFO method or the specific goods LIFO method of accounting for inventories may use the weighted average method as provided in this paragraph (c)(2)(iv) to estimate the change in the amount of costs that must be allocated to inventories for prior years. The weighted average method under this paragraph (c)(2)(iv) is only available to a taxpayer that lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method provided for in paragraph (c)(2)(iii) of this section. Moreover, a taxpayer that qualifies for the use of the weighted average method under this paragraph (c)(2)(iv) must utilize such method only with respect to items or costs for which it lacks sufficient information to revalue under the facts and circumstances revaluation method. Particular items or costs must be revalued under the facts and circumstances revaluation method if sufficient information exists to make such a revaluation. If a taxpayer lacks sufficient information to otherwise apply the weighted average method under this paragraph (c)(2)(iv) (for example, the taxpayer is unable to revalue the costs of any of its items in inventory due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method, to whatever extent is necessary to allow the taxpayer to apply the weighted average method.

(B) *Weighted average method for FIFO taxpayers*—(1) *In general.* This paragraph (c)(2)(iv)(B) sets forth the mechanics of the weighted average method as applicable to FIFO taxpayers. Under the weighted average method, an item in ending inventory for which sufficient data is not available for revaluation under section 263A and the regulations thereunder must be revalued by using the weighted average percentage increase or decrease with respect to such item for the earliest subsequent taxable year for which sufficient data is available. With respect to an item for which no subsequent data exists, such item must be revalued by using the weighted average percentage increase or decrease with respect to all reasonably comparable items in the taxpayer's inventory for the same year or the earliest subsequent taxable year for which sufficient data is available.

(*2*) *Example.* The provisions of this paragraph (c)(2)(iv)(B) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. Taxpayer A manufactures bolts and uses the FIFO method to identify inventories. Under A's former method, A did not capitalize all of the costs required to be capitalized under section 263A. A maintains inventories of bolts, two types of which it no longer produces. Bolt A was last produced in 1994. The revaluation of the costs of Bolt A under this section for bolts produced in 1994 results in a 20 percent increase of the costs of Bolt A. A portion of the inventory of Bolt A, however, is attributable to 1993. A does not have sufficient data for revaluation of the 1993 cost for Bolt A. With respect to Bolt A, A may apply the 20 percent increase determined for 1994 to the 1993 production as an acceptable estimate. Bolt B was last produced in 1992 and no data exists that would allow revaluation of the inventory cost of Bolt B. The inventories of all other bolts for which information is available are attributable to 1994 and 1995. Revaluation of the costs of these other bolts using available data results in an average increase in inventory costs of 15 percent for 1994 production. With respect to Bolt B, the overall 15 percent increase for A's inventory for 1994 may be used in revaluing the cost of Bolt B.

(C) *Weighted average method for specific goods LIFO taxpayers*—(1) *In general.* This paragraph (c)(2)(iv)(C) sets forth the mechanics of the weighted average method as applicable to LIFO taxpayers using the specific goods method of valuing inventories. Under the weighted average method, the inventory layers with respect to an item for which data is available are revalued under this section and the increase or decrease in amount for each layer is expressed as a percentage of change from the cost in the layer as originally valued. A weighted average of the percentage of change for all layers for each type of good is computed and applied to all earlier layers for each type of good that lack sufficient data to allow for revaluation. In the case of earlier layers for which sufficient data exists, such layers are to be revalued using actual data. In cases where sufficient data is not available to make a weighted average estimate with respect to a particular item of inventory, a weighted average increase or decrease is to be determined using all other inventory items revalued by the taxpayer in the same specific goods grouping. This percentage increase or decrease is then used to revalue the cost of the item for which data is lacking. If the taxpayer lacks sufficient data to revalue any of the inventory items contained in a specific goods grouping, then the weighted aver-

age increase or decrease of substantially similar items (as determined by principles similar to the rules applicable to dollar-value LIFO taxpayers in §1.472–8(b)(3)) must be applied in the revaluation of the items in such grouping. If insufficient data exists with respect to all the items in a specific goods grouping and to all items that are substantially similar (or such items do not exist), then the weighted average for all revalued items in the taxpayer's inventory must be applied in revaluing items for which data is lacking.

(2) *Example.* The provisions of this paragraph (c)(2)(iv)(C) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer M is a manufacturer that produces two different parts. Under M's former method, M did not capitalize all of the costs required to be capitalized under section 263A. Work-in-process inventory is recorded in terms of equivalent units of finished goods. M's records show the following at the end of 1996 under the specific goods LIFO inventory method:

LIFO Product and layer	*Number*	*Cost*	*Carrying values*
Product #1:			
1993	150	$5.00	$750
1994	100	6.00	600
1995	100	6.50	650
1996	50	7.00	350
			$2,350
Product #2:			
1993	200	$4.00	$800
1994	200	4.50	900
1995	100	5.00	500
1996	100	6.00	600
			$2,800

Total carrying value of Products #1 and #2 under M's former method $5,150

(ii) M has sufficient data to revalue the unit costs of Product #1 using its new method for 1994, 1995 and 1996. These costs are: $7.00 in 1994, $7.75 in 1995, and $9.00 in 1996. This data for Product #1 results in a weighted average percentage change of 20.31 percent [(100 × ($7.00 – $6.00)) + (100 × ($7.75 – $6.50)) + (50 × ($9.00 – $7.00)) divided by (100 x $6.00) + (100 × $6.50) + (50 × $7.00)]. M has sufficient data to revalue the unit costs of Product #2 only in 1995 and 1996. These costs are: $6.00 in 1995 and $7.00 in 1996. This data for Product #2 results in a weighted average percentage change of 18.18 percent [(100 × ($6.00 – $5.00)) + (100 × ($7.00 – $6.00)) divided by (100 × $5.00) + (100 × $6.00)].

(iii) M can estimate its revalued costs for Product #1 for 1993 by applying the weighted average increase computed for Product #1 (20.31 percent) to the unit costs originally carried on M's records for 1993 under M's former method. The estimated revalued unit cost of Product #1 would be $6.02 ($5.00 × 1.2031). M estimates its revalued costs for Product #2 for 1993 and 1994 in a similar fashion. M applies the weighted average increase determined for Product #2 (18.18 percent) to the unit costs of $4.00 and $4.50 for 1993 and 1994 respectively. The revalued unit costs of Product #2 are $4.73 for 1993 ($4.00 × 1.1818) and $5.32 for 1994 ($4.50 × 1.1818).

(iv) M's inventory would be revalued as follows:

LIFO Product and layer	*Number*	*Cost*	*Carrying values*
Product #1:			
1993	150	$6.02	$903
1994	100	7.00	700
1995	100	7.75	775
1996	50	9.00	450
			$2,828
Product #2:			
1993	200	$4.73	$946
1994	200	5.32	1,064
1995	100	6.00	600
1996	100	7.00	700
			$3,310

Total value of Products #1 and #2 as revalued under M's new method $6,138

Total amount of adjustment required under section 481(a) [$6,138 – $5,150] $988

(D) *Adjustments to inventory costs from prior years.* For special rules applicable when a revaluation using the weighted average method includes costs not incurred in prior years, see paragraph (c)(2)(v)(E) of this section.

(v) *3-year average method*—(A) *In general.* A taxpayer using the dollar-value LIFO method of accounting for inventories may revalue all existing LIFO layers of a trade or business based on the 3-year average method as provided in this paragraph (c)(2)(v). The 3-year average method is based on the average percentage change (the 3-year revaluation factor) in the current costs of inventory for each LIFO pool based on the three most recent taxable years for which the taxpayer has sufficient information (typically, the three most recent taxable years of such trade or business). The 3-year revaluation factor is applied to all layers for each pool in beginning inventory in the year of change. The 3-year average method is available to any dollar-value taxpayer that complies with the requirements of this paragraph (c)(2)(v) regardless of whether such taxpayer lacks sufficient data to revalue its inventory costs under the facts and circumstances revaluation method prescribed in paragraph (c)(2)(iii) of this section. The 3-year average method must be applied with respect to all inventory in a taxpayer's trade or business. A taxpayer is not permitted to apply the method for the revaluation of some, but not all, inventory costs on the basis of pools, business units, or other measures of inventory amounts that do not constitute a separate trade or business. Generally, a taxpayer revaluing its inventory using the 3-year average method must establish a new base year. See, paragraph (b)(2)(iii)(A)(2)(i) of this section. However, a dollar-value LIFO taxpayer using the 3-year average method and either the simplified production method or the simplified resale method to revalue its inventory is permitted, but not required, to establish a new base year. See, paragraph (b)(2)(iii)(A)(2)(ii) of this section. If a taxpayer lacks sufficient information to otherwise apply the 3-year average method under this paragraph (c)(2)(v) (for example, the taxpayer is unable to revalue the costs of any of its LIFO pools for three years due to a lack of information), then the taxpayer must use reasonable estimates and procedures, as described in the facts and circumstances revaluation method under paragraph (c)(2)(iii) of this section, to whatever extent is necessary to allow the taxpayer to apply the 3-year average method.

(B) *Consecutive year requirement.* Under the 3-year average method, if sufficient data is available to calculate the revaluation factor for more than three years, the taxpayer may use data from such additional years in determining the average percentage increase or decrease only if the additional years are consecutive to and prior to the year of change. The requirement under the preceding sentence to use consecutive years is applicable under this method regardless of whether any inventory costs in beginning inventory as of the year of change are viewed as incurred in, or attributable to, those consecutive years under the LIFO inventory method. Thus, the requirement to use data from consecutive years may result in using information from a year in which no LIFO increment occurred. For example, if a taxpayer is changing its method of accounting in 1997 and has sufficient data to revalue its inventory for the years 1991 through 1996, the taxpayer may calculate the revaluation factor using all six years. If, however, the taxpayer has sufficient data to revalue its inventory for the years 1990 through 1992, and 1994 through 1996, only the three years consecutive to the year of change, that is, 1994

through 1996, may be used in determining the revaluation factor. Similarly, for example, a taxpayer with LIFO increments in 1995, 1993, and 1992 may not calculate the revaluation factor based on the data from those years alone, but instead must use the data from consecutive years for which the taxpayer has information.

(C) *Example.* The provisions of this paragraph (c)(2)(v) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Taxpayer G, a calendar year taxpayer, is a reseller that is required to change its method of accounting under section 263A. G will not use either the simplified production method or the simplified resale method. G adopted the dollar-value LIFO inventory method in 1991, using a single pool and the double extension method. G's beginning LIFO inventory as of January 1, 1997, computed using its former method, for the year of change is as follows:

	Base year costs	*Index*	*LIFO carrying value*
Base layer	$14,000	1.00	$14,000
1991 layer	4,000	1.20	4,800
1992 layer	5,000	1.30	6,500
1993 layer	2,000	1.35	2,700
1994 layer	0	1.40	0
1995 layer	4,000	1.50	6,000
1996 layer	5,000	1.60	8,000
Total	$34,000	....	$42,000

(ii) G is able to recompute total inventoriable costs incurred under its new method for the three preceding taxable years as follows:

	Current cost as recorded (former method)	*Current cost as adjusted (new method)*	*Percentage change*
1994	$35,000	$45,150	.29
1995	43,500	54,375	.25
1996	54,400	70,720	.30
Total	$132,900	$170,245	.28

(iii) Applying the average revaluation factor of .28 to each layer, G's inventory is restated as follows:

	Restated base year costs	*Index*	*Restated LIFO carrying value*
Base layer	$17,920	1.00	$17,920
1991 layer	5,120	1.20	6,144
1992 layer	6,400	1.30	8,320
1993 layer	2,560	1.35	3,456
1994 layer	0	1.40	0
1995 layer	5,120	1.50	7,680
1996 layer	6,400	1.60	10,240
Total	$43,520	....	$53,760

(iv) The adjustment required by section 481(a) is $11,760. This amount may be computed by multiplying the average percentage of .28 by the LIFO carrying value of G's inventory valued using its former method ($42,000). Alternatively, the adjustment required by section 481(a) may be computed by the difference between—

(*A*) The revalued costs of the taxpayer's inventory under its new method ($53,760), and

(*B*) The costs of the taxpayer's inventory using its former method ($42,000).

(v) In addition, the inventory as of the first day of the year of change (January 1, 1997) becomes the new base year cost for purposes of determining the LIFO index in future years. See, paragraphs (b)(2)(iii)(A)(2)(i) and (b)(2)(iii)(B) of this section. This requires that layers in years prior to the base year be restated in terms of the new base year index. The current year cost of G's inventory, as adjusted, is $70,720. Such cost must be apportioned to each layer in proportion to the restated base year cost of that layer to total restated base year costs ($43,520), as follows:

	Restated base year costs	*Restated index*	*Restated LIFO carrying value*
Old base layer	$29,120	.615	$17,920
1991 layer	8,320	.738	6,144
1992 layer	10,400	.80	8,320
1993 layer	4,160	.831	3,456
1994 layer	0	—	0
1995 layer	8,320	.923	7,680
1996 layer	10,400	.985	10,240
Total	$70,720	....	$53,760

(D) *Short taxable years.* A short taxable year is treated as a full 12 months.

(E) *Adjustments to inventory costs from prior years—(1) General rule—(i)* The use of the revaluation factor, based on current costs, to estimate the revaluation of prior inventory layers under the 3-year average method, as described in paragraph (c)(2)(v) of this section, may result in an allocation of costs that include amounts attributable to costs not incurred during the year in which the layer arose. To the extent a taxpayer can demonstrate that costs that contributed to the determination of the revaluation factor could not have affected a prior year, the revaluation factor as applied to that year may be adjusted under the restatement adjustment procedure, as described in paragraph (c)(2)(v)(F) of this section. The determination that a cost could not have affected a prior year must be made by a taxpayer only upon showing that the type of cost incurred during the years used to calculate the revaluation factor (revaluation years) was not present during such prior year. An item of cost will not be eligible for the restatement adjustment procedure simply because the cost varies in amount from year to year or the same type of cost is described or referred to by a different name from year to year. Thus, the restatement adjustment procedure allowed under paragraph (c)(2)(v)(F) of this section is not available in a prior year with respect to a particular cost if the same type of cost was incurred both in the revaluation years and in such prior year, although the amount of such cost and the name or description thereof may vary.

(*ii*) The provisions of this paragraph (c)(2)(v)(E) are also applicable to taxpayers using the weighted average method in revaluing inventories under paragraph (c)(2)(iv) of this section. Thus, to the extent a taxpayer can demonstrate that costs that contributed to the determination of the restatement of a particular year or item could not have affected a prior year or item, the taxpayer may adjust the revaluation of that prior year or item accordingly under the weighted average method. All the requirements and definitions, however, applicable to the restatement adjustment procedure under this paragraph (c)(2)(v)(E) fully apply to a taxpayer using the weighted average method to revalue inventories.

(*2*) *Examples of costs eligible for restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(E) are illustrated by the following four examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the four examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that introduced a defined benefit pension plan in 1994, and made the plan available to personnel whose labor costs were (directly or indirectly) properly allocable to resale activities. A determines the revaluation factor based on data available for the years 1994 through 1996, for which the pension plan was in existence. Based on these facts, the costs of the pension plan in the revaluation years are eligible for the restatement adjustment procedure for years prior to 1994.

Example 2. Assume the same facts as in *Example 1*, except that a defined contribution plan was available, during prior years, to personnel whose labor costs were properly allocable to resale activities. The defined contribution plan was terminated before the introduction of the defined benefit plan in 1994. Based on these facts, the costs of the defined benefit pension plan in the revaluation years are not eligible for the restatement adjustment procedure with respect to years for which the defined contribution plan existed.

Example 3. Taxpayer C is a manufacturer that established a security department in 1995 to patrol and safeguard its production and warehouse areas used in C's trade or business. Prior to 1995, C had not been required to utilize security personnel in its trade or business; C established the security department in 1995 in response to increasing vandalism and theft at its plant locations. Based on these facts, the costs of the security department are eligible for the restatement adjustment procedure for years prior to 1995.

Example 4. Taxpayer D is a reseller that established a payroll department in 1995 to process the company's weekly payroll. In the years 1991 through 1994, D engaged the services of an outside vendor to process the company's payroll. Prior to 1991, D's payroll processing was done by D's accounting department, which was responsible for payroll processing as well as for other accounting functions. Based on these facts, the costs of the payroll department are not eligible for the restatement adjustment procedure. D was incurring the same type of costs in earlier years as D was incurring in the payroll department in 1995 and subsequent years, although these costs were designated by a different name or description.

(F) *Restatement adjustment procedure—(1) In general—(i)* This paragraph (c)(2)(v)(F) provides a restatement adjustment procedure whereunder a taxpayer may adjust the restatement of inventory costs in prior taxable years in order to produce a different restated value than the value that would otherwise occur through application of the revaluation factor to such prior taxable years.

(ii) Under the restatement adjustment procedure as applied to a particular prior year, a taxpayer must determine the particular items of cost that are eligible for the restatement adjustment with respect to such prior year. The taxpayer must then recompute, using reasonable estimates and procedures, the total inventoriable costs that would have been incurred for each revaluation year under the taxpayer's former method and the taxpayer's new method by making appropriate adjustments in the data for such revaluation year to reflect the particular costs eligible for adjustment.

(iii) The taxpayer must then compute the total percentage change with respect to each revaluation year, using the revised estimates of total inventoriable costs for such year as described in paragraph (c)(2)(v)(F)(1)(ii) of this section. The percentage change must be determined by calculating the ratio of the revised total of the inventoriable costs for such revaluation year under the taxpayer's new method to the revised total of the inventoriable costs for such revaluation year under the taxpayer's former method.

(iv) An average of the resulting percentage change for all revaluation years is then calculated, and the resulting average is applied to the prior year in issue.

(2) *Examples of restatement adjustment procedure.* The provisions of this paragraph (c)(2)(v)(F) are illustrated by the following two examples. The principles set forth in these examples are applicable both to production and resale activities and the year of change in the two examples is 1997. The examples read as follows:

Example 1. Taxpayer A is a reseller that is eligible to make a restatement adjustment by reason of the costs of a defined benefit pension plan that was introduced in 1994, during the revaluation period. The revaluation factor, before adjustment of data to reflect the pension costs, is as provided in the example in paragraph (c)(2)(v)(C) of this section. Thus, for example, with respect to the year 1994, the total inventoriable costs under A's former method is $35,000, the total inventoriable costs under A's new method is $45,150, and the percentage change is .29. Under the method of accounting used by A during 1994 (the former method), none of the pension costs were included as inventoriable costs. Thus, under the restatement adjustment procedure, the total inventoriable cost under A's former method would remain at $35,000 if the pension plan had not been in existence. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .20 ([$42,000 – $35,000]/$35,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence. Such revalued layers would then be viewed as restated in compliance with the requirements of this paragraph. With respect to cost layers incurred during years for which the pension plan was in existence, no adjustment of the revaluation factor would occur.

Example 2. Assume the same facts as in *Example 1,* except that a portion of the pension costs were included as inventoriable costs under the method used by A during 1994 (the former method). Under the restatement adjustment procedure, A determines that the total inventoriable costs for 1994 under the former method, if the pension plan had not been in existence, would have been $34,000. Similarly, A determines that the total inventoriable costs for 1994 under A's new method, if the pension plan had not been in existence, would have been $42,000. The restatement adjustment for 1994 determined under this paragraph (c)(2)(v)(F) would then be equal to .24 ([$42,000 – $34,000]/$34,000). A would make similar calculations with respect to 1995 and 1996. The average of such amounts for each of the three years in the revaluation period would then be determined as in the example in paragraph (c)(2)(v)(C) of this section. Such average would be used to revalue cost layers for years for which the pension plan was not in existence.

(3) *Intercompany items*—(i) *Revaluing intercompany transactions.* Pursuant to any change in method of accounting for costs subject to section 263A, taxpayers are required to revalue the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method. The requirement of the preceding sentence applies with respect to both inventory produced by a taxpayer and inventory acquired by the taxpayer for resale. In addition, the requirements of this paragraph (c)(3) apply only to any intercompany item of the taxpayer as of the beginning of the year of change in method of accounting. See §1.1502–13(b)(2)(ii). A taxpayer must revalue the amount of any intercompany item only if the inventory property sold in the intercompany transaction is held as inventory by a buying member as of the date the taxpayer changes its method of accounting under section 263A. Corresponding changes to the adjustment required under section 481(a) must be made with respect to any adjustment of the intercompany item required under this paragraph (c)(3). Moreover, the requirements of this paragraph (c)(3) apply regardless of whether the taxpayer has any items in beginning inventory as of the year of change in method of accounting. See §1.1502–13 for the definition of intercompany transaction.

(ii) *Example.* The provisions of this paragraph (c)(3) are illustrated by the following example. The principles set forth in this example are applicable both to production and resale activities and the year of change in the example is 1997. The example reads as follows:

Example. (i) Assume that S, a member of a consolidated group filing its federal income tax return on a calendar year, manufactures and sells inventory property to B, a member of the same consolidated group, in 1996. The sale between S and B is an intercompany transaction as defined under §1.1502–13(b)(1). The gain from the intercompany transaction is an intercompany item to S under §1.1502–13(b)(2). As of the beginning of the year of change in method of accounting (January 1, 1997), the inventory property is still held by B based on the particular inventory method of accounting used by B for federal income tax purposes (for example, the LIFO or FIFO inventory method). The property was sold by S to B in 1996 for $150; the cost of goods sold with respect to the property under the method in effect at the time the inventory was produced was $100, resulting in an intercompany item of $50 to S under §1.1502–13. As of January 1, 1997, S still has an intercompany item of $50.

(ii) S is required to revalue the amount of its intercompany item to an amount equal to what the intercompany item would have been had the cost of goods sold for that inventory property been determined under S's new method. Assume that the cost of the inventory under this method would have been $110, had the method applied to S's manufacture of the property in 1996. Thus, S is required to revalue the amount of its intercompany item to $40 (that is, $150 less $110), necessitating a negative adjustment

to the intercompany item of $10. Moreover, S is required to increase its adjustment under section 481(a) by $10 in order to prevent the omission of such amount by virtue of the decrease in the intercompany item.

(iii) *Availability of revaluation methods.* In revaluing the amount of any intercompany item resulting from the sale or exchange of inventory property in an intercompany transaction to an amount equal to the intercompany item that would have resulted had the cost of goods sold for that inventory property been determined under the taxpayer's new method, a taxpayer may use the other methods and procedures otherwise properly available to that particular taxpayer in revaluing inventory under section 263A and the regulations thereunder, including, if appropriate, the various simplified methods provided in section 263A and the regulations thereunder and the various procedures described in this paragraph (c).

(4) *Anti-abuse rule*—(i) *In general.* Section 263A(i)(1) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of section 263A, including regulations to prevent the use of related parties, pass-thru entities, or intermediaries to avoid the application of section 263A and the regulations thereunder. One way in which the application of section 263A and the regulations thereunder would be otherwise avoided is through the use of entities described in the preceding sentence in such a manner as to effectively avoid the necessity to restate beginning inventory balances under the change in method of accounting required or permitted under section 263A and the regulations thereunder.

(ii) *Deemed avoidance of this section*—(A) *Scope.* For purposes of this paragraph (c), the avoidance of the application of section 263A and the regulations thereunder will be deemed to occur if a taxpayer using the LIFO method of accounting for inventories, transfers inventory property to a related corporation in a transaction described in section 351, and such transfer occurs:

(*1*) On or before the beginning of the transferor's taxable year beginning in 1987; and

(*2*) After September 18, 1986.

(B) *General rule.* Any transaction described in paragraph (c)(4)(ii)(A) of this section will be treated in the following manner:

(*1*) Notwithstanding any provision to the contrary (for example, section 381), the transferee corporation is required to revalue the inventories acquired from the transferor under the provisions of this paragraph (c) relating to the change in method of accounting and the adjustment required by section 481(a), as if the inventories had never been transferred and were still in the hands of the transferor; and

(*2*) Absent an election as described in paragraph (c)(4)(iii) of this section, the transferee must account for the inventories acquired from the transferor by treating such inventories as if they were contained in the transferee's LIFO layer(s).

(iii) *Election to use transferor's LIFO layers.* If a transferee described in paragraph (c)(4)(ii) of this section so elects, the transferee may account for the inventories acquired from the transferor by allocating such inventories to LIFO layers corresponding to the layers to which such properties were properly allocated by the transferor, prior to their transfer. The transferee must account for such inventories for all subsequent periods with reference to such layers to which the LIFO costs were allocated. Any such election is to be made on a statement attached to the timely filed federal income tax return of the transferee for the first taxable year for which section 263A and the regulations thereunder applies to the transferee.

(iv) *Tax avoidance intent not required.* The provisions of paragraph (c)(4)(ii) of this section will apply to any transaction described therein, without regard to whether such transaction was consummated with an intention to avoid federal income taxes.

(v) *Related corporation.* For purposes of this paragraph (c)(4), a taxpayer is related to a corporation if—

(A) the relationship between such persons is described in section 267(b)(1), or

(B) such persons are engaged in trades or businesses under common control (within the meaning of paragraphs (a) and (b) of section 52).

(d) *Non-inventory property*—(1) *Need for adjustments.* A taxpayer that changes its method of accounting for costs subject to section 263A with respect to non-inventory property must revalue the non-inventory property on hand at the beginning of the year of change as set forth in paragraph (d)(2) of this section, and compute an adjustment under section 481(a). The adjustment under section 481(a) will equal the difference between the adjusted basis of the property as revalued using the taxpayer's new method and the adjusted basis of the property as originally valued using the taxpayer's former method.

(2) *Revaluing property.* A taxpayer must revalue its non-inventory property as of the beginning of the year of change in method of accounting. The facts and circumstances revaluation method of paragraph (c)(2)(iii) of this section must be used to revalue this property. In revaluing non-inventory property, however, the only additional section 263A costs that must be taken into account are those additional section 263A costs incurred after the later of December 31, 1986, or the date the taxpayer first becomes subject to section 263A, in taxable years ending after that date. See §1.263A–1(d)(3) for the definition of additional section 263A costs.

§ 1.263A–7T [Removed]

Par. 5. Section 1.263A–7T is removed.

§ 1.263A–15 [Amended]

Par. 6. Section 1.263A–15 is amended by removing "1.263A–7T (e) generally" from the last sentence in paragraph (a)(1) and replacing it with "1.263A–7".

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved July 28, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 4, 1997, 8:45 a.m., and published in the issue of the Federal Register for August 5, 1997, 62 F.R. 42051)

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26 CFR 1.263A–4T: Rules for property produced in a farming business (temporary).

T.D. 8729

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Rules for Property Produced in a Farming Business

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the application of section 263A of the Internal Revenue Code to property produced in a farming business. These regulations affect certain taxpayers engaged in the trade or business of farming. These regulations are necessary to provide guidance with respect to section 263A(d).

The text of the temporary regulations also serves as the text of REG–208151–91 on page 625 of this Bulletin.

DATES: These regulations are effective August 22, 1997. For dates of applicability, see §1.263A–4T(f) of these regulations.

SUPPLEMENTARY INFORMATION:

Background

Prior to the enactment of section 263A, the rules that governed the deduction or capitalization of costs incurred with respect to property produced in the trade or business of farming were set forth in several different statutory and regulatory provisions. Costs regarded as preparatory expenditures were required to be capitalized under section 263. Preparatory expenditures are expenditures incurred prior to raising agricultural or horticultural commodities or that otherwise enable a farmer to begin the farming process. See, e.g., Rev. Rul. 83–28, 1983–1 C.B. 47. Preparatory expenditures include the costs of clearing land, leveling and grading land, drilling and equipping wells, acquiring irrigation systems, acquiring seeds or seedlings, budding trees, and acquiring animals.

Costs regarded as developmental expenditures (sometimes referred to as cultural practices expenditures) were generally permitted to be deducted, or, at a taxpayer's election, could be capitalized. See, e.g., *Wilbur v. Commissioner,* 43 T.C. 322 (1964), acq., 1965–2 C.B. 7. Developmental expenditures are those expenditures incurred by a taxpayer so that the growing process may continue in the desired manner. Developmental expenditures are expenditures that, if incurred while the plant or animal was in a productive state, would be deductible. See *Maple v. Commissioner,* 27 T.C.M. 944 (1968), *aff'd,* 440 F.2d 1055 (9th Cir. 1971). Developmental expenditures include the costs of irrigating, fertilizing, spraying, cultivating, pruning, feeding, providing veterinary services, rent on land, and depreciation allowances on irrigation systems or structures.

Former sections 278 and 447 provided special rules requiring the capitalization of certain developmental expenditures. Former section 278(a) provided special rules for citrus and almond groves. Under former section 278(a), all otherwise deductible costs of developing citrus or almond groves incurred before the end of the fourth taxable year after permanent planting were required to be capitalized. Rev. Rul. 83–128, 1983–2 C.B. 57, clarified that the costs incurred prior to permanent planting were also required to be capitalized.

Former sections 278(b) and 447(b) provided special rules for farming syndicates, corporations, and partnerships with a corporate partner. Section 447 requires certain corporations and partnerships with a corporate partner to use an accrual method of accounting (accrual method). Former section 447(b) required these taxpayers to capitalize preproductive period expenses. Preproductive period expenses were defined as any expenses attributable to crops, animals, trees, or other property having a crop or yield and that are incurred during the preproductive period of such property. Soil and water conservation expenditures, as defined in section 175, and land-clearing expenditures as defined in former section 182, are preproductive period expenses if they are incurred in a preproductive period of an agricultural or horticultural activity and if the taxpayer elects to deduct these expenses rather than capitalize them. House Comm. on Ways and Means, Tax Reform Act of 1975, H.R. Rep. No. 94–658, 94th Cong., 1st Sess. 93 (1975).

In the case of a farming syndicate engaged in planting, cultivating, maintaining, or developing an orchard, vineyard, or grove, former section 278(b) required the capitalization of all otherwise deductible expenditures incurred with respect to the orchard, vineyard, or grove, if incurred prior to the first taxable year in which there was a crop or yield in commercial quantities.

Former section 278(c) provided a relief provision. Under this provision, sections 278(a) or (b) would not require the capitalization of developmental expenditures attributable to an orchard, vineyard, or grove that was replanted after having been lost or damaged by reason of freezing temperatures, disease, drought, pests, or casualty.

Section 263A, enacted in the Tax Reform Act of 1986, Pub. L. 99–514, 100 Stat. 2085, 1986–3 C.B. Vol. 1 (the 1986 Act), provides uniform capitalization rules that govern the treatment of costs incurred in the production of property or the acquisition of property for resale. Section 263A was enacted, in part, to prevent the inappropriate mismatching of income and expense that results from the current deduction of the costs of producing property. Section 263A generally incorporates and expands upon the rules set forth in several code and regulatory sections, including section 263, and former sections 278 and 447.

Section 263A(b) generally provides that the uniform capitalization rules apply to the taxpayer's production of real or tangible personal property. Section 1.263A–2(a)(1)(i) clarifies that for purposes of section 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow. Sections 263A(d) and (e) provide special rules for property produced in a farming business.

Section 263A, as enacted in 1986, generally required taxpayers to capitalize the costs of producing plants and animals. Taxpayers not required by section 447 or 448(a)(3) to use an accrual method were excepted from capitalizing the preproductive period costs of plants and animals (except animals held for slaughter) that had a preproductive period of 2 years or less. Section 263A was amended as part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. 100–203, 101 Stat. 1330, 1987–3 C.B. Vol. 1 (the 1987 Act), the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100–647, 102 Stat. 3342, 1988–3 C.B. Vol. 1 (the 1988 Act),

and the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101–239, 103 Stat. 2106 (the 1989 Act). Under the 1988 Act, the scope of the exception for these taxpayers is expanded to include all animals irrespective of the length of the preproductive period.

In addition, taxpayers not required by section 447 or 448(a)(3) to use an accrual method may elect not to capitalize the costs of plants (other than certain costs of producing citrus and almond trees) with a preproductive period in excess of 2 years. If a taxpayer makes this election, the taxpayer must treat such plants as section 1245 property and upon disposition of these plants any amount allowable as a deduction that would, but for the election, have been capitalized must be recaptured and treated as a deduction allowed for depreciation with respect to such property. See section 263A(e)(1). Also, if the taxpayer makes the election, the taxpayer and related persons must apply the alternative depreciation system provided in section 168(g)(2) to all property used by the taxpayer or related person predominantly in a farming business and placed in service in any taxable year in which the election out of section 263A is in effect. See section 263A(e)(2).

On March 30, 1987, the IRS published in the **Federal Register** a notice of proposed rulemaking (52 FR 10118) by cross reference to temporary regulations published the same day (T.D. 8131, 52 FR 10052). Amendments to the notice of proposed rulemaking and temporary regulations were published in the **Federal Register** on August 7, 1987, by a notice of proposed rulemaking (52 FR 29391) that cross referenced to temporary regulations published the same day (T.D. 8148, 52 FR 29375). Notice 88–24, 1988–1 C.B. 491, provided that forthcoming regulations would modify the temporary regulations and the regulations under §1.471–6. Notice 88–86, 1988–2 C.B. 401, provided that forthcoming regulations would clarify the definition of a related person for purposes of the election out of section 263A. In addition, Notice 88–86 provided that forthcoming regulations would provide that certain taxpayers could elect to use the simplified production method for property used in the trade or business of farming. On August 5, 1994, the temporary regulations relating to property produced in a farming business were reissued and published in the **Federal Register** (T.D. 8559, 59 FR 39958). Because substantial changes are being made from the 1994 temporary regulations, the IRS and Treasury Department have decided to issue, in part, new proposed and temporary, rather than final, regulations.

Explanation of Provisions

Property Produced In The Trade Or Business Of Farming

The temporary regulations clarify that the special rules of section 263A(d) apply only to property produced in a farming business. The temporary regulations provide that for purposes of section 263A, the term farming means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. The regulations clarify that for this purpose harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer. Accordingly, while a taxpayer that grows a plant may apply the special rules of section 263A(d) to the costs of growing and harvesting the plant, the special rules of section 263A(d) do not apply to a taxpayer that merely contract harvests agricultural or horticultural commodities grown or raised by another taxpayer. Similarly, the temporary regulations clarify that the special rules of section 263A(d) do not apply to a taxpayer that merely buys and resells plants or animals grown or raised by another. In evaluating whether a taxpayer is engaged in the production, or merely the resale, of plants or animals, it is anticipated that consideration will be given to factors including: the length of time between the taxpayer's acquisition of a plant or animal and the time the plant or animal is made available for sale to the taxpayer's customers, and, in the case of plants, whether plants acquired by the taxpayer are planted in the ground or kept in temporary containers.

The temporary regulations provide that a farming business does not include the processing of commodities or products beyond those activities that are incident to the growing, raising, or harvesting of such products.

Preparatory And Developmental Costs

The IRS and Treasury Department believe that, in general, section 263A does not change the rules regarding capitalization of costs during the preparatory period. Thus, the temporary regulations clarify that, as under prior law, taxpayers generally must capitalize preparatory expenditures, including the cost of seeds, seedlings, and animals; clearing, leveling and grading land; drilling and equipping wells; irrigation systems; and budding trees. However, because section 263A requires the capitalization of certain indirect costs as well as direct costs, the amount of preparatory expenditures capitalized may be greater under section 263A than under prior law.

Section 263A expands the circumstances under which costs that were once termed developmental expenditures must be capitalized. The temporary regulations clarify that costs that were, in years prior to the enactment of section 263A, regarded as developmental are included in the category of preproductive period costs. Section 263A generally requires the capitalization of preproductive period costs including the costs of irrigating, fertilizing, spraying, cultivating, pruning, feeding, providing veterinary services, rent on land, and depreciation allowances on irrigation systems or structures. Preproductive period costs also include real estate taxes, interest, and soil and water conservation expenditures incurred during the preproductive period of a plant.

Taxpayers that are required by section 447 or 448(a)(3) to use an accrual method must capitalize all preproductive period costs of plants (without regard to the length of the preproductive period) and animals. Taxpayers that are not required by section 447 or 448(a)(3) to use an accrual method qualify for an exception to this general rule. Under this exception, taxpayers are not required to capitalize preproductive period costs incurred with respect to animals, or with respect to plants that have a preproductive period of 2 years or less. Thus,

under this exception, taxpayers are required to capitalize only those preproductive period costs incurred with respect to plants that have a preproductive period in excess of 2 years. The temporary regulations clarify that, for purposes of determining whether a plant has a preproductive period in excess of 2 years, in the case of a plant grown in commercial quantities in the United States, the nationwide weighted average preproductive period of such plant is used.

The IRS and Treasury Department are considering the publication of guidance with respect to the length of the preproductive period of certain plants that will have more than one crop or yield. At the present time, the IRS and Treasury Department anticipate that such guidance would provide that plants producing the following crops or yields have a nationwide weighted average preproductive period in excess of 2 years: almonds, apples, apricots, avocados, blueberries, blackberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts. The IRS and Treasury Department invite comments on this issue.

Capitalization Period

Preproductive period costs (e.g., irrigating, fertilizing, real estate taxes, etc.) are capitalized during the preproductive period of a plant or animal. A taxpayer that grows a plant that will have more than one crop or yield is engaged in the production of two types of property, the plant and the crop or yield of the plant (e.g., the orange tree and the orange). The temporary regulations clarify the capitalization period for plants that will have more than one crop or yield, for crops or yields of plants that will have more than one crop or yield, and for other plants.

The temporary regulations clarify that the preproductive period of a plant generally begins when a taxpayer first incurs costs with respect to the plant, e.g., when the plant is acquired or the seed is planted. In the case of the crop or yield of a plant that has become productive in marketable quantities, the preproductive period of the crop or yield begins when the crop or yield first appears, whether in the form of a sprout, bloom, blossom, bud, etc.

In the case of a plant that will have more than one crop or yield, the preproductive period of the plant ends when the plant becomes productive in marketable quantities (i.e., when the plant is placed in service for purposes of depreciation). In the case of the crop or yield of a plant that has become productive in marketable quantities, the preproductive period of the crop or yield ends when the crop or yield is disposed of. Finally, in the case of other plants, the preproductive period ends when the plant is disposed of.

The temporary regulations provide that the preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. The temporary regulations clarify that, in the case of an animal that will be used in the trade or business of farming, the preproductive period generally ends when the animal is placed in service for purposes of depreciation. However, in the case of an animal that will have more than one yield, the preproductive period ends when the animal produces (e.g., gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of. The temporary regulations additionally clarify that, in the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield on a reasonable and consistent basis. Any depreciation allowance on the animal may be allocated entirely to the yield.

Method Of Capitalizing Costs

The temporary regulations provide that the costs required to be capitalized with respect to farming property may, if the taxpayer chooses, be determined using any reasonable inventory valuation method, such as the farm-price method of accounting (farm-price method) or the unit-livestock-price method of accounting (unit-livestock-price method). The use of these inventory valuation methods avoids the necessity of accounting for the costs of raising plants or animals by tracing costs to each separate plant or animal. In addition, under the temporary regulations, these inventory methods may be used by a taxpayer regardless of whether the farming property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash method or an accrual method.

The temporary regulations clarify that notwithstanding a taxpayer's use of the farm-price method with respect to farming property to which the provisions of section 263A apply, the taxpayer is not required, solely by such use, to use the same method of accounting with respect to farming property to which the provisions of section 263A do not apply.

Under the unit-livestock-price method, the taxpayer adopts a standard unit price for each animal within a particular class. This standard unit price is used by the taxpayer in lieu of specifically identifying and tracing the costs of raising each animal in the taxpayer's farming business. Taxpayers using the unit-livestock-price method must adopt a reasonable method of classifying animals with respect to their age and kind so that the unit prices assigned by the taxpayer to animals in each class are reasonable. Thus, taxpayers using the unit-livestock-price method typically classify livestock based on their age (for example, a separate class will typically be established for calves, yearlings, and 2-year olds).

The temporary regulations under section 263A modify the rule set forth in §1.471–6 providing that no increase in unit cost is required under the unit-livestock-price method with respect to the taxable year in which certain animals are purchased, if the purchases occur in the last 6 months of the taxable year. The temporary regulations provide that any taxpayer required to use an accrual method under section 448(a)(3) must include in inventory the annual standard unit price for all animals purchased during the taxable year, regardless of when in the taxable year the purchases are made. The temporary regulations further amend this rule and provide that all taxpayers using the unit-livestock-price method must modify the annual standard price to reasonably reflect the particular period in the taxable year in which purchases of

livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit-livestock-price method. The temporary regulations do not specify the particular modification that must be made to the annual standard price for any particular taxpayer, but rather allow any reasonable modification made by the taxpayer to the annual standard price to avoid significant distortions in income. For example, assume a taxpayer purchases and raises cattle for slaughter. Assume further that the taxpayer is required to use an accrual method under section 447 so that section 263A applies to the taxpayer's costs of raising the cattle. The temporary regulations provide that the taxpayer may not expense the costs of raising cattle that are purchased in the latter half of the taxpayer's taxable year. Instead, the taxpayer must modify the annual standard price so as to reasonably capitalize the costs of raising the cattle, based on the date of their purchase.

In Notice 88–86, the IRS noted that commentators had inquired as to the availability of the simplified production method of accounting (simplified production method) for farmers using the unit-livestock-price method for the costs of raising livestock. The temporary regulations clarify that farmers using the unit-livestock-price method are permitted to elect the simplified production method, as well as the simplified service cost method of accounting, under section 263A. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer's standard unit price determined under these temporary and final regulations. The term additional section 263A costs includes all additional costs required to be capitalized under section 263A including costs that are required to be capitalized under section 263A that are not reflected in the standard unit prices (e.g., general and administrative costs and depreciation, including depreciation on a calf's mother).

In light of the additional costs required to be capitalized under section 263A, taxpayers should not adopt unit prices utilized under pre-section 263A unit-livestock-price rules without carefully analyzing whether these unit prices reflect all of the costs required to be capitalized under section 263A.

Election Not To Capitalize Costs

Certain taxpayers, other than those required to use an accrual method by section 447 or 448(a)(3), may elect not to capitalize the preproductive period costs of certain plants even though such plants have a preproductive period in excess of 2 years and would otherwise be subject to the capitalization requirements of section 263A. Taxpayers making this election may continue to deduct (subject to other limitations of the Code) the preproductive period costs that were deductible under the rules in effect before the enactment of section 263A. The temporary regulations clarify that although a taxpayer producing a citrus or almond grove may make this election, the election does not apply to the preproductive period costs of a citrus or almond grove that are incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted.

If a taxpayer makes this election with respect to any plant, the taxpayer must treat the plant as section 1245 property. In addition, the taxpayer, and any person related to the taxpayer, must use the alternative depreciation system of section 168(g)(2) for any property used predominantly in a farming business that is placed in service in a taxable year for which the election is in effect.

Casualty Loss Exception

Section 263A(d) provides an exception from capitalization for preproductive period costs incurred with respect to plants that are replacing certain plants that were lost by reason of certain casualties. The temporary regulations clarify that this exception for preproductive period costs does not apply to preparatory expenditures or the costs of capital assets. In addition, the temporary regulations clarify that the casualty loss exception applies whether the plants are replanted on the same parcel of land as the plants destroyed by casualty or a parcel of land of the same acreage in the United States. The temporary regulations additionally clarify that the exception applies to all plants replanted on such acreage, even if the plants are replanted in greater density than the plants destroyed by the casualty.

Final Regulations

In final regulations, cross references to §1.263A–4T are provided in §§1.61–4, 1.162–12, 1.263A–1, and 1.471–6.

Under §1.471–6(f), taxpayers using the unit livestock method may not subsequently change the classification or unit costs they initially adopted without obtaining the approval of the Commissioner. As provided in Notice 88–24, the final regulations modify the rule in §1.471–6(f) and require that taxpayers adjust the unit prices upward from time to time, to reflect increases in costs taxpayers experience in raising livestock. Any other changes in the classification or unit prices used in the unit- livestock-price method will continue to be allowed only with the consent of the Commissioner.

Effective Date And Transitional Rule

The temporary regulations provide that, in the case of property that is not inventory in the hands of the taxpayer, the regulations are generally effective for costs incurred on or after August 22, 1997, in taxable years ending after such date. In the case of inventory property, the temporary regulations are generally effective for taxable years beginning after August 22, 1997. However, taxpayers in compliance with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), as modified by other administrative guidance, that continue to comply with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), as modified by other administrative guidance, will not be required to apply these new temporary rules until the notice of proposed rulemaking that cross-references these temporary regulations is finalized. The amendment to §1.471–6(f) is effective for taxable years beginning after August 22, 1997.

Effect on Other Documents

The following publications will be obsolete when the notice of proposed rulemaking that cross-references these temporary regulations is finalized: Notice 87–76, 1987–2 C.B. 384; Notice 88–24, 1988–1 C.B. 491; and section V of Notice 88–86, 1988–2 C.B. 401.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

§1.61–4 [Amended]

Par. 2. Section 1.61–4 is amended by:

1. Adding a new sentence "See section 263A for rules regarding costs that are required to be capitalized." at the end of the concluding text of paragraph (a).

2. Adding a new sentence "See section 263A for rules regarding costs that are required to be capitalized." after the fourth sentence of the concluding text of paragraph (b).

§1.162–12 [Amended]

Par. 3. Section 1.162-12(a) is amended by:

1. Removing the eighth sentence, and adding the sentence "For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and §1.263A–4T." in its place.

2. Adding a new sentence "For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and the regulations thereunder." after the third sentence.

Par. 4. Section 1.263A–0T is added to read as follows:

§1.263A–0T Outline of regulations under section 263A (temporary).

This section lists the paragraphs in §1.263A–4T.

§1.263A–4T Rules for property produced in a farming business (temporary).

(a) Introduction.
(1) In general.
(2) Exception.
(i) In general.
(ii) Tax shelter.
(iii) Presumption.
(iv) Costs required to be capitalized or inventoried under another provision.
(v) Examples.
(3) Farming business.
(i) In general.
(A) Plant.
(B) Animal.
(ii) Incidental activities.
(A) In general.
(B) Activities that are not incidental.
(*1*) In general.
(*2*) Examples.
(b) Application of section 263A to property produced in a farming business.
(1) In general.
(i) Plants.
(ii) Animals.
(2) Preproductive period.
(i) Plant.
(A) In general.
(B) Applicability of section 263A.
(C) Actual preproductive period.
(*1*) Beginning of the preproductive period.
(*2*) End of the preproductive period.
(*i*) In general.
(*ii*) Marketable quantities.
(D) Examples.
(ii) Animal.
(A) Beginning of the preproductive period.
(B) End of the preproductive period.
(C) Allocation of costs between animal and first yield.
(c) Inventory methods.
(1) In general.
(2) Available for property used in a trade or business.
(3) Exclusion of property to which section 263A does not apply.
(d) Election not to have section 263A apply.
(1) Introduction.
(2) Availability of the election.
(3) Time and manner of making the election.
(4) Special rules.
(i) Section 1245 treatment.
(ii) Required use of alternative depreciation system.
(iii) Related person.
(A) In general.
(B) Members of family.
(5) Examples.
(e) Exception for certain costs resulting from casualty losses.
(1) In general.
(2) Ownership.
(3) Examples.
(4) Special rule for citrus and almond groves.
(i) In general.
(ii) Example.
(f) Effective date and transition rule.

§1.263A–1 [Amended]

Par. 5. Section 1.263A–1 is amended by:

1. Removing the last sentence of paragraph (b)(3) and adding the sentence "See §1.263A–4T for specific rules relating to taxpayers engaged in the trade or business of farming." in its place.

2. Removing the last sentence of paragraph (b)(4) and adding the sentence "See §1.263A–4T, however, for rules relating to taxpayers producing certain trees to which section 263A applies." in its place.

Par. 6. Section 1.263A–4T is revised to read as follows:

§1.263A–4T Rules for property produced in a farming business (temporary).

(a) *Introduction*—(1) *In general.* The regulations under this section provide guidance with respect to the application of section 263A to property produced in a farming business as defined in paragraph (a)(3) of this section. Except as otherwise provided by the rules of this section, the general rules of §§1.263A–1 through 1.263A–3 and 1.263A–7 through 1.263A–15 apply to property produced in a farming business. A taxpayer that engages in the raising or growing of any agricultural or horticultural commodity, including

both plants and animals, is engaged in the production of property. Section 263A generally requires the capitalization of the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of this property. Taxpayers that do not qualify for the exception described in paragraph (a)(2) of this section must capitalize these costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(2) *Exception*—(i) *In general.* A taxpayer is not required to capitalize the preproductive period costs of producing plants with a preproductive period of 2 years or less or the costs of producing animals, if the taxpayer is not—

(A) A corporation or partnership required to use an accrual method of accounting (accrual method) under section 447 in computing its taxable income from farming; or

(B) A tax shelter required to use an accrual method under section 448(a)(3).

(ii) *Tax shelter.* A farming business is considered a tax shelter, and thus a taxpayer required to use an accrual method under section 448(a)(3), if the farming business is—

(A) A farming syndicate as defined in section 464(c); or

(B) A tax shelter, within the meaning of section 6662(d)(2)(C)(iii).

(iii) *Presumption.* Marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance, within the meaning of section 6662(d)(2)(C)(iii), if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(iv) *Costs required to be capitalized or inventoried under another provision.* The exception from capitalization provided in this paragraph (a)(2) does not apply to any cost that is required to be capitalized or inventoried under another Code or regulatory provision, such as section 263 or section 471.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (a)(2):

Example 1. Farmer A grows trees that have a preproductive period in excess of 2 years, and that produce an annual crop. Farmer A is not required by section 447 or 448(a)(3) to use an accrual method. Accordingly, Farmer A qualifies for the exception described in this paragraph (a)(2). Since the trees have a preproductive period in excess of 2 years, Farmer A must capitalize the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of the trees. Since the annual crop has a preproductive period of 2 years or less, Farmer A is not required to capitalize the costs of the crops.

Example 2. Assume the same facts as *Example 1,* except that Farmer A is required by section 447 or 448(a)(3) to use an accrual method. Farmer A does not qualify for the exception described in this paragraph (a)(2). Farmer A is required to capitalize the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of the trees and crops, including all preproductive period costs.

(3) *Farming business*—(i) *In general.* A farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than 6 years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this section, the term harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another. Similarly, the trade or business of merely buying and reselling plants or animals grown or raised by another is not a farming business.

(A) *Plant.* A plant produced in a farming business includes, but is not limited to, a fruit, nut, or other crop bearing tree, an ornamental tree, a vine, a bush, sod, and the crop or yield of a plant that will have more than one crop or yield. Sea plants are produced in a farming business if they are tended and cultivated as opposed to merely harvested.

(B) *Animal.* An animal produced in a farming business includes, but is not limited to, any stock, poultry or other bird, and fish or other sea life raised by the taxpayer. Thus, for example, the term animal may include a cow, chicken, emu, or salmon raised by the taxpayer. Fish and other sea life are produced in a farming business if they are raised on a fish farm. A fish farm is an area where fish or other sea life are grown or raised as opposed to merely caught or harvested.

(ii) *Incidental activities*—(A) *In general.* Farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural products. For example, a taxpayer in the trade or business of growing fruits and vegetables may harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the trade or business of farming with respect to the growing of fruits and vegetables and the processing activities incident to their harvest.

(B) *Activities that are not incidental*—(*1*) *In general.* Farming business does not include the processing of commodities or products beyond those activities that are normally incident to the growing, raising, or harvesting of such products.

(*2*) *Examples.* The following examples illustrate the provisions of this paragraph (a)(3)(ii):

Example 1. Individual A is in the business of growing and harvesting wheat and other grains. Individual A also processes grain that Individual A has harvested in order to produce breads, cereals, and other similar food products, which Individual A then sells to customers in the course of its business. Although Individual A is in the farming business with respect to the growing and harvesting of grain, Individual A is not in the farming business with respect to the processing of such grain to produce the food products.

Example 2. Individual B is in the business of raising poultry and other livestock. Individual B also operates a meat processing operation in which the poultry and other livestock are slaughtered, processed, and packaged or canned. The packaged or canned meat is sold to Individual B's customers. Although Individual B is in the farming business with respect to the raising of poultry and other livestock, Individual B is not in the farming business with respect to the slaughtering, processing, packaging, and canning of such animals to produce the food products.

(b) *Application of section 263A to property produced in a farming business*—(1) *In general.* Unless otherwise provided in this section, section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of any property in a farming business (including animals and plants without regard to the length of their preproductive period).

(i) *Plants.* Costs typically required to be capitalized under section 263A include the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing such plant during the preproductive period. These costs include, but are not limited to, management, irrigation, pruning, fertiliz-

ing (including costs that the taxpayer has elected to deduct under section 180), soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), frost protection, spraying, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes (except state and federal income taxes), and interest required to be capitalized under section 263A(f).

(ii) *Animals.* Costs typically required to be capitalized under section 263A include the acquisition cost of the animal, and the costs of raising or caring for such animal during the preproductive period. Preproductive period costs include, but are not limited to, the costs of management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under sections 175 or 180), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation and repairs on buildings and equipment used in raising the animals (for example, barns, trucks, and trailers), farm overhead, taxes (except state and federal income taxes), and interest required to be capitalized under section 263A(f).

(2) *Preproductive period*—(i) *Plant*—(A) *In general.* The preproductive period of property produced in a farming business means —

(*1*) In the case of a plant that will have more than one crop or yield, the period before the first marketable crop or yield from such plant;

(*2*) In the case of the crop or yield of a plant that will have more than one crop or yield, the period before such crop or yield is disposed of; or

(*3*) In the case of any other plant, the period before such plant is disposed of.

(B) *Applicability of section 263A.* For purposes of determining whether a plant has a preproductive period in excess of 2 years, the preproductive period of plants grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant. For all other plants, the taxpayer is required, at or before the time the seed or plant is acquired or planted, to reasonably estimate the preproductive period of the plant. If the taxpayer estimates a preproductive period in excess of 2 years, the taxpayer must capitalize preproductive period costs. If the estimate is reasonable, based on the facts in existence at the time it is made, the determination of whether section 263A applies is not modified at a later time even if the actual length of the preproductive period differs from the estimate. The actual length of the preproductive period will, however, be considered in evaluating the reasonableness of the taxpayer's future estimates. Thus, the nationwide weighted average preproductive period or the estimated preproductive period are only used for purposes of determining whether the preproductive period of a plant is greater than 2 years.

(C) *Actual preproductive period.* The plant's actual preproductive period is used for purposes of determining the period during which a taxpayer must capitalize preproductive period costs with respect to a particular plant.

(*1*) *Beginning of the preproductive period.* The actual preproductive period of a plant begins when the taxpayer first incurs costs that directly benefit or are incurred by reason of the plant. Generally, this occurs when the taxpayer plants the seed or plant. In the case of a taxpayer that acquires plants that have already been planted, or plants that are tended, by the taxpayer or another, prior to permanent planting, the actual preproductive period of the plant begins upon acquisition of the plant by the taxpayer. In the case of the crop or yield of a plant that will have more than one crop or yield and that has become productive in marketable quantities, the actual preproductive period begins when the crop or yield first appears, for example, in the form of a sprout, bloom, blossom, or bud.

(*2*) *End of the preproductive period*—(*i*) *In general.* In the case of a plant that will have more than one crop or yield, the actual preproductive period ends when the plant first becomes productive in marketable quantities. In the case of any other plant (including the crop or yield of a plant that will have more than one crop or yield), the actual preproductive period ends when the plant, crop, or yield is sold or otherwise disposed of.

(*ii*) *Marketable quantities.* A plant that will have more than one crop or yield becomes productive in marketable quantities when it is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention).

(D) *Examples.* The following examples illustrate the provisions of this paragraph (b)(2)(i):

Example 1. (i) Farmer A, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer A acquires the plants by purchasing them from an unrelated party, Corporation B, and plants them immediately. The nationwide weighted average preproductive period of the plant is 4 years. The particular plants grown by Farmer A do not begin to produce in marketable quantities until 4 years and 6 months after they are planted by Farmer A.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer A is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer A must begin to capitalize such costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer A must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer A must capitalize the preproductive period costs of the plants for a period of 4 years and 6 months, notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 4 years.

Example 2. (i) Farmer B, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. The nationwide weighted average preproductive period of the plant is 2 years and 5 months. Farmer B acquires the plants by purchasing them from an unrelated party, Corporation B. Farmer B enters into a contract with Corporation B under which Corporation B will retain and tend the plants for 7 months following the sale. At the end of 7 months, Farmer B takes possession of the plants and plants them in the permanent orchard. The plants become productive in marketable quantities 1 years and 11 months after they are planted by Farmer B.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize such costs when the purchase occurs. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer B must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 2 years and 6 months (the 7 months the plants are tended by Corporation B and the 1 year and 11 months after the plants are planted by Farmer B), notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 2 years and 5 months.

Example 3. (i) Assume the same facts as in *Example 2*, except that Farmer B acquires the plants by purchasing them from Corporation B when the plants are 7 months old and that the plants are planted by Farmer B upon acquisition.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize such costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 1 year and 11 months.

Example 4. (i) Farmer C, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer C acquires the plants from an unrelated party and plants them immediately. The nationwide weighted average preproductive period of the plant is 2 years and 3 months. The particular plants grown by Farmer C begin to produce in marketable quantities 1 year and 10 months after they are planted by Farmer C.

(ii) Since the plants are deemed to have a nationwide weighted average preproductive period in excess of 2 years, Farmer C is required to capitalize the preproductive period costs of the plants, notwithstanding the fact that the particular plants grown by Farmer C become productive in less than 2 years. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer C must begin to capitalize such costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer C properly ceases capitalization of preproductive period costs when the plants become productive in marketable quantities (i.e., after 1 year and 10 months).

Example 5. (i) Farmer D, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are not grown in commercial quantities in the United States. At the time the plants are planted Farmer D reasonably estimates that the plants will have a preproductive period of 4 years. The actual plants grown by Farmer D do not begin to produce in marketable quantities until 4 years and 6 months after they are planted by Farmer D.

(ii) Since the plants have an estimated preproductive period in excess of 2 years, Farmer D is required to capitalize the preproductive period costs of the plants. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer D must begin to capitalize such costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(2) of this section, Farmer D must continue to capitalize costs until the plants begin to produce in marketable quantities. Thus, Farmer D must capitalize the preproductive period costs of the plants for a period of 4 years and 6 months, notwithstanding the fact that Farmer D estimated that the plants would become productive after 4 years.

Example 6. (i) Farmer E, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section grows plants that are not grown in commercial quantities in the United States. The plants do not have more than 1 crop or yield. At the time the plants are planted Farmer E reasonably estimates that the plants will have a preproductive period of 1 year and 10 months. The actual plants grown by Farmer E are not ready for harvesting and disposal until 2 years and 2 months after the seeds are planted by Farmer E.

(ii) Because Farmer E's estimate of the preproductive period (which was 2 years or less) was reasonable at the time made based on the facts, Farmer E will not be required to capitalize the preproductive period costs of the plants notwithstanding the fact that the actual preproductive period of the plants exceeded 2 years. See paragraph (b)(2)(i)(B) of this section. However, Farmer E must take the actual preproductive period of the plants into consideration when making future estimates of the preproductive period of such plants.

Example 7. Farmer F, a calendar year taxpayer that does not qualify for the exception in paragraph (a)(2) of this section, grows trees that will have more than one crop. Farmer F acquires and plants the trees in April, 1998. On October 1, 2003, the trees are placed in service within the meaning of section 168. Under paragraph (b)(2)(i)(C)(2)(*ii*) of this section, the trees become productive in marketable quantities on October 1, 2003. The preproductive period costs incurred by Farmer F on or before October 1, 2003, are capitalized to the trees. Preproductive period costs incurred after October 1, 2003, are capitalized to a crop when incurred during the preproductive period of the crop and expensed when incurred between the disposal of one crop and the appearance of the next crop. *See* paragraphs (b)(2)(i)(A), (b)(2)(i)(C)(*1*) and (b)(2)(i)(C)(2) of this section.

(ii) *Animal.* An animal's actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period expenses with respect to a particular animal.

(A) *Beginning of the preproductive period.* The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation.

(B) *End of the preproductive period.* In the case of an animal that will be used in the trade or business of farming (e.g., a dairy cow), the preproductive period generally ends when the animal is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention). However, in the case of an animal that will have more than one yield (e.g., a breeding cow), the preproductive period ends when the animal produces (e.g., gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of.

(C) *Allocation of costs between animal and first yield.* In the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield on a reasonable basis. Any depreciation allowance on the animal may be allocated entirely to the yield. The allocation method used by a taxpayer is a method of accounting that must be used consistently and is subject to the rules of section 446 and the regulations thereunder.

(c) *Inventory methods*—(1) *In general.* Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See §1.471–6. Under the unit-livestock-price method, unit prices must include all costs required to be capitalized under section 263A. A taxpayer using the unit-livestock-price method may elect to use the cost allocation methods in §1.263A–1(f) or 1.263A–2(b) to allocate its direct and indirect costs to the property produced in the business of farming. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer's standard unit price as modified by this paragraph (c)(1). The term additional section 263A costs includes all additional costs required to be capitalized under section 263A. Tax shelters, as defined in paragraph (a)(2)(ii) of this section, that use the unit-livestock-price method for inventories must include in inventory the annual standard unit price for all animals that are acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Taxpayers required by section 447 or 448(a)(3) to use an accrual method that use the unit-livestock-price method must modify the annual standard price in order to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit livestock method.

(2) *Available for property used in a trade or business.* The farm price method or the unit livestock method may be used by any taxpayer to allocate costs to any plant or animal under this section, regardless of whether the plant or animal is held or treated as inventory property by the taxpayer. Thus, for example, a taxpayer may use the unit livestock method to account for the costs of raising livestock that will be used in the trade or business of farming (e.g., a breeding animal or a dairy cow) even though the property in question is not inventory property.

(3) *Exclusion of property to which section 263A does not apply.* Notwithstand-

ing a taxpayer's use of the farm price method with respect to farm property to which the provisions of section 263A apply, that taxpayer is not required, solely by such use, to use the farm price method with respect to farm property to which the provisions of section 263A do not apply. Thus, for example, assume Farmer A raises fruit trees that have a preproductive period in excess of 2 years and to which the provisions of section 263A, therefore, apply. Assume also that Farmer A raises cattle and is not required to use an accrual method by section 447 or 448(a)(3). Because Farmer A qualifies for the exception in paragraph (a)(2) of this section, Farmer A is not required to capitalize the costs of raising the cattle. Although Farmer A may use the farm price method with respect to the fruit trees, Farmer A is not required to use the farm price method with respect to the cattle. Instead, Farmer A's accounting for the cattle is determined under other provisions of the Code and regulations.

(d) *Election not to have section 263A apply*—(1) *Introduction.* This paragraph (d) permits certain taxpayers to make an election not to have the rules of this section apply to any plant produced in a farming business conducted by the electing taxpayer. The election is a method of accounting under section 446, and once an election is made, it is revocable only with the consent of the Commissioner.

(2) *Availability of the election.* The election described in this paragraph (d) is available to any taxpayer that produces plants in a farming business, except that no election may be made by a corporation, partnership, or tax shelter required to use the accrual method under section 447 or 448(a)(3). Moreover, the election does not apply to the costs of planting, cultivation, maintenance, or development of a citrus or almond grove (or any part thereof) incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees were planted in the permanent grove (including costs incurred prior to the permanent planting). If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(3) *Time and manner of making the election.* A taxpayer makes the election under this paragraph (d) by not capitalizing the preproductive period costs of producing property in a farming business and by applying the special rules in paragraph (d)(4) of this section, on its timely filed original return (including extensions) for the first taxable year in which the taxpayer is otherwise required to capitalize preproductive period costs under section 263A. Thus, in order to be treated as having made the election under this paragraph (d), it is necessary to report both income and expenses in accordance with the rules of this paragraph (d) (e.g., it is necessary to use the alternative depreciation system as provided in paragraph (d)(4)(ii) of this section). Thus, for example, a farmer who deducts preproductive period costs that are otherwise required to be capitalized under section 263A but fails to use the alternative depreciation system under section 168(g)(2) for applicable property placed in service has not made an election under this paragraph (d) and is not in compliance with the provisions of section 263A. In the case of a partnership or S corporation, the election must be made by the partner, shareholder, or member.

(4) *Special rules.* If the election under this paragraph (d) is made, the taxpayer is subject to the special rules in this paragraph (d)(4).

(i) *Section 1245 treatment.* The plant produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of the plant is recaptured (i.e., treated as ordinary income) to the extent of the total amount of the deductions that, but for the election, would have been required to be capitalized with respect to the plant. In calculating the amount of gain that is recaptured under this paragraph (d)(4)(i), a taxpayer may use the farm price method or another simplified method permitted under these regulations in determining the deductions that otherwise would have been capitalized with respect to the plant.

(ii) *Required use of alternative depreciation system.* If the taxpayer or a related person makes an election under this paragraph (d), the alternative depreciation system (as defined in section 168(g)(2)) must be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect. The requirement to use the alternative depreciation system by reason of an election under this paragraph (d) will not prevent a taxpayer from making an election under section 179 to deduct certain depreciable business assets.

(iii) *Related person*—(A) *In general.* For purposes of this paragraph (d)(4), related person means —

(*1*) The taxpayer and members of the taxpayer's family;

(*2*) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family;

(*3*) A corporation and any other corporation that is a member of the same controlled group (within the meaning of section 1563(a)(1)); and

(*4*) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

(B) *Members of family.* For purposes of this paragraph (d)(4)(iii), *members of the taxpayer's family,* and *members of family* (for purposes of applying section 318(a)(1)), means the spouse of the taxpayer (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and any of the taxpayer's children (including legally adopted children) who have not reached the age of 18 as of the last day of the taxable year in question.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (d):

Example 1. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows apple trees that have a preproductive period greater than 2 years. In addition, Farmer A grows and harvests wheat and other grains. Farmer A elects under this paragraph (d) not to have the rules of section 263A apply to the preproductive period costs of growing the apple trees.

(ii) In accordance with paragraph (d)(4) of this section, Farmer A is required to use the alternative depreciation system described in section 168(g)(2) with respect to all property used predominantly in any farming business in which Farmer A engages (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including trees and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated as provided in section 168(g)(2).

Example 2. Assume the same facts as in *Example 1*, except that Farmer A and members of Farmer A's family (as defined in paragraph (d)(4)(iii)(B) of this section) also own 51 percent (in value) of the interests in Partnership P, which is engaged in the trade or business of growing and harvesting corn. Partnership P is a related person to Farmer A under the provisions of paragraph (d)(4)(iii) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g)(2) also apply to any property used predominantly in a trade or business of farming which Partnership P places in service during a year for which an election made by Farmer A is in effect.

(e) *Exception for certain costs resulting from casualty losses*—(1) *In general.* Section 263A does not require the capitalization of costs that are attributable to the replanting, cultivating, maintaining, and developing of any plants bearing an edible crop for human consumption (including, but not limited to, plants that constitute a grove, orchard, or vineyard) that were lost or damaged while owned by the taxpayer by reason of freezing temperatures, disease, drought, pests, or other casualty (replanting costs). Such replanting costs may be incurred with respect to property other than the property on which the damage or loss occurred to the extent the acreage of the property with respect to which the replanting costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. This paragraph (e) applies only to the replanting of plants of the same type as those lost or damaged. This paragraph (e) applies to plants replanted on the property on which the damage or loss occurred or property of the same or lesser acreage in the United States irrespective of differences in density between the lost or damaged and replanted plants. Plants bearing crops for human consumption are those crops normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (e) because that crop is not normally eaten or drunk by humans.

(2) *Ownership.* Replanting costs described in paragraph (e)(1) of this section generally must be incurred by the taxpayer that owned the property at the time the plants were lost or damaged. Paragraph (e)(1) of this section will apply, however, to costs incurred by a person other than the taxpayer that owned the plants at the time of damage or loss if—

(i) The taxpayer that owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants at all times during the taxable year in which the replanting costs are paid or incurred; and

(ii) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintaining, or developing of such plants during the taxable year in which the replanting costs are paid or incurred. A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A(e)(6).

(3) *Examples.* The following examples illustrate the provisions of this paragraph (e):

Example 1. (i) Farmer T grows cherry trees that have a preproductive period in excess of 2 years and produce an annual crop. These cherries are normally eaten by humans. Farmer T grows the trees on a 100 acre parcel of land (parcel 1) and the groves of trees cover the entire acreage of parcel 1. Farmer T also owns a 150 acre parcel of land (parcel 2) that Farmer T holds for future use. Both parcels are in the United States. In 1998, the trees and the irrigation and drainage systems that service the trees are destroyed in a casualty (within the meaning of paragraph (e)(1) of this section). Farmer T installs new irrigation and drainage systems on parcel 1, purchases young trees (seedlings), and plants the seedlings on parcel 1.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. In accordance with paragraph (e)(1) of this section, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A.

Example 2. (i) Assume the same facts as in *Example 1* except that Farmer T decides to replant the seedlings on parcel 2 rather than on parcel 1. Accordingly, Farmer T installs the new irrigation and drainage systems on 100 acres of parcel 2 and plants seedlings on those 100 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. Because the acreage of the related portion of parcel 2 does not exceed the acreage of the destroyed orchard on parcel 1, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A. See paragraph (e)(1) of this section.

Example 3. (i) Assume the same facts as in *Example 1* except that Farmer T replants the seedlings on parcel 2 rather than on parcel 1, and Farmer T additionally decides to expand its operations by growing 125 rather than 100 acres of trees. Accordingly, Farmer T installs new irrigation and drainage systems on 125 acres of parcel 2 and plants seedlings on those 125 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. The costs of planting, cultivating, developing, and maintaining 100 acres of the trees during their preproductive period are not required to be capitalized by section 263A. The costs of planting, cultivating, maintaining, and developing the additional 25 acres are, however, subject to capitalization. See paragraph (e)(1) of this section.

(4) *Special rule for citrus and almond groves*—(i) *In general.* The exception in this paragraph (e) is available with respect to a citrus or almond grove, notwithstanding the taxpayer's election not to have section 263A apply (described in paragraph (d) of this section).

(ii) *Example.* The following example illustrates the provisions of this paragraph (e)(4):

Example. (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows citrus trees that have a preproductive period of 5 years. Farmer A elects, under paragraph (d) of this section, not to have section 263A apply to the preproductive period costs. This election, however, is unavailable with respect to the preproductive period costs of a citrus grove incurred within the first 4 years after the trees were planted. See paragraph (d)(2) of this section. After the citrus grove has become productive in marketable quantities, the citrus grove is destroyed by a casualty within the meaning of paragraph (e)(1) of this section.

(ii) Farmer A must capitalize the preproductive period costs incurred before the close of the fourth taxable year beginning with the year in which the trees were permanently planted. As a result of the election not to have section 263A apply to preproductive period costs, Farmer A may deduct the preproductive period costs incurred in the fifth year. The costs of replanting, cultivating, maintaining, and developing the trees destroyed by a casualty are exempted from capitalization under this paragraph (e).

(f) *Effective date and transition rule.* In the case of property that is not inventory in the hands of the taxpayer, this section is generally effective for costs incurred on or after August 22, 1997, in taxable years ending after such date. In the case of inventory property, this section is generally effective for taxable years beginning after August 22, 1997. However, taxpayers in compliance with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), and other administrative guidance, that continue to comply with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), and other administrative guidance, will not be required to apply these new temporary rules until final regulations are published in the **Federal Register.**

§1.471–6 [Amended]

Par. 7. Section 1.471–6 is amended as follows:

1. Adding two sentences to the end of paragraph (c).

2. Removing the second sentence in paragraph (d) and adding two sentences in its place.

3. Revising the last three sentences of paragraph (f).

The additions and revision read as follows:

§1.471–6 Inventories of livestock raisers and other farmers.

* * * * *

(c) * * * In addition, these inventory methods may be used to account for the costs of property produced in a farming business that are required to be capitalized under section 263A regardless of whether the property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash or an accrual method of accounting. Thus, for example, the unit livestock method may be utilized by a taxpayer in accounting under section 263A for the costs of raising animals that will be used for draft, breeding, or dairy purposes.

(d) * * * If this method of valuation is used, it generally must be applied to all property produced by the taxpayer in the trade or business of farming, except as to livestock accounted for, at the taxpayer's election, under the unit livestock method of accounting. However, see §1.263A–4T(c)(3) for an exception to this rule. * * *

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(f) * * * Except as otherwise provided in this paragraph, once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years. For taxable years beginning after August 22, 1997, a taxpayer using the unit livestock method must, however, annually reevaluate the unit livestock prices and must adjust the prices upward to reflect increases in the costs of raising livestock. The consent of the Commissioner is not required to make such upward adjustments. No other changes in the classification of animals or unit prices shall be made without the consent of the Commissioner. See §1.263A–4T for rules regarding the computation of costs for purposes of the unit livestock method.

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Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved July 28, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on August 21, 1997, 8:45 a.m., and published in the issue of the Federal Register for August 22, 1997, 62 F.R. 44542)

Section 267.—Losses, Expenses, and Interest With Respect to Transactions Between Related Taxpayers

26 CFR 1.267(a)–1: Deductions disallowed.

When a payor provides a per diem allowance to an employee who is a related party, the rules set forth for the deemed substantiation to the payor of the amount of the employee's ordinary and necessary business expenses for lodging, meal, and/or incidental expenses incurred while traveling away from home, do not apply. See Rev. Proc. 97–59, page 594.

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

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

Optional rules are provided under which an employee of a federal government agency who is reimbursed for ordinary and necessary business expenses relating to travel, entertainment, gifts, or listed property (such as an employee's automobile) may make an adequate accounting to the employer to substantiate those expenses by submitting only an account book, diary, log, etc., without submitting documentary evidence such as receipts. See Rev. Proc. 97–45 page 499.

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26 CFR 1.274(d)–1: Substantiation requirements.

Optional rules are provided under which an employee of a federal government agency who is reimbursed for ordinary and necessary business expenses relating to travel, entertainment, gifts, or listed property (such as an employee's automobile) may make an adequate accounting to the employer to substantiate those expenses by submitting only an account book, diary, log, etc., without submitting documentary evidence such as receipts. See Rev. Proc. 97–45 page 499.

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26 CFR 1.274(d)–1(a): Substantiation requirements.

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 97–58, page 587.

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

Simplified optional method for substantiating the amount of a deduction or expense for business use of an automobile. See Rev. Proc. 97–58, page 587.

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26 CFR 1.274(d)–1(a): Substantiation requirements.

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meals, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. See Rev. Proc. 97–59, page 594.

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

Rules are set forth for substantiating the amount of ordinary and necessary business expense of an employee for lodging, meals, and incidental expenses or meal and incidental expenses incurred while traveling away from home when a payor provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Rules are also set forth for an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. See Rev. Proc. 97–59, page 594.

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of July 1997. See Rev. Rul. 97–27, page 97.

Federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

Federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

Federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subchapter C.—Corporate Distributions and Adjustments
Part III.—Corporate Organizations and Reorganizations
Subpart B.—Effects on Shareholder and Security Holders

Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355–2: Limitations.

The revenue procedure modifies the "No Rule" revenue procedure, Rev. Proc. 97–3, 1997–1 I.R.B. 85, to delete certain transactions under § 355 of the Code. See Rev. Proc. 97–53, page 528.

Part V.—Carryovers

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

The adjusted federal long-term rate is set forth for the month of July 1997. See Rev. Rul. 97–27, page 97.

The adjusted federal long-term rate is set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted federal long-term rate is set forth for the month of September 1997. See Rev. Rul. 97–36, page101.

The adjusted federal long-term rate is set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted federal long-term rate is set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted federal long-term rate is set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subchapter D.—Deferred Compensation, Etc.
Part I.—Pension, Profit-Sharing, Stock Bonus Plans, Etc.
Subpart A.—General Rules

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

26 CFR 1.401(b)–1: Certain retroactive changes in plan.

A procedure describes when plans that are qualified under § 401(a) or § 403(a) must be amended for the Small Business Job Protection Act of 1996, Pub. L. 104–188, the Uruguay Round Agreements Act, Pub. L. 103–465, and the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353. See Rev. Proc. 97–41, page 489.

T.D. 8727

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Remedial Amendment Period

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the remedial amendment period, during which a sponsor of a qualified retirement plan or an employer that maintains a qualified retirement plan can make retroactive amendments to the plan to eliminate certain qualification defects for the entire period. These final and temporary regulations clarify the scope of the Commissioner's authority to provide relief from plan disqualification under the regulations, to enable the Commissioner to provide appropriate relief for plan amendments relating to changes to the plan qualification rules made in the Small Business Job Protection Act of 1996 and the Uruguay Round Agreements Act of 1994. These final and temporary regulations affect sponsors of qualified retirement plans, and employers that maintain qualified retirement plans. The text of the temporary regulations also serves as the text of the proposed regulations set forth in REG–106043–97, page 654.

DATES: These regulations are effective August 1, 1997.

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 401(b). The temporary regulations provide guidance to clarify the scope of the Commissioner's authority to provide relief from plan disqualification under section 401(b) and the regulations. This guidance will enable the Commissioner to provide appropriate relief concerning the timing of plan amendments relating to changes to the plan qualification rules made in the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, and the Uruguay Round Agreements Act of 1994, Pub. L. No. 103–465, as well as for other plan amendments that may be needed as a result of future changes to the Internal Revenue Code.

Explanation of Provisions

Section 401(b) provides that a plan is considered to satisfy the qualification requirements of section 401(a) for the period beginning with the date on which it was put into effect, or for the period beginning with the earlier of the date on which any amendment that caused the plan to fail to satisfy those requirements was adopted or put into effect, and ending with the time prescribed by law for filing the employer's return for the taxable year in which that plan or amendment was adopted (including extensions) or such later time as the Secretary may designate. The relief provided under section 401(b) applies only if all provisions of the plan needed to satisfy the qualification requirements are in effect by the end of the specified period and have been made effective for all purposes for the entire period.

Section 1.401(b)–1(b) lists the plan provisions that may be amended retroactively pursuant to rules of section 401(b). These plan provisions, termed "disqualifying provisions," include the plan provisions listed in section 401(b), as well as plan provisions that result in failure of a plan to satisfy the qualification requirements of the Code by reason of a change in those requirements effected by the legislation listed in §1.401(b)–1(b)(2)(i) and (ii). Under §1.401(b)–1(b)(2)(ii), a disqualifying provision also includes a plan provision that is integral to a qualification requirement changed by specified legislation. Section 1.401(b)–1(b)(2)(iii), as in effect prior to amendment by the final regulations, provided that a disqualifying provision includes a plan provision that results in failure of the plan to satisfy the Code's qualification requirements by rea-

son of a change in those requirements effected by amendments to the Code, that is designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision.

Former §1.401(b)–1(c), which has been redesignated §1.401(b)–1(d) under the final regulations, provides rules for determining the period for which the relief provided under section 401(b) applies (the "remedial amendment period"). Former §1.401(b)–1(c)(1) defines the beginning of the remedial amendment period for the disqualifying provisions listed in §1.401(b)–1(b)(1) and §1.401(b)–1(b)(2)-(i) and (ii).

The temporary regulations make certain changes to clarify the scope of the Commissioner's authority to provide relief from plan disqualification under section 401(b). These changes are needed to clarify the rules relating to the plan provisions that may be designated by the Commissioner as disqualifying provisions based on amendments to the plan qualification requirements of the Internal Revenue Code. Section 1.401(b)–1T(b)(3) provides that a disqualifying provision includes a plan provision designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision that either (1) results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements; or (2) is integral to a qualification requirement of the Code that has been changed. Section 1.401(b)–1T(c)(2) provides the Commissioner with explicit authority to impose limits and provide additional rules regarding the amendments that may be made with respect to disqualifying provisions during the remedial amendment period. Section 1.401(b)–1T(d)(1)(iv) and (v) provide conforming rules regarding the beginning of the remedial amendment period for disqualifying provisions described in §1.401(b)–1T(b)(3).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding one entry for §1.401(b)–1 to read in part as follows:

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

§1.401(b)–1 also issued under 26 U.S.C. 401(b). * * *

§1.401(b)–1 [Amended]

Par. 2. Section 1.401(b)–1 is amended as follows:

1. Paragraphs (c), (d) and (e) are redesignated as paragraphs (d), (e) and (f), respectively.

2. Following newly redesignated paragraph (d)(2)(iv), the two undesignated paragraphs are designated as paragraphs (d)(3) and (d)(4), respectively.

Par. 3. In the list below, for each section indicated in the left column, remove the language in the middle column, and add the language in the right column.

SECTION	REMOVE	ADD
1.401(b)–1 (a), first sentence	(c), (d) and (e)	(d), (e) and (f)
1.401(b)–1 (b)(1)	effective or	effective.
1.401(b)–1 (d)(1)(ii)	earlier), or	earlier),
1.401(b)–1 (d)(1)(iii)	such provision.	such provision, or
1.401(b)–1 (d)(2) introductory text	paragraph (d)	paragraph (e)
1.401(b)–1 (d)(3)	(c)(2)(i), (c)(2)(ii), and (c)(2)(iii)	(d)(2)(i), (d)(2)(ii) and (d)(2)(iii)
1.401(b)–1 (d)(4)	(c)(2)	(d)(2)
1.401(b)–1 (d)(4)	(c)(2)(i)	(d)(2)(i)
1.401(b)–1 (e)(1)(ii)(C), third sentence	paragraph (d)(1)	paragraph (e)(1)
1.401(b)–1 (e)(2)(ii)(C), third sentence	paragraph (d)(2)	paragraph (e)(2)
1.401(b)–1 (e)(3) introductory text	this paragraph (d)	this paragraph (e)
1.401(b)–1 (e)(3) introductory text	which paragraph (d)(1) or (2)	which paragraph (e)(1) or (2)
1.401(b)–1 (e)(3) introductory text	in paragraph (d)(1) or (2)	in paragraph (e)(1) or (2)
1.401(b)–1 (e)(4)	paragraph (d)(3)	paragraph (e)(3)
1.401(b)–1 (e)(4)	paragraph (c)	paragraph (d)
1.401(b)–1 (e)(5) introductory text	subdivisions (i), (ii) and (iii) of this subparagraph	paragraphs (e)(5)(i), (ii) and (iii) of this section
1.401(b)–1 (e)(5) introductory text	paragraph (c)	paragraph (d)
1.401(b)–1 (e)(5)(iii)	paragraph (d)(5)(ii)	paragraph (e)(5)(ii)

Par. 4. Section 1.401(b)–1 is further amended as follows:

1. Paragraph (b)(2)(iii) is removed.

2. Paragraphs (b)(3), (c) and (d)(1)(iv) are added.

The additions read as follows:

§1.401(b)–1 Certain retroactive changes in plan.

* * * * *

(b) * * *

(3) A plan provision described in §1.401(b)–1T(b)(3).

(c) *Special rules applicable to disqualifying provisions.* For special rules applicable to disqualifying provisions, see §1.401(b)–1T(c).

(d) * * *

(1) * * *

(iv) In the case of a disqualifying provision described in §1.401(b)–1T(b)(3), the date described in §1.401(b)–1T(d)(1)(iv) or (v), whichever applies to the disqualifying provision.

Par. 5. Section 1.401(b)–1T is added to read as follows:

§1.401(b)–1T Certain retroactive changes in plan (temporary).

(a) [Reserved]. For further information, see §1.401(b)–1(a).

(b) *Disqualifying provisions.* For purposes of §1.401(b)–1, with respect to a plan described in §1.401(b)–1(a), the term "disqualifying provision" means:

(1) and (2) [Reserved]. For further information, see §1.401(b)–1(b)(1) and (2).

(3) A plan provision designated by the Commissioner, at the Commissioner's discretion, as a disqualifying provision that either—

(i) Results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements; or

(ii) Is integral to a qualification requirement of the Code that has been changed.

(c) *Special rules applicable to disqualifying provisions*—(1) *Absence of plan provision.* For purposes of paragraph (b)(3) of this section and §1.401(b)–1(b)(2), a disqualifying provision includes the absence from a plan of a provision required by, or, if applicable, integral to the applicable change to the qualification requirements of the Internal Revenue Code, if the plan was in effect on the date the change became effective with respect to the plan.

(2) *Method of designating of disqualifying provisions.* The Commissioner may designate a plan provision as a disqualifying provision pursuant to paragraph (b)(3) of this section only in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(3) *Authority to impose limitations.* In the case of a provision that has been designated as a disqualifying provision by the Commissioner pursuant to paragraph (b)(3) of this section, the Commissioner may impose limits and provide additional rules regarding the amendments that may be made with respect to that disqualifying provision during the remedial amendment period. The Commissioner may impose these limits and provide these additional rules only in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(d) *Remedial amendment period.* (1) The remedial amendment period with respect to a disqualifying provision begins:

(i) through (iii) [Reserved]. For further information, see §1.401(b)–1(d)(1)(i) through (iii).

(iv) In the case of a disqualifying provision described in paragraph (b)(3)(i) of this section, the date on which the change effected by an amendment to the Internal Revenue Code became effective with respect to the plan, or

(v) In the case of a disqualifying provision described in paragraph (b)(3)(ii) of this section, the first day on which the plan was operated in accordance with such provision, as amended, unless another time is specified by the Commissioner in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii)(b) of this chapter.

(2) [Reserved]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved July 22, 1997.

(Filed by the Office of the Federal Register on July 31, 1997, 8:45 a.m., and published in the issue of the Federal Register for August 1, 1997, 62 F.R. 41272)

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

Covered compensation tables; 1998. The covered compensation tables for the 1998 calendar year for determining contributions to defined benefit plans and permitted disparity are set forth.

Rev. Rul. 97–45

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code (the "Code") and the Income Tax Regulations, thereunder, for the 1998 plan year.

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

Section 401(l)(5)(E)(ii) of the Code states that the determination for any year preceding the year in which the employee attains social security retirement age shall be made by assuming that there is no increase in covered compensation after the determination year and before the employee attains social security retirement age.

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

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

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

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

For purposes of determining covered compensation for the 1998 year the taxable wage base is $68,400.

The following tables provide covered compensation for 1998:

1998 Covered Compensation Table

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	1998 Covered Compensation
1907	1972	$4,488
1908	1973	4,704
1909	1974	5,004
1910	1975	5,316
1911	1976	5,664
1912	1977	6,060
1913	1978	6,480
1914	1979	7,044
1915	1980	7,692
1916	1981	8,460
1917	1982	9,300
1918	1983	10,236
1919	1984	11,232
1920	1985	12,276
1921	1986	13,368
1922	1987	14,520
1923	1988	15,708
1924	1989	16,968
1925	1990	18,312
1926	1991	19,728
1927	1992	21,192
1928	1993	22,716
1929	1994	24,312
1930	1995	25,920
1931	1996	27,576
1932	1997	29,304
1933	1998	31,128
1934	1999	32,940
1935	2000	34,752
1936	2001	36,528
1937	2002	38,292
1938	2004	41,748
1939	2005	43,488
1940	2006	45,216

1998 Covered Compensation Table—Continued

Calendar Year of Birth	Calendar Year of Social Security Retirement Age	1998 Covered Compensation
1941	2007	46,908
1942	2008	48,552
1943	2009	50,136
1944	2010	51,684
1945	2011	53,208
1946	2012	54,684
1947	2013	56,136
1948	2014	57,432
1949	2015	58,644
1950	2016	59,760
1951	2017	60,780
1952	2018	61,716
1953	2019	62,592
1954	2020	63,420
1955	2022	64,872
1956	2023	65,544
1957	2024	66,120
1958	2025	66,612
1959	2026	67,044
1960	2027	67,404
1961	2028	67,716
1962	2029	67,944
1963	2030	68,148
1964	2031	68,304
1965 or later	2032	68,400

1998 Rounded Covered Compensation Table

Year of Birth	Covered Compensation
1933	$30,000
1934	33,000
1935 – 1936	36,000
1937	39,000
1938 – 1939	42,000
1940	45,000
1941 – 1942	48,000
1943 – 1944	51,000
1945 – 1946	54,000
1947 – 1948	57,000
1949 – 1951	60,000
1952 – 1954	63,000
1955 – 1959	66,000
1960 or later	68,400

Section 403.—Taxation of Employee Annuities

A procedure describes when tax-sheltered annuity plans within the meaning of § 403(b) must be amended for the Small Business Job Protection Act of 1996, Pub. L. 104–188. See Rev. Proc. 97–41, page 489.

Section 408.—Individual Retirement Accounts

26 CFR 1.408–5: Annual reports by trustees or issuers.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.408–7: Reports on distributions from individual retirement plans.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Subpart B.—Special Rules

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 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subchapter E.—Accounting Periods and Methods of Accounting

Part II.—Methods of Accounting

Subpart A.—Methods of Accounting in General

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446–1: General rule for methods of accounting.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for package design costs. See Rev. Proc. 97–35, page 448.

How may an automobile dealer change its method of accounting to use the Alternative LIFO Method. See Rev. Proc. 97–36, page 450.

26 CFR 1.446–1: General rule for methods of accounting.

Questions and answers about the application of section 475 and the regulations thereunder. See Rev. Rul. 97–39, page 62.

26 CFR 1.446–1: General rule for methods of accounting.

What information must a taxpayer provide in order to obtain automatic consent to change accounting method when section 475(a) becomes applicable as a result of the taxpayer making an election (i) to treat transactions within a consolidated group as transactions with customers as provided by section 1.475(c)–1(a), or (ii) not to be governed by the exemptions from the status of a dealer in securities provided by section 1.475(c)–1(b) or –1(c)? See Rev. Proc. 97–43, page 494.

26 CFR 1.446–1: General rule for methods of accounting.

What procedures should taxpayers follow to obtain automatic consent to change their method of accounting for costs paid or incurred to convert or replace computer software to recognize dates beginning in the year 2000. See Rev. Proc. 97–50, page 525.

Subpart B.—Taxable Year For Which Items of Gross Income Included

Section 451.—General Rule for Taxable Year of Inclusion

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for the income from an advance payment related to the sale of a multi-year service warranty contract. See Rev. Proc. 97–37, page 455.

Section 454.—Obligations Issued at a Discount

26 CFR § 1.454–1: Obligations issued at a discount.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for the interest income on Series E or EE U.S. savings bonds. See Rev. Proc. 97–37, page 455.

Section 455.—Prepaid Subscription Income

26 CFR § 1.455–6: Time and manner of making election.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for prepaid subscription income. See Rev. Proc. 97–37, page 455.

Subpart C.—Taxable Year For Which Deductions Taken

Section 461.—General Rule for Taxable Year of Deduction

26 CFR § 1.461–4: Economic performance.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting. See Rev. Proc. 97–37, page 455.

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 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

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 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subpart D.—Inventories

Section 471.—General Rule for Inventories

26 CFR 1.471–1: Need for inventories.

The cost of recoverable and nonrecoverable line pack gas or cushion gas is a capital expenditure. Line pack gas or cushion gas in not inventory. See Rev. Rul. 97–54, page 23.

26 CFR § 1.471–1: Need for inventories;

26 CFR § 1.471–2: Valuation of inventories;

26 CFR § 1.471–3: Inventories at cost.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for certain cash discounts. See Rev. Proc. 97–37, page 455.

Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The May 1997 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, May 31, 1997.

Rev. Rul. 97–28

The following Department Store Inventory Price Indexes for May 1997 were issued by the Bureau of Labor Statistics on June 17, 1997. The indexes are accepted by the Internal Revenue Service, under §1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, May 31, 1997.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	May 1996	May 1997	Percent Change from May 1996 to May 1997[1]
1. Piece Goods	545.1	529.2	–2.9
2. Domestics and Draperies	649.3	649.3	0.0
3. Women's and Children's Shoes	659.7	663.7	0.6
4. Men's Shoes	906.5	918.8	1.4
5. Infants' Wear	631.2	642.0	0.7
6. Women's Underwear	534.1	537.7	0.7
7. Women's Hosiery	286.8	296.7	3.5
8. Women's and Girls' Accessories	550.8	566.2	2.8
9. Women's Outerwear and Girls' Wear	417.9	435.1	4.1
10. Men's Clothing	626.1	630.2	0.7
11. Men's Furnishings	593.3	601.9	1.4
12. Boys' Clothing and Furnishings	493.3	500.2	1.4
13. Jewelry	1020.1	1004.9	–1.5
14. Notions	773.8	755.8	–2.3
15. Toilet Articles and Drugs	883.8	907.2	2.6
16. Furniture and Bedding	668.0	673.4	0.8
17. Floor Coverings	576.1	592.7	2.9

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS—Continued
(January 1941 = 100, unless otherwise noted)

Groups	June 1996	June 1997	Percent Change from June 1996 to June 1997[1]
18. Housewares	803.9	806.3	0.3
19. Major Appliances	245.1	242.0	–1.3
20. Radio and Television	79.2	76.7	–3.2
21. Recreation and Education[2]	112.8	109.8	-2.7
22. Home Improvements[2]	127.2	132.4	4.1
23. Auto Accessories[2]	107.4	107.2	–0.2
Groups 1 – 15: Soft Goods	603.0	612.3	1.5
Groups 16 – 20: Durable Goods	467.6	465.4	–0.5
Groups 21 – 23: Misc. Goods[2]	113.7	112.2	–1.3
Store Total[3]	556.3	560.7	0.8

[1] Absence of a minus sign before percentage change in this column signifies price increase.
[2] Indexes on a January 1986 = 100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

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26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The June 1997 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, June 30, 1997.

Rev. Rul. 97–32

The following Department Store Inventory Price Indexes for June 1997 were issued by the Bureau of Labor Statistics on July 16, 1997. The indexes are accepted by the Internal Revenue Service, under §1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, June 30, 1997.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	June 1996	June 1997	Percent Change from June 1996 to June 1997[1]
1. Piece Goods	551.1	541.0	-1.8
2. Domestics and Draperies	641.0	644.1	0.5
3. Women's and Children's Shoes	649.3	651.0	0.3
4. Men's Shoes	895.4	904.0	1.0
5. Infants' Wear	627.1	642.5	2.5
6. Women's Underwear	535.4	539.3	0.7
7. Women's Hosiery	288.0	295.7	2.7
8. Women's and Girls' Accessories	545.5	569.4	4.4
9. Women's Outerwear and Girls' Wear	401.1	415.3	3.5

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS—Continued
(January 1941 = 100, unless otherwise noted)

Groups	June 1996	June 1997	Percent Change from June 1996 to June 1997[1]
10. Men's Clothing	612.2	625.0	2.1
11. Men's Furnishings	584.5	589.8	0.9
12. Boys' Clothing and Furnishings	485.7	494.5	1.8
13. Jewelry	1011.5	1002.1	-0.9
14. Notions	774.1	752.1	-2.8
15. Toilet Articles and Drugs	877.8	913.5	4.1
16. Furniture and Bedding	673.6	673.2	-0.1
17. Floor Coverings	576.4	592.4	2.8
18. Housewares	808.7	808.1	-0.1
19. Major Appliances	245.5	243.5	-0.8
20. Radio and Television	79.3	76.2	-3.9
21. Recreation and Education[2]	112.8	109.5	-2.9
22. Home Improvements[2]	127.4	132.8	4.2
23. Auto Accessories[2]	107.5	108.0	0.5
Groups 1 – 15: Soft Goods	592.4	602.5	1.7
Groups 16 – 20: Durable Goods	469.7	465.9	-0.8
Groups 21 – 23: Misc. Goods[2]	113.7	112.2	-1.3
Store Total[3]	550.3	554.8	0.8

[1] Absence of a minus sign before percentage change in this column signifies price increase.
[2] Indexes on a January 1986 = 100 base.
[3] The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

What is the "Alternative LIFO Method." See Rev. Proc. 97–36, page 450.

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26 CFR §1.472–6: Change from LIFO inventory method;

26 CFR §1.472–8: Dollar value method of pricing LIFO inventories.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change from the LIFO method of accounting for all its LIFO inventory, or to change to an alternate LIFO inventory method. See Rev. Proc. 97–37, page 455.

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26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The July 1997 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, July 31, 1997.

Rev. Rul. 97–37

The following Department Store Inventory Price Indexes for July 1997 were issued by the Bureau of Labor Statistics on August 14, 1997. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, July 31, 1997.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	July 1996	July 1997	Percent Change from July 1996 to July 1997[1]
1. Piece Goods	539.2	539.8	0.1
2. Domestics and Draperies	635.6	656.1	3.2
3. Women's and Children's Shoes	643.9	641.6	–0.4
4. Men's Shoes	888.2	902.6	1.6
5. Infants' Wear	609.3	637.9	4.7
6. Women's Underwear	536.9	543.5	1.2
7. Women's Hosiery	289.3	297.8	2.9
8. Women's and Girls' Accessories	544.7	544.5	0.0
9. Women's Outerwear and Girls' Wear	380.6	395.0	3.8
10. Men's Clothing	610.3	621.6	1.9
11. Men's Furnishings	573.0	585.9	2.3
12. Boys' Clothing and Furnishings	475.9	495.9	4.2
13. Jewelry	1016.0	1003.9	–1.2
14. Notions	779.4	797.5	2.3
15. Toilet Articles and Drugs	880.9	905.7	2.8
16. Furniture and Bedding	671.6	662.8	–1.3
17. Floor Coverings	577.5	598.2	3.6
18. Housewares	811.9	807.2	–0.6
19. Major Appliances	245.8	243.1	–1.1
20. Radio and Television	79.2	75.9	–4.2
21. Recreation and Education[2]	112.7	109.8	–2.6
22. Home Improvements[2]	126.8	132.7	4.7
23. Auto Accessories[2]	107.0	108.6	1.5
Groups 1 – 15: Soft Goods	582.4	594.9	2.1
Groups 16 – 20: Durable Goods	470.3	464.2	–1.3
Groups 21 – 23: Misc. Goods[2]	113.5	112.5	–0.9
Store Total[3]	544.2	549.8	1.0

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

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26 CFR 1.472-2(e): LIFO conformity requirement.

Last-in, first-out inventories, automobile dealers. A franchised automobile dealer that elected the LIFO inventory method violates the LIFO conformity requirement of Code section 472 by providing to the credit subsidiary of its franchisor an income statement that fails to reflect the LIFO inventory method in the computation of net income.

Rev. Rul. 97-42

ISSUE

Whether a franchised automobile dealer that elected the last-in, first-out (LIFO) inventory method for federal income tax purposes violates the LIFO conformity requirement of § 472(c) or (e)(2) of the Internal Revenue Code by providing certain monthly income statements to the credit subsidiary of its franchisor (an automobile manufacturer).

FACTS

A, *B*, and *C* are franchised automobile dealers engaged in the purchase, sale, and service of automobiles manufactured by *X*. *A*, *B*, and C regularly finance their purchases of new automobiles through *Y*, a subsidiary of *X*.

For federal income tax purposes, *A*, *B*, and *C* use the accrual method of accounting and a calendar taxable year. Each dealer elected to use the LIFO inventory method to account for its automobile inventory beginning with its taxable year ended December 31, 1970.

Pursuant to the terms of the franchise agreements with *X* and the financing agreements with *Y*, *X* and *Y* must receive balance sheets and income statements from *A*, *B*, and *C* within 10 days after the end of each month. The income statements are prepared in a format required by *X* or on pre-printed forms supplied by *X* and present the dealers' operating results for both the month and the calendar year-to-date.

During 1996, *A*, *B*, and *C*'s monthly financial statements were received by *X* and *Y*. In the January through November income statements, *A*, *B*, and *C* calculated their Cost of Goods Sold using the specific identification inventory method instead of the LIFO inventory method. Under the specific identification method, the cost of the dealers' beginning and ending inventories is determined by reference to *X*'s actual invoice price for the automobiles on hand.

Situation 1 — LIFO Reflected in Gross Profit. *A* provided the following income statement to *X* and *Y* for the month of December:

INCOME STATEMENT
December 1996

	Month	*Year-to-Date*
Sales of Automobiles	$ 300x	$ 3,600x
Cost of Goods Sold	(255x)	(2,400x)
Gross Profit	$ 45x	$ 1,200x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Net Income	$ 15x	$ 840x

A calculated its Cost of Goods Sold for the year and the month as follows. First, *A* used the specific identification inventory method to calculate a tentative cost of goods sold for the year ($2,340x) and the month ($195x). Then, *A* made an adjustment of $60x (representing a $60x increase in *A*'s LIFO reserve for 1996) to the tentative cost of goods sold to arrive at Cost of Goods Sold for the year ($2,400x) and the month ($255x), respectively.

Situation 2 — LIFO Reflected in Net Income. *B* provided the following income statement to *X* and *Y* for the month of December:

INCOME STATEMENT
December 1996

	Month	*Year-to-Date*
Sales of Automobiles	$ 300x	$ 3,600x
Cost of Goods Sold	(195x)	(2,340x)
Gross Profit	$ 105x	$ 1,260x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Operating Profit	$ 75x	$ 900x
Other Income & Expenses	(60x)	(60x)
Net Income	$ 15x	$ 840x

B used the specific identification inventory method to calculate its Cost of Goods Sold and Gross Profit for both the year and month without adjusting for a $60x increase in *B*'s LIFO reserve for 1996. On the Other Income and Expenses line, B reduced Operating Profit in the Year-to-Date column by $60x (representing the $60x increase in *B*'s LIFO reserve for 1996) and in the Month column by $60x to arrive at *B*'s Net Income for the year ($840x) and the month ($15x), respectively.

Situation 3 — LIFO Not Reflected on the Income Statement. *C* provided the following income statement to *X* and *Y* for the month of December:

INCOME STATEMENT
December 1996

	Month	*Year-to-Date*
Sales of Automobiles	$ 300x	$ 3,600x
Cost of Goods Sold	(195x)	(2,340x)
Gross Profit	$ 105x	$ 1,260x
Variable Expenses	(12x)	(144x)
Fixed Expenses	(18x)	(216x)
Operating Profit	$ 75x	$ 900x
Other Income & Expenses	–0–	–0–
Net Income	$ 75x	$ 900x

C used the specific identification inventory method to calculate its Cost of Goods Sold, Gross Profit, and Net Income for the year and month without adjusting for a $60x increase in *C*'s LIFO reserve for 1996. Thus, the December 1996 income statement does not reflect *C*'s use of the LIFO inventory method.

LAW AND ANALYSIS

Section 472(a) authorizes a taxpayer to use the LIFO inventory method in accordance with regulations prescribed by the Secretary.

Section 472(c) provides that a taxpayer may not elect to use the LIFO inventory method unless it establishes to the satisfaction of the Commissioner that it used no method other than the LIFO method in inventorying goods to ascertain the income, profit, or loss of the first taxable year for which the LIFO method is to be used, for the purpose of a report or statement covering that taxable year to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

Section 472(e) provides that a taxpayer electing to use the LIFO inventory method must continue to use the LIFO inventory method unless the taxpayer: (1) obtains the consent of the Commissioner to change to a different method; or (2) is required by the Commissioner to change to a different method because the taxpayer has used some inventory method other than LIFO to ascertain the income, profit, or loss of any subsequent taxable year in a report or statement covering that taxable year (a) to shareholders, partners, other proprietors, or beneficiaries, or (b) for credit purposes.

Section 1.472–2(e)(1) of the Income Tax Regulations provides that a taxpayer electing to use the LIFO inventory method must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss of the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, has not used any inventory method other than LIFO.

Section 1.472–2(e)(1) generally provides exceptions to the LIFO conformity requirement. Under § 1.472–2(e)(1)(iv), a taxpayer is not at variance with the LIFO conformity requirement if it uses an inventory method other than LIFO in a report or statement covering a period of less than an entire taxable year.

However, § 1.472–2(e)(6) provides that a series of credit statements or financial reports is considered a single statement or report covering an entire taxable year if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the entire taxable year. For this purpose a taxable year includes any one-year period that both begins and ends in a taxable year for which the taxpayer used the LIFO inventory method. § 1.472–2(e)(2). Thus, income statements prepared on the basis of a calendar year may be subject to the LIFO conformity requirement even though the taxpayer employs a fiscal year for federal income tax purposes.

Under § 1.472–2(e)(2)(vi), a taxpayer is not at variance with the LIFO conformity requirement if it uses costing methods or accounting methods to ascertain income, profit, or loss in financial statements for credit purposes if such methods are not inconsistent with the LIFO inventory method. The use of cost estimates is an example of a costing method that is not inconsistent with the LIFO inventory method. § 1.472–2(e)(8)(ix).

The financial statements received by *Y* are "for credit purposes" within the meaning of §§ 472(c) and (e)(2) because they were issued to a creditor with whom *A*, *B*, and *C* maintain continuing credit relationships. Thus, under §§ 472(c), 472(e)(2), and § 1.472–2(e)(1), *A*, *B*, and *C* violated the LIFO conformity requirement if they used a method other than LIFO in inventorying goods to ascertain

the income, profit, or loss for the taxable year covered by the financial statements provided to *Y*.

In *Situations 1 and 2*, *A* and *B* did not violate the LIFO conformity requirement in their statements to *Y* because they used the LIFO method in inventorying goods to ascertain their net income in the Month and Year-to-Date columns of the December income statement. The results in *Situations 1 and 2* would be the same if the $60x LIFO adjustment reflected in the Month and Year-to-Date columns of the December 1996 income statement had been a reasonable estimate of the change in LIFO reserve for the year. Further, if *A* or *B* had employed a fiscal taxable year, the results in Situations 1 and 2 would be the same if *A* or *B* made either an adjustment for the change in the LIFO reserve that occurred during the calendar year in the Month and Year-to-Date column of the December income statement or an adjustment for the change in the LIFO reserve that occurred during the fiscal year in the Month and Year-to-Date columns of the income statements provided for the last month of the fiscal year.

In *Situation 3*, *C* violated the LIFO conformity requirement in its statements to *Y* because *C* used a method other than LIFO in inventorying goods to ascertain its net income in the Year-to-Date column of the December income statement. Further, *C* violated the LIFO conformity requirement because the January through November income statements can be combined with the December income statement to ascertain *C*'s net income for the year using a single inventory method other than LIFO. The result in *Situation 3* would be the same even if *C*'s December 31, 1996 Balance Sheet had reflected a 1996 adjustment to *C*'s LIFO reserve.

HOLDING

A franchised automobile dealer that elected the LIFO inventory method for federal income tax purposes violates the LIFO conformity requirement of § 472(c) or (e)(2) by providing to the credit subsidiary of its franchisor (an automobile manufacturer) an income statement for the taxable year that fails to reflect the LIFO inventory method in the computation of net income.

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26 CFR 1.472-1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The August 1997 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, August 31, 1997.

Rev. Rul. 97-43

The following Department Store Inventory Price Indexes for August 1997 were issued by the Bureau of Labor Statistics on September 16, 1997. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, August 31, 1997.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Aug. 1996	Aug. 1997	Percent Change from Aug. 1996 to Aug. 1997[1]
1. Piece Goods	524.3	509.3	-2.9
2. Domestics and Draperies	642.6	652.8	1.6
3. Women's and Children's Shoes	640.3	644.1	0.6
4. Men's Shoes	895.9	895.6	0.0
5. Infants' Wear	610.3	621.2	1.8
6. Women's Underwear	525.8	548.8	4.4
7. Women's Hosiery	287.5	301.6	4.9
8. Women's and Girls' Accessories	546.2	539.7	-1.2
9. Women's Outerwear and Girls' Wear	381.2	397.4	4.2
10. Men's Clothing	611.7	621.2	1.6
11. Men's Furnishings	567.9	584.8	3.0
12. Boys' Clothing and Furnishings	485.4	492.2	1.4
13. Jewelry	1023.8	1008.6	-1.5
14. Notions	770.0	793.8	3.1
15. Toilet Articles and Drugs	885.1	904.7	2.2
16. Furniture and Bedding	669.2	661.0	-1.2
17. Floor Coverings	588.7	598.8	1.7

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS—Continued
(January 1941 = 100, unless otherwise noted)

Groups	Aug. 1996	Aug. 1997	Percent Change from Aug. 1996 to Aug. 1997[1]
18. Housewares	810.6	806.1	–0.6
19. Major Appliances	244.8	242.8	–0.8
20. Radio and Television	78.8	75.4	–4.3
21. Recreation and Education[2]	112.1	110.1	–1.8
22. Home Improvements[2]	125.9	132.3	5.1
23. Auto Accessories[2]	107.2	108.4	1.1
Groups 1 – 15: Soft Goods	582.9	594.5	2.0
Groups 16 – 20: Durable Goods	469.2	463.1	–1.3
Groups 21 – 23: Misc. Goods[2]	113.1	112.6	–0.4
Store Total[3]-	544.0	549.3	1.0

[1]Absence of a minus sign before percentage change in this column signifies price increase.

[2]Indexes on a January 1986=100 base.

[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

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26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The September 1997 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, September 30, 1997.

Rev. Rul. 97–47

The following Department Store Inventory Price Indexes for September 1997 were issued by the Bureau of Labor Statistics on October 16, 1997. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, September 30, 1997.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Sept. 1996	Sept. 1997	Percent Change from Sept. 1996 to Sept. 1997[1]
1. Piece Goods	534.8	521.1	–2.6
2. Domestics and Draperie	644.1	646.6	0.4
3. Women's and Children's Shoes	647.9	652.0	0.6
4. Men's Shoes	916.1	902.9	–1.4
5. Infants' Wear	631.9	623.3	–1.4
6. Women's Underwear	536.0	557.8	4.1
7. Women's Hosiery	289.0	304.3	5.3
8. Women's and Girls' Accessories	557.1	544.1	–2.3
9. Women's Outerwear and Girls' Wear	407.2	422.2	3.7
10. Men's Clothing	612.0	620.2	1.3
11. Men's Furnishings	573.6	603.1	5.1
12. Boys' Clothing and Furnishings	489.8	498.7	1.8
13. Jewelry	1040.3	1009.5	–3.0
14. Notions	795.2	842.0	5.9
15. Toilet Articles and Drugs	895.9	904.6	1.0
16. Furniture and Bedding	675.6	662.7	–1.9
17. Floor Coverings	589.9	583.2	–1.1
18. Housewares	810.0	816.8	0.8
19. Major Appliances	247.1	243.4	–1.5
20. Radio and Television	77.2	74.9	–3.0
21. Recreation and Education[2]	111.4	108.9	–2.2
22. Home Improvements[2]	125.9	131.7	4.6
23. Auto Accessories[2]	107.0	108.3	1.2
Groups 1 – 15: Soft Goods	596.8	606.4	1.6
Groups 16 – 20: Durable Goods	469.0	465.3	–0.8
Groups 21 – 23: Misc. Goods[2]	112.6	111.8	–0.7
Store Total[3]	552.2	556.7	0.8

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

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26 CFR 1.472–1: Last-in, first-out inventories.

LIFO; price indexes; department stores. The October 1997 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or within reference to, October 31, 1997.

Rev. Rul. 97–52

The following Department Store Inventory Price Indexes for October 1997 were issued by the Bureau of Labor Statistics on November 18, 1997. The indexes are accepted by the Internal Revenue Service, under § 1.472–1(k) of the Income Tax Regulations and Rev. Proc. 86–46, 1986–2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory methods for tax years ended on, or with reference to, October 31, 1997.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups - soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS
(January 1941 = 100, unless otherwise noted)

Groups	Oct. 1996	Oct. 1997	Percent Change from Oct. 1996 to Oct. 1997[1]
1. Piece Goods	561.0	534.5	–4.7
2. Domestics and Draperies	641.0	638.4	–0.4
3. Women's and Children's Shoes	661.8	672.2	1.6
4. Men's Shoes	920.1	910.2	–1.1
5. Infants' Wear	626.4	615.5	–1.7
6. Women's Underwear	536.8	560.1	4.3
7. Women's Hosiery	285.7	301.6	5.6
8. Women's and Girls' Accessories	557.5	541.7	–2.8
9. Women's Outerwear and Girls' Wear	417.5	431.3	3.3
10. Men's Clothing	621.9	625.3	0.5
11. Men's Furnishings	581.7	601.0	3.3
12. Boys' Clothing and Furnishings	490.7	505.9	3.1
13. Jewelry	1043.6	995.5	–4.6
14. Notions	797.3	844.4	5.9
15. Toilet Articles and Drugs	901.4	916.4	1.7
16. Furniture and Bedding	667.5	666.2	–0.2
17. Floor Coverings	585.2	578.2	–1.2
18. Housewares	808.1	812.1	0.5
19. Major Appliances	246.2	243.3	–1.2
20. Radio and Television	77.8	74.5	–4.2
21. Recreation and Education[2]	111.8	108.6	–2.9
22. Home Improvements[2]	125.6	132.7	5.7
23. Auto Accessories[2]	107.4	107.9	0.5
Groups 1 – 15: Soft Goods	603.4	610.1	1.1
Groups 16 – 20: Durable Goods	467.7	463.9	–0.8
Groups 21 – 23: Misc. Goods[2]	112.9	111.6	–1.2
Store Total[3]	556.1	558.5	0.4

[1]Absence of a minus sign before percentage change in this column signifies price increase.
[2]Indexes on a January 1986=100 base.
[3]The store total index covers all departments, including some not listed separately, except for the following: candy, foods, liquor, tobacco, and contract departments.

Section 475.—Mark-to-Market Accounting Method for Dealers in Securities

26 CFR 1.475(b)–2: Exemptions—identification requirements. (Also §§ 446, 475, 7805; 1.446–1, 1.475(c)–1, 301.7805–1.)

Mark-to-market accounting method for dealers in securities. This ruling provides guidance to enable taxpayers to comply with the mark-to-market requirements of section 475 of the Code. Rev. Ruls. 94–7 and 93–76 clarified, modified, partially obsoleted, and superseded.

Rev. Rul. 97–39

PURPOSE

This revenue ruling provides guidance under § 475 of the Internal Revenue Code to enable taxpayers to comply with the mark-to-market requirements of § 475. Rev. Rul. 93–76, 1993–2 C.B. 235 (which was previously modified by Rev. Rul. 94–7, 1994–1 C.B. 151), is clarified, modified, partially obsoleted, and superseded.

LAW

Section 475 of the Code was enacted on August 10, 1993, in the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"), section 13223, 1993-3 C.B. 1, 69. It requires mark-to-market accounting treatment for certain securities held by a "dealer in securities" as defined in § 475(c)(1). This requirement is effective for all taxable years ending on or after December 31, 1993. Section 475 was amended on August 5, 1997, in the Taxpayer Relief Act of 1997 (the "1997

Act"), section 1001(b) (redesignating old § 475(e) as § 475(g) and adding new § 475(e) and (f) to allow dealers in commodities and traders in securities and commodities to elect mark-to-market accounting, effective for taxable years ending after August 5, 1997). This revenue ruling is limited to issues arising under the 1993 Act and does not address issues arising under the 1997 Act.

Section 475(a) sets forth two mark-to-market rules. First, any security that is inventory in the hands of a dealer must be included in inventory at its fair market value. Second, any security that is not inventory in the hands of a dealer and that is held at the close of any taxable year is treated as sold by the dealer for its fair market value on the last business day of that taxable year, and any gain or loss is required to be taken into account for that taxable year.

Section 475(b)(1) provides that the mark-to-market rules do not apply to: (1) any security held for investment; (2) any evidence of indebtedness that is acquired (including originated), or any obligation to acquire an evidence of indebtedness that is entered into, by a dealer in the ordinary course of its trade or business, but only if the evidence of indebtedness or obligation to acquire an evidence of indebtedness is not held for sale; (3) any security that is a hedge with respect to a security that is not subject to the mark-to-market rules; and (4) any security that is a hedge of a position, right to income, or liability that is not a security in the hands of the taxpayer. Under § 475(b)(2), a security must be clearly identified in the dealer's records as being covered by one of the exceptions described in § 475(b)(1) before the close of the day on which the dealer acquired, originated, or entered into the security.

In addition to the identification requirements in § 475(b), § 475(c)(2)(F)(iii) requires a dealer in securities to identify a position that is not a security described in § 475(c)(2)(A)–(E), but that is treated as a security because it is a hedge with respect to such a security.

ISSUES AND HOLDINGS

Issue 1: If a taxpayer is not otherwise a dealer in securities within the meaning of § 475(c)(1) but, nevertheless, timely identifies all of its securities as being covered by one of the exceptions in § 475(b)(1), does that "protective identification" cause the taxpayer to be treated as a dealer?

Holding 1: No. A taxpayer that is not a dealer in securities within the meaning of § 475(c)(1) does not become a dealer in securities or create an inference that it is a dealer in securities by making a protective identification of its securities.

Issue 2: Is a bank or an insurance company excepted from the mark-to-market rules on the grounds that it is, per se, not a dealer in securities within the meaning of § 475(c)(1)?

Holding 2: No. A bank or an insurance company is subject to the mark-to-market rules if its activities bring it within the definition of a dealer in securities in § 475(c)(1). For example, many banks are dealers because they regularly originate and sell loans. As another example, an insurance company that regularly makes and sells policyholder loans is a dealer for purposes of § 475.

Issue 3: If a taxpayer's sole business consists of trading in securities (that is, the taxpayer does not purchase from, sell to, or otherwise enter into transactions with customers), is the taxpayer a dealer in securities within the meaning of § 475(c)?

Holding 3: No. A taxpayer whose sole business consists of trading in securities is not a dealer in securities within the meaning of § 475(c) because that taxpayer does not purchase from, sell to, or enter into transactions with, customers in the ordinary course of a trade or business.

Issue 4: Does the classification of a security under financial accounting principles, including FASB Statement No. 115 (Accounting for Certain Investments in Debt and Equity Securities), determine whether the security qualifies for one of the exceptions to the mark-to-market rules under § 475(b)(1)?

Holding 4: No. The classification of a security under financial accounting principles is not dispositive of the treatment of the security for federal income tax purposes. For example, for purposes of § 475, a security may in certain cases qualify for the held-for-investment exception to the mark-to-market rules even though, under applicable financial accounting principles, the security is classified as available for sale.

Issue 5: Does an identification of a security as "held for investment" under § 1236 serve to identify that security as "held for investment" (within the meaning of § 475(b)(1)(A)) or as "not held for sale" (within the meaning of § 475(b)(1)(B))?

Holding 5: No. Taxpayers may choose not to identify under § 475(b)(2) some or all of the securities that they identify under § 1236(a)(1). (For a transitional rule applicable to securities held as of the close of the last taxable year ending before December 31, 1993, however, see § 1.475(b)–4(a) of the Income Tax Regulations.) Accordingly, even if a § 1236 identification has been made, an identification of a security or hedge is a valid identification for purposes of § 475(b)(2) only if it contains a specific reference to § 475; this specific reference, however, may be effected by any reasonable method. For instance, certain accounts may be identified in such a way that placing a security or hedge in the account identifies the security or hedge for purposes of both § 1236(a)(1) and § 475(b)(1)(A), (B), or (C). See Holding 6 below. See Holding 15 below for a transitional rule that requires less specificity for identification of securities held by certain taxpayers that were not dealers in securities under § 1.475(c)–1T (as contained in 26 CFR part 1 revised April 1, 1996).

Issue 6: Is a dealer in securities required to use a special procedure to comply with the identification requirements under § 475?

Holding 6: No. Unless the Commissioner otherwise prescribes, a dealer may comply with the identification requirements under § 475 using any reasonable method (see, for example, guidance concerning identification requirements under §§ 988(a)(1)(B), 1221, 1236(a)(1), and 1256(e)(2)(C)). The identification, however, must be made on, and retained as part of, the dealer's books and records. The dealer's books and records must clearly indicate the specific security or hedge being identified, and the identification must clearly indicate that it is being made for purposes of § 475. Alternatively, the dealer may identify specific accounts as containing only securities or hedges that are covered by a particular exception, so that placing a security or

hedge in the account identifies the security or hedge as being covered by that exception. Under § 1.475(b)–2(a), an identification need not distinguish between an exception under § 475(b)(1)(A) (concerning certain securities held for investment) and one under § 475(b)(1)(B) (concerning securities not held for sale). Exceptions under either of these provisions, however, must be distinguished from exceptions under § 475(b)(1)(C) (concerning securities held as hedges).

In addition, rather than identifying specific securities or accounts as being covered by an exception described in § 475(b)(1), a dealer may comply with the identification requirement under § 475(b) by clearly indicating the specific securities or accounts that are not covered by a particular exception (that is, indicating that they are covered by some other exception or that they are not exempt) and identifying all other securities or accounts as being covered by a particular exception.

For example, a dealer may place on its books and records a statement that, unless otherwise identified, all of its securities for which an identification is still timely (including securities yet to be acquired) are identified as exempt under either § 475(b)(1)(A) or (B). This statement is effective to identify under § 475(b)(1)(A) or (B) each security covered by its terms unless, before the expiration of the period during which the security may be timely identified, the dealer identifies it as not exempt or as exempt under § 475(b)(1)(C).

Analogously, under Rev. Rul. 64–160, 1964–1 (Part I) C.B. 306, modified by Rev. Rul. 76–489, 1976–2 C.B. 250, dealers can identify specified accounts as containing only securities held for investment for purposes of § 1236(a)(1). Accordingly, dealers can satisfy the identification requirements of § 475(b)(2) by unambiguously indicating that all of the securities in one or more of these accounts are also described, for example, in § 475(b)(1)(A) or (B). Once such an identification of an account is made, placing a security in the account identifies the security not only as being "held for investment" for purposes of § 1236 but also as being described in the applicable subparagraph of § 475(b)(1).

Issue 7 in Rev. Rul. 93–76 concerned transitional identification issues for securities acquired, originated, or entered into between August 10, 1993, and October 31, 1993. As the transition period has now ended, Issue 7 is obsolete and is not reprinted in this revenue ruling.

Issue 8: If a dealer in securities originates or acquires an evidence of indebtedness in the ordinary course of a trade or business, are there any exceptions to the requirement that the dealer make an identification under § 475(b)(2) before the close of the day on which it originates or acquires the security?

Holding 8: Yes. Pending further guidance, if a financial institution (as defined in § 265(b)(5)) originates or acquires an evidence of indebtedness in the ordinary course of a trade or business, an identification of the evidence of indebtedness is timely if it is made in accordance with the dealer's accounting practice, but no later than 30 calendar days after the date of origination, or acquisition, by the financial institution. The preceding sentence applies to any dealer in securities for evidences of indebtedness that are mortgage loans.

Also, pending further guidance, a dealer in securities that enters into commitments to acquire mortgage loans may identify those commitments as being held for investment if the dealer acquires the mortgage loans and holds the mortgages as investments. This identification of commitments to acquire mortgage loans must be made in accordance with the dealer's accounting practice, but no later than 30 calendar days after the date of acquisition of the mortgage loans.

Issues 9, 10, and 11 discussed transitional issues concerning proper identification, computation of adjustments, and the period over which to spread any adjustments, for taxable years that included December 31, 1993. As the transition period has now passed, Issues 9, 10, and 11 are obsolete and are not reprinted in this revenue ruling.

Issue 12: May a taxpayer use an amended return to make an election under § 1.475(c)–1(c)(1)(ii) (which concerns taxpayers that purchase securities from customers but make no more than negligible sales of securities)?

Holding 12: For any taxable year for which an original federal income tax return is filed after October 31, 1997, an election under § 1.475(c)–1(c)(1)(ii) must be made on an original federal income tax return that is filed on or before the due date (including any extensions of time) for that return. For any taxable year for which an original federal income tax return was filed on or before October 31, 1997, an election under § 1.475(c)– 1(c)(1)(ii) also may be made on an amended return filed not later than October 31, 1997. Not later than December 15, 1997, compliance with § 475 must be reflected on an original or amended return for every other taxable year which is subject to the election and the original return for which is due on or before October 31, 1997. Note that amended returns must be filed before the expiration of the statute of limitations on assessment under § 6501(a).

As is noted in Holding 17 below, a taxpayer subject to more than one exemption must affirmatively elect out of all applicable exemptions to be treated as a dealer in securities.

Issue 13: If a taxpayer wishes to use an amended return to make an election out of the customer paper exemption under § 1.475(c)–1(b)(4)(i)(B), by what date must the taxpayer file the amended return?

Holding 13: Section 1.475(c)–1(b)(4)(i)(B) provides a June 23, 1997, deadline to make the customer paper election on an amended return. Notice 97–37, 1997–27 I.R.B. 8, provides that additional guidance will extend that deadline. Accordingly, that deadline to file an amended return is extended to October 31, 1997. Not later than December 15, 1997, compliance with § 475 must be reflected on an original or amended return for every other taxable year which is subject to the election and the original return for which is due on or before October 31, 1997. Note that amended returns must be filed before the expiration of the statute of limitations on assessment under § 6501(a).

Issue 14: What is the general rule for identifying a security as excepted from mark-to-market accounting?

Holding 14: For a security to be exempt from mark-to-market accounting, the taxpayer must make an identification that is timely under § 475(b)(2), which generally requires a security to be identified before the close of the day on which it is acquired. For the only current exceptions to this rule, see Holding 8 above (identifications of securities by financial institutions and dealers in mortgages), § 1.475(b)–1(b)(4)(ii)(A)

(identification of securities to which § 1.475(b)–1(b)(1) ceases to apply), and Holding 15 below (special identification rules for taxpayers not treated as dealers under § 1.475(c)–1T). For information about the required specificity of the identification, see Holding 5 above.

Issue 15: If a taxpayer makes an election out of either § 1.475(c)–1(b)(1) (customer paper exemption) or § 1.475(c)–1(c)(1) (negligible sales exemption) and the election has the effect of causing the taxpayer to be treated as a dealer in securities for a taxable year starting before the date the taxpayer filed the documentation effecting the election (date of the election), how does the taxpayer identify securities that were acquired before the date of the election?

Holding 15: A special identification regime applies to taxpayers that satisfy the following criteria:

First, the taxpayer is making an election out of the customer paper exemption, the negligible sales exemption, or both.

Second, the taxpayer was not treated as a dealer in securities under § 1.475(c)–1T (as contained in 26 CFR part 1 revised April 1, 1996).

The special identification regime applies only to securities ("transition securities") for which an identification would have been timely under the general rule (described in Holding 14 above) only if made on or before October 31, 1997. In applying the preceding sentence, a taxpayer may choose to substitute any earlier date that is on or after December 24, 1996. To make this substitution, the taxpayer must place in its books and records no later than October 31, 1997, an unambiguous statement that the taxpayer chooses to apply the general identification rule described in Holding 14 for all securities acquired on or after the specific date selected by the taxpayer.

Under the special identification regime, a transition security was properly identified as exempt for the purposes of § 475(b)(2) or (c)(2)(F)(iii) if the information that is contained in the taxpayer's books and records and that was entered substantially contemporaneously with the date of acquisition of the transition security supports a conclusion that the transition security was described by § 475(b)(1)(A), (B), or (C). This rule applies even if the information in the books and records does not meet the specificity that Holding 5 generally requires for identification. The status of a transition security that was acquired before the first day of the taxable year for which the election is being made is determined by examining the books and records as of the last day of the preceding taxable year.

The taxpayer must, by October 31, 1997, place in its books and records a statement resolving ambiguities, if any, concerning which transition securities are properly identified within the meaning of the preceding paragraph. Any information that supports treating a transition security as being described in § 475(b)(2) or (c)(2)(F)(iii) must be applied consistently.

A taxpayer, in determining whether a transition security must be identified, must apply the following principles: if the transition security was identified under § 1.1221–2 or § 1256(e) and the item being hedged is described in § 475(b)(1)(C)(i) or (ii), the § 1.1221–2 or § 1256(e) identification constitutes an identification for purposes of § 475(b)(2); and, if the item being hedged was ordinary property, as defined in § 1.1221–2, and the taxpayer did not identify the transition security as a hedging transaction, the transition security cannot be identified under § 475(b)(1)(C).

If a taxpayer made a protective identification (as described in Issue 1 above) of a transition security, and subsequent to the protective identification the taxpayer makes an election that causes the taxpayer to be a dealer in securities for purposes of § 475, the protective identification is recognized and the taxpayer is subject to the general rules governing identifications for all transition securities that were eligible to be timely identified after the date that the taxpayer began making protective identifications. Thus, if a transition security was properly and timely identified as exempt from being marked to market and remains eligible for the exemption claimed, that transition security is not marked to market even though § 475 applies to the taxpayer. If a transition security was properly and timely identified and thereafter ceases to be held for investment or as a hedge, see § 475(b)(3). If a transition security was not eligible to be identified as exempt, see § 475(d)(2).

Issue 16: If an issuer of an evidence of indebtedness has the right to prepay at any time without a penalty (for example, a revolving credit card balance), does that right preclude that indebtedness from having a fair market value that is greater than the face value of the obligation?

Holding 16: No. Securities must be marked to fair market value based on all the facts and circumstances. For example, in light of contractual interest rates and general payment history on customer obligations, the fair market value of a customer obligation may be greater than the face amount, even if the customer has the right to repay the debt at its face amount at any time.

Issue 17: If a taxpayer would meet the definition of a dealer in securities under § 475 but otherwise satisfies more than one exemption from dealer status, must the taxpayer elect out of all applicable exemptions to be a dealer in securities for the purpose of § 475?

Holding 17: Generally, a taxpayer must make an election out of all applicable exemptions in order to be treated as a dealer under § 475. A taxpayer subject to multiple exemptions from § 475 must file all the documentation required to elect out of each applicable exemption. Sometimes, the documentation required for one election satisfies all of the filing requirements for another election. For example, if a taxpayer is subject to both the customer paper exemption under § 1.475(c)–1(b) and the negligible sales exemption under § 1.475(c)–1(c), the taxpayer may make an election under § 1.475(c)–1(b)(4) that is effective as of January 1, 1993, and timely file an amended 1993 federal income tax return using mark-to-market accounting for securities. The amended 1993 return itself represents an election out of the negligible sales exemption.

Issue 18: How does a taxpayer that is in its first year of existence elect out of an exemption from dealer status under § 475?

Holding 18: If a taxpayer decides for its first year of existence to make an election out of the negligible sales exemption to account for securities on a mark-to-market basis, the taxpayer should attach to its original return for that first year the following statement: "[Insert name and taxpayer identification number of the taxpayer] hereby elects not to be governed by § 1.475(c)–1(c)(1)(i) of the income tax regulations for the taxable year ending [describe the last day of the year] and for subsequent taxable years." If a taxpayer decides for its first year of existence to make an election out of the customer paper

exemption or to make the intragroup-customer election, the taxpayer must meet the requirements of § 1.475(c)–1.

Issue 19: Which changes of accounting method are covered by the consent provisions of § 13223(c)(2) of the 1993 Act?

Holding 19: Under § 13223(c)(2) of the 1993 Act, certain changes of accounting method are treated as made with the consent of the Commissioner. This treatment extends only to a change in method that was effected by a taxpayer who (1) became a dealer for the taxable year that includes December 31, 1993, merely by virtue of the passage of the 1993 Act, and (2) who accounted for securities as a dealer under § 475 on its original federal income tax return for that year. Consent for other changes of method to comply with § 475 must be obtained either on a taxpayer-by-taxpayer basis or as part of automatic consent contained in published guidance. See Rev. Proc. 97–43, page 494, this Bulletin.

Issue 20: If a taxpayer is accounting for securities by marking them to market under § 475(a), may the taxpayer, without the consent of the Commissioner, file a federal income tax return for a later taxable year that does not account for securities on a mark-to-market basis?

Holding 20: No. Once a taxpayer has used the § 475 mark-to-market method as its method of accounting for securities, the taxpayer may not change that method of accounting without obtaining the consent of the Commissioner. See § 446(e). Unless the Commissioner otherwise prescribes, to request consent the taxpayer must comply with the requirements of Rev. Proc. 97–27, 1997–21 I.R.B. 10. For example, if a taxpayer accounts for securities by marking them to market because the taxpayer made more than negligible sales of securities and in a later year makes only negligible sales of securities, the taxpayer must obtain the consent of the Commissioner to change its method of accounting for securities. If a taxpayer made no more than negligible sales of securities but, pursuant to § 1.475(c)–1(c)-(1)(ii), accounted for securities on a mark-to-market basis and the taxpayer makes no more than negligible sales of securities in a subsequent year, the taxpayer must obtain the consent of the Commissioner to change its method of accounting for securities. Especially in the latter example, consent for the change will be granted only in unusual circumstances.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 93–76 as modified by Rev. Rul. 94–7, is clarified, modified, partially obsoleted, and superseded. Notice 97–37, 1997–27 I.R.B. 8, is obsoleted.

PROSPECTIVE APPLICATION

Pursuant to § 7805(b), if an identification is made on or before June 30, 1997, and the identification complies with the requirements set forth in the third paragraph of Holding 6 of Rev. Rul. 93-76, the identification will not be treated as failing to satisfy the requirements of § 475(b)(2) solely on the grounds that it failed to identify the operative subparagraph of that provision.

PAPERWORK REDUCTION ACT

The collections of information contained in this revenue ruling have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1558.

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

The collections of information in this revenue ruling are in sections 26 CFR 1.475(b)–2, 26 CFR 1.475(b)–4, and 26 CFR 1.475(c)–1. This information is required to facilitate the administration of § 475 of the Internal Revenue Code. This information will be used to facilitate audits of taxpayers that elect to not be governed by certain exemptions under § 475 of the Code. The collections of information are required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The recordkeeping burden described in Holding 6 was reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1496.

The estimated total annual recordkeeping burden described in Holding 15 is 450,000 hours.

The estimated annual burden per recordkeeper varies from 15 hours to 45 hours, depending on individual circumstances, with an estimated average of 22.5 hours. The estimated number of recordkeepers is 20,000.

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.

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26 CFR 1.475(c)–1; Definitions—dealer in securities.

What information must a taxpayer provide in order to obtain automatic consent to change accounting method when section 475(a) becomes applicable as a result of the taxpayer making an election (i) to treat transactions within a consolidated group as transactions with customers as provided by section 1.475(c)–1(a), or (ii) not to be governed by the exemptions from the status of a dealer in securities provided by section 1.475(c)–1(b) or –1(c)? See Rev. Proc. 97–43, page 494.

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6 CFR 1.475(c)–1: Exemptions—identification requirements.

Questions and answers about the application of section 475 and the regulations thereunder. See Rev. Rul. 97–39, page 62.

Part III.—Adjustments

Section 481.—Adjustments Required by Changes in Methods of Accounting

26 CFR 1.481–4: Adjustments taken into account with consent.

How is the section 481(a) adjustment taken into account when a taxpayer changes its method of accounting for package design costs. See Rev. Proc. 97–35, page 448.

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26 CFR §1.481–1: Adjustments in general;

26 CFR §1.481–4: Adjustments taken into account with consent.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change a method of accounting. See Rev. Proc. 97–37, page 455.

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26 CFR 1.481–1: Adjustments in general.

26 CFR 1.481–4: Adjustments taken into account with consent.

What procedures should taxpayers follow to obtain automatic consent to change their method of accounting for costs paid or incurred to convert or re-

place computer software to recognize dates beginning in the year 2000. See Rev. Proc. 97–50, page 525.

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 October 1997. See Rev. Rul. 97–41, page 102.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

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 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

26 CFR 1.483–1: Computation of interest on certain deferred payments.

As defined by section 1274A, the definitions for both "qualified debt instruments" and "cash method debt instruments" have dollar ceilings on the stated principal amount. The limits to the stated principal amount are adjusted for inflation for sales or exchanges occurring in the 1998 calendar year. See Rev. Rul. 97–56, page 107.

Subchapter F.—Exempt Organizations
Part I.—General Rule

Section 501.—Exemption From Tax on Corporations, Certain Trusts, Etc.

26 CFR 1.501(c)(5)–1: Labor, agricultural, and horticultural organizations.

T.D. 8726

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Requirements for Tax Exempt Section 501(c)(5) Organizations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations clarifying certain requirements of section 501(c)(5). The requirements are clarified to provide needed guidance to organizations on the requirements an organization must meet in order to be exempt from tax as an organization described in section 501(c)(5).

DATES: These regulations are effective on December 21, 1995.

SUPPLEMENTARY INFORMATION:

Background

On December 21, 1995, the IRS published in the **Federal Register** (60 F.R. 66228 [EE–53–95, 1996–1 C.B. 766]) a notice of proposed rulemaking under section 501(c)(5). The proposed regulations clarified that organizations whose principal activity is administering retirement plans are not section 501(c)(5) organizations.

A public hearing was held on June 5, 1996. Written comments were received. After consideration of all of the comments, the proposed regulations under section 501(c)(5) are adopted as revised by this Treasury Decision. The comments and revisions are discussed below.

Explanation of Revisions and Summary of Comments

Section 501(c)(5) describes certain labor, agricultural and horticultural organizations. Section 401(a) sets forth the requirements for exemption for qualified employee benefit pension trusts. Section 501(a) exempts from federal income taxes organizations described in section 401(a) or section 501(c). Thus, section 401(a) and section 501(c)(5) should be read as enactments of Congress *in pari materia,* taken together as one consistent body of law. *Pacific Co. v. Johnson,* 285 U.S. 480, 495 (1932).

The Treasury and IRS believe that section 501(c)(5) should be interpreted in a manner consistent with the Employee Retirement Income Security Act of 1974, Pub. L. No. 93–406, 88 Stat. 829 (1974) (ERISA), as amended. ERISA was enacted as a "comprehensive and reticulated statute" to regulate retirement plans and trusts, "the product of a decade of Congressional study of the Nation's private employee benefit system." *Mertens v. Hewitt Assoc.,* 508 U.S. 248, 251 (1993), citing *Nachman v. PBGC,* 446 U.S. 359, 361 (1980). Congress intended that pension trusts satisfy the comprehensive requirements of section 401(a), as amended by ERISA, in order to be tax exempt. See S. Rep. No. 383, 93d Cong., 1st Sess. at 33, *reprinted in* 1974–3 C.B. (Supp.) 112; H. Rep. No. 807, 93d Cong., 1st Sess. at 33, *reprinted in* 1974–3 C.B. (Supp) 236, 266.

Accordingly, Treasury and the IRS continue to believe that an organization whose principal purpose is managing employer-sponsored retirement plans is not an exempt labor organization described in section 501(c)(5). (However, an employer-sponsored pension trust may nevertheless qualify for exemption under section 501(a) if it meets the requirements of section 401(a).) *Morganbesser v. United States,* 984 F.2d 560 (2d Cir. 1993), nonacq. 1995–2 C.B. 2.; *In re Morganbesser,* AOD CC-1995-016 (Dec. 26, 1995).

Consistent with ERISA and interpreting section 401(a) and section 501(c)(5) as part of a consistent whole, these regulations provide a general rule that an organization is not described in section 501(c)(5) if its principal activity is to receive, hold, invest, disburse or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs. However, to the extent that

ERISA provides special rules for certain types of retirement savings plans, it is appropriate to take those rules into account in interpreting provisions of the Code relating to such plans, including section 501(c)(5).

As noted by one commentator, ERISA excepts certain dues-financed plans from Parts 2 and 3 of Title I of ERISA (vesting, funding and certain other qualification requirements). Those pension trusts sponsored by labor organizations for their members, which accept no employer contributions, do not qualify for exemption under section 401(a) because they are not maintained by an employer. Section 401(a), Rev. Rul. 80–306, 1980–2 C.B. 131. Accordingly, the regulations provide that an organization (including a pension trust) may qualify as an organization described in section 501(c)(5) if it meets all of the following requirements:

(1) the organization is established and maintained by another labor organization described in section 501(c)(5) (determined without reference to the tests in Treas. Reg. § 1.501(c)(5)–1(b)(2));

(2) the organization is not directly or indirectly established or maintained in whole or in part by any employer or by any government (or any agency, instrumentality or controlled entity thereof);

(3) the organization is funded by membership dues paid to the labor organization establishing and maintaining the organization and earnings thereon; and

(4) after September 2, 1974 (the date of enactment of ERISA, 88 Stat. 829), the organization's governing documents have not permitted or provided for nor did the organization accept, any contribution from any employer or from any government (or any agency, instrumentality or controlled entity thereof). Treas. Reg. § 1.501(c)(5)–1(b)(2).

Treas. Reg. § 1.892–2T(c) governs the tax status of a pension trust that is wholly owned and controlled by a foreign sovereign.

Scope

These regulations solely address the tax exempt status of organizations under section 501(c)(5) whose principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with savings or investment plans or programs. Other Code sections and tax principles apply to the tax exempt status of these organizations and the tax consequences of these arrangements to employers and participants in these arrangements.

One commentator requested that the IRS clarify that the regulations do not apply to health and welfare benefits not specifically mentioned in the regulations, such as retiree health benefits, death benefits, and group legal services. The regulations address only savings or investment plans or programs, (including pension or other retirement savings plans or programs) and do not address other types of benefits. Cf. Rev. Rul. 62–17, 1962–1 C.B. 87.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act, (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.501(c)(5)–1 is amended by:

1. Redesignating paragraph (b) as paragraph (c).

2. Adding a new paragraph (b).

The addition reads as follows:

§ 1.501(c)(5)–1 Labor, agricultural, and horticultural organizations.

* * * * *

(b)(1) *General rule.* An organization is not a organization described in section 501(c)(5) if the principal activity of the organization is to receive, hold, invest, disburse or otherwise manage funds associated with savings or investment plans or programs, including pension or other retirement savings plans or programs.

(2) *Exception.* Paragraph (b)(1) of this section shall not apply to an organization which—

(i) Is established and maintained by another labor organization described in section 501(c)(5), (determined without regard to this paragraph (b)(2));

(ii) Is not directly or indirectly established or maintained in whole or in part by one or more—

(A) Employers;

(B) Governments or agencies or instrumentalities thereof; or

(C) Government controlled entities;

(iii) Is funded by membership dues from members of the labor organization described in this paragraph (b)(2) and earnings thereon; and

(iv) Has not at any time after September 2, 1974 (the date of enactment of the Employee Retirement Income Security Act of 1974, Pub. L. 93–406, 88 Stat. 829) provided for, permitted or accepted employer contributions.

(3) *Example.* The principles of this paragraph (b) are illustrated by the following example:

Example. Trust A is organized in accordance with a collective bargaining agreement between labor union K and multiple employers. Trust A forms part of a plan that is established and maintained pursuant to the agreement and which covers employees of the signatory employers who are members of K. Representatives of both the employers and K serve as trustees. A receives contributions from the employers who are subject to the agreement. Retirement benefits paid to K's members as specified in the agreement are funded exclusively by the employers' contributions and accumulated earnings. A also provides information to union members about their retirement benefits and assists them with administrative tasks associated with the benefits. Most of A's activities are devoted to these functions. From time to time, A also participates in the renegotiation of the collective bargaining agreement. A's principal activity is to receive, hold, invest, disburse, or otherwise manage funds associated with a retirement savings plan. In addition, A does not satisfy all the requirements of the exception described in paragraph (b)(2) of this section. (For example, A accepts contributions from employers). Therefore, A is not a labor organization described in section 501(c)(5).

* * * * *

Acting Commissioner of Internal Revenue
Assistant Secretary of the Treasury

(Filed by the Office of the Federal Register on July 28, 1997, 8:45 a.m., and published in the issue of the Federal Register for July 29, 1997, 62 F.R. 40447)

Part III.—Taxation of Business Income of Certain Exempt Organizations

Section 512.—Unrelated Business Taxable Income

The Service provides an inflation adjustment to the maximum amount of annual dues that can be paid to certain agricultural or horticultural organizations without any portion being treated as unrelated trade or business income by reason of any benefits or privileges available to members for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Section 513.—Unrelated Trade or Business

The Service provides an inflation adjustment to the maximum amount of a "low cost article" for taxable years beginning in 1998. Funds raised through a charity's distribution of "low cost articles" will not be treated as unrelated business income to the charity. See Rev. Proc. 97–57, page 584.

Part VIII.—Higher Education Savings Entities

Section 529.—Qualified State Tuition Programs

How have the rules for qualified state tuition programs been changed by the Taxpayer Relief Act of 1997? See Notice 97–60, page 310.

Section 530.—Education Individual Retirement Accounts

What are the rules for education individual retirement accounts, as enacted by the Taxpayer Relief Act of 1997? See Notice 97–60, page 310.

Subchapter H.—Banking Institutions
Part I.—Rules of General Application to Banking Institutions

Section 585.—Reserves for Losses on Loans of Banks

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change from the § 585 reserve method of accounting to the § 166 specific charge-off method. See Rev. Proc. 97–37, page 455.

Subchapter J.—Estates, Trusts, Beneficiaries, and Decedents
Part I.—Estates, Trusts, and Beneficiaries
Subpart A.—General Rules For Taxation of Estates and Trusts

Section 641.—Imposition of Tax

How are electing small business trust distributions treated under section 641(d)? See Notice 97–49, page 304.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

Federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

Federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subchapter K.—Partners and Partnerships
Part I.—Determination of Tax Liability

Section 704.—Partner's Distributive Share

26 CFR 1.704–1: Determination of partner's distributive share.
(Also § 752; 1.752–2.)

Calculation of a partner's limited deficit restoration obligation. This ruling holds that the amount of a partner's limited deficit restoration obligation is the amount of money that the partner would be required to contribute to the partnership to satisfy partnership liabilities if all partnership property were sold for the amount of the partnership's book basis in the property.

Rev. Rul. 97–38

ISSUE

If a partner is treated as having a limited deficit restoration obligation under § 1.704–1(b)(2)(ii)(*c*) of the Income Tax Regulations by reason of the partner's liability to the partnership's creditors, how is the amount of that obligation calculated?

FACTS

In year 1, *GP* and *LP*, general partner and limited partner, each contribute $100*x* to form limited partnership *LPRS*. In general, *GP* and *LP* share *LPRS*'s income and loss 50 percent each. However, *LPRS* allocates to *GP* all depreciation deductions and gain from the sale of depreciable assets up to the amount of those deductions. *LPRS* maintains capital accounts according to the rules set forth in § 1.704–1(b)(2)(iv), and the partners agree to liquidate according to positive capital account balances under the rules of§ 1.704–1(b)(2)(ii)(*b*)(*2*).

Under applicable state law, *GP* is liable to creditors for all partnership recourse liabilities, but *LP* has no personal liability. *GP* and *LP* do not agree to unconditional deficit restoration obligations as described in § 1.704–1(b)(2)(ii)(*b*)(*3*) (in general, a deficit restoration obligation requires a partner to restore any deficit capital account balance following the liquidation of the partner's interest in the partnership); *GP* is obligated to restore a deficit capital account only to the extent necessary to pay creditors. Thus, if *LPRS* were to liquidate after paying all creditors and *LP* had a positive capital account balance, *GP* would not be required to restore *GP*'s deficit capital account to permit a liquidating distribution to *LP*. In addition, *GP* and *LP* agree to a qualified income offset, thus satisfying the requirements of the alternate test for economic effect of § 1.704–1(b)(2)(ii)(*d*). *GP* and *LP* also agree that no allocation will be made that causes or increases a deficit balance in any partner's capital account in excess of the partner's obligation to restore the deficit.

LPRS purchases depreciable property for $1,000*x* from an unrelated seller, paying $200*x* in cash and borrowing the $800*x* balance from an unrelated bank that is not the seller of the property. The note is recourse to *LPRS*. The principal of the loan is due in 6 years; interest is payable semi-annually at the applicable federal rate. *GP* bears the entire economic risk of loss for *LPRS*'s recourse liability, and *GP*'s basis in *LPRS* (outside basis) is increased by $800*x*. *See* § 1.752–2.

In each of years 1 through 5, the property generates $200*x* of depreciation. All

other partnership deductions and losses exactly equal income, so that in each of years 1 through 5 *LPRS* has a net loss of $200*x*.

LAW AND ANALYSIS

Under § 704(b) of the Internal Revenue Code and the regulations thereunder, a partnership's allocations of income, gain, loss, deduction, or credit set forth in the partnership agreement are respected if they have substantial economic effect. If allocations under the partnership agreement would not have substantial economic effect, the partnership's allocations are determined according to the partners' interests in the partnership. The fundamental principles for establishing economic effect require an allocation to be consistent with the partners' underlying economic arrangement. A partner allocated a share of income should enjoy any corresponding economic benefit, and a partner allocated a share of losses or deductions should bear any corresponding economic burden. *See* § 1.704–1(b)-(2)(ii)(*a*).

To come within the safe harbor for establishing economic effect in § 1.704–1(b)(2)(ii), partners must agree to maintain capital accounts under the rules of § 1.704–1(b)(2)(iv), liquidate according to positive capital account balances, and agree to an unconditional deficit restoration obligation for any partner with a deficit in that partner's capital account, as described in § 1.704–1(b)(2)(ii)(*b*)(*3*). Alternatively, the partnership may satisfy the requirements of the alternate test for economic effect provided in § 1.704–1(b)(2)(ii)(*d*). *LPRS*'s partnership agreement complies with the alternate test for economic effect.

The alternate test for economic effect requires the partners to agree to a qualified income offset in lieu of an unconditional deficit restoration obligation. If the partners so agree, allocations will have economic effect to the extent that they do not create a deficit capital account for any partner (in excess of any limited deficit restoration obligation of that partner) as of the end of the partnership taxable year to which the allocation relates. Section 1.704–1(b)(2)(ii)(*d*)(*3*) (flush language).

A partner is treated as having a limited deficit restoration obligation to the extent of: (1) the outstanding principal balance of any promissory note contributed to the partnership by the partner, and (2) the amount of any unconditional obligation of the partner (whether imposed by the partnership agreement or by state or local law) to make subsequent contributions to the partnership. Section 1.704–1(b)(2)-(ii)(*c*).

LP has no obligation under the partnership agreement or state or local law to make additional contributions to the partnership and, therefore, has no deficit restoration obligation. Under applicable state law, *GP* may have to make additional contributions to the partnership to pay creditors. However, *GP*'s obligation only arises to the extent that the amount of *LPRS*'s liabilities exceeds the value of *LPRS*'s assets available to satisfy the liabilities. Thus, the amount of *GP*'s limited deficit restoration obligation each year is equal to the difference between the amount of the partnership's recourse liabilities at the end of the year and the value of the partnership's assets available to satisfy the liabilities at the end of the year.

To ensure consistency with the other requirements of the regulations under § 704(b), where a partner's obligation to make additional contributions to the partnership is dependent on the value of the partnership's assets, the partner's deficit restoration obligation must be computed by reference to the rules for determining the value of partnership property contained in the regulations under § 704(b). Consequently, in computing *GP*'s limited deficit restoration obligation, the value of the partnership's assets is conclusively presumed to equal the book basis of those assets under the capital account maintenance rules of § 1.704–1(b)(2)(iv). *See* § 1.704–1(b)(2)(ii)(d)(value equals basis presumption applies for purposes of determining expected allocations and distributions under the alternate test for economic effect); § 1.704–1(b)(2)(iii)(value equals basis presumption applies for purposes of the substantiality test); § 1.704–1(b)(3)(iii) (value equals basis presumption applies for purposes of the partner's interest in the partnership test); § 1.704–2(d) (value equals basis presumption applies in computing partnership minimum gain).

The *LPRS* agreement allocates all depreciation deductions and gain on the sale of depreciable property to the extent of those deductions to *GP*. Because *LPRS*'s partnership agreement satisfies the alternate test for economic effect, the allocations of depreciation deductions to *GP* will have economic effect to the extent that they do not create a deficit capital account for *GP* in excess of *GP*'s obligation to restore the deficit balance. At the end of year 1, the basis of the depreciable property has been reduced to $800*x*. If *LPRS* liquidated at the beginning of year 2, selling its depreciable property for its basis of $800*x*, the proceeds would be used to repay the $800*x* principal on *LPRS*'s recourse liability. All of *LPRS*'s creditors would be satisfied and *GP* would have no obligation to contribute to pay them. Thus, at the end of year 1, *GP* has no obligation to restore a deficit in its capital account.

Because *GP* has no obligation to restore a deficit balance in its capital account at the end of year 1, an allocation that reduces *GP*'s capital account below $0 is not permitted under the partnership agreement and would not satisfy the alternate test for economic effect. An allocation of $200*x* of depreciation deductions to *GP* would reduce *GP*'s capital account to negative $100*x*. Because the allocation would result in a deficit capital account balance in excess of *GP*'s obligation to restore, the allocation is not permitted under the partnership agreement, and would not satisfy the safe harbor under the alternate test for economic effect. Therefore, the deductions for year 1 must be allocated $100*x* each to *GP* and *LP* (which is in accordance with their interests in the partnership).

The allocation of depreciation of $200*x* to *GP* in year 2 has economic effect. Although the allocation reduces *GP*'s capital account to negative $200*x*, while *LP*'s capital account remains $0, the allocation to *GP* does not create a deficit capital account in excess of *GP*'s limited deficit restoration obligation. If *LPRS* liquidated at the beginning of year 3, selling the depreciable property for its basis of $600*x*, the proceeds would be applied toward the $800*x* *LPRS* liability. Because *GP* is obligated to restore a deficit capital account to the extent necessary to pay creditors, *GP* would be required to contribute $200*x* to *LPRS* to satisfy the outstanding liability. Thus, at the end of year 2, *GP* has a deficit restoration obligation of $200*x*,

and the allocation of depreciation to *GP* does not reduce *GP*'s capital account below its obligation to restore a deficit capital account.

This analysis also applies to the allocation of $200*x* of depreciation to *GP* in years 3 through 5. At the beginning of year 6, when the property is fully depreciated, the $800*x* principal amount of the partnership liability is due. The partners' capital accounts at the beginning of year 6 will equal negative $800*x* and $0, respectively, for *GP* and *LP*. Because value is conclusively presumed to equal basis, the depreciable property would be worthless and could not be used to satisfy *LPRS*'s $800*x* liability. As a result, *GP* is deemed to be required to contribute $800*x* to *LPRS*. A contribution by *GP* to satisfy this limited deficit restoration obligation would increase *GP*'s capital account balance to $0.

HOLDING

When a partner is treated as having a limited deficit restoration obligation by reason of the partner's liability to the partnership's creditors, the amount of that obligation is the amount of money that the partner would be required to contribute to the partnership to satisfy partnership liabilities if all partnership property were sold for the amount of the partnership's book basis in the property.

Subchapter L.—Insurance Companies
Part I.—Life Insurance Companies
Subpart C.—Life Insurance Deductions

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Section 809.—Reduction in Certain Deductions of Mutual Life Insurance Companies

26 CFR 1.809–9: Computation of the differential earnings rate and the recomputed differential earnings rate.

Mutual life insurance companies; differential earnings rate. The differential earnings rate for 1996 and the recomputed differential earnings rate for 1995 are set forth for use by mutual life insurance companies to compute their income tax liabilities for 1996.

Rev. Rul. 97–35

This revenue ruling contains the differential earnings rate for 1996 and the recomputed differential earnings rate for 1995. Under § 809 of the Internal Revenue Code, mutual life insurance companies use these rates in computing their Federal income tax liability for taxable years beginning in 1996. This revenue ruling also contains the figures on which the determinations of these rates are based. Notice 97–17, 1997–10 I.R.B. 34, contained tentative determinations of these rates.

Section 809(a) provides that, in the case of any mutual life insurance company, the amount of the deduction allowable under § 808 for policyholder dividends is reduced (but not below zero) by the "differential earnings amount." Any excess of the differential earnings amount over the amount of the deduction allowable under § 808 is taken into account as a reduction in the closing balance of reserves under subsections (a) and (b) of § 807. The "differential earnings amount" for any taxable year is the amount equal to the product of (a) the life insurance company's average equity base for the taxable year multiplied by (b) the "differential earnings rate" for that taxable year. The "differential earnings rate" for the taxable year is the excess of (a) the "imputed earnings rate" for the taxable year over (b) the "average mutual earnings rate" for the second calendar year preceding the calendar year in which the taxable year begins. The "imputed earnings rate" for any taxable year is the amount that bears the same ratio to 16.5 percent as the "current stock earnings rate" for the taxable year bears to the "base period stock earnings rate."

Section 809(f) provides that, in the case of any mutual life insurance company, if the "recomputed differential earnings amount" for any taxable year exceeds the differential earnings amount for that taxable year, the excess is included in life insurance gross income for the succeeding taxable year. If the differential earnings amount for any taxable year exceeds the recomputed differential earnings amount for that taxable year, the excess is allowed as a life insurance deduction for the succeeding taxable year. The "recomputed differential earnings amount" for any taxable year is an amount calculated in the same manner as the differential earnings amount for that taxable year, except that the average mutual earnings rate for the calendar year in which the taxable year begins is substituted for the average mutual earnings rate for the second calendar year preceding the calendar year in which the taxable year begins.

The stock earnings rates and mutual earnings rates taken into account under § 809 generally are determined by dividing statement gain from operations by the average equity base. For this purpose, the term "statement gain from operations" means "the net gain or loss from operations required to be set forth in the annual statement, determined without regard to Federal income taxes, and . . . properly adjusted for realized capital gains and losses. . . ." *See* § 809(g)(1). The term "equity base" is defined as an amount determined in the manner prescribed by regulations equal to surplus and capital increased by the amount of nonadmitted financial assets, the excess of statutory reserves over the amount of tax reserves, the sum of certain other reserves, and 50 percent of any policyholder dividends (or other similar liability) payable in the following taxable year. *See* § 809(b)(2), (3), (4), (5) and (6). Section 1.809–10 of the Income Tax Regulations provides that the

equity base includes both the asset valuation reserve and the interest maintenance reserve for taxable years ending after December 31, 1991.

Section 1.809–9(a) of the regulations provides that neither the differential earnings rate under § 809(c) nor the recomputed differential earnings rate that is used in computing the recomputed differential earnings amount under § 809(f)(3) may be less than zero.

For purposes of § 809, the differential earnings rate for 1996 and the rate used to calculate the recomputed differential earnings amount for 1995 (the recomputed differential earnings rate for 1995), and the figures on which these two rates are based are set forth in Table 1.

Rev. Rul. 97–35 Table 1

Determination of Rates To Be Used for Taxable Years Beginning in 1996

Differential earnings rate for 1996	6.447
Recomputed differential earnings rate for 1995	0
Imputed earnings rate for 1995	12.625
Imputed earnings rate for 1996	15.669
Base period stock earnings rate	18.221
Current stock earnings rate for 1996	17.303
Stock earnings rate for 1993	23.385
Stock earnings rate for 1994	11.437
Stock earnings rate for 1995	17.087
Average mutual earnings rate for 1994	9.222
Average mutual earnings rate for 1995	16.477

Subchapter E.—Definitions and Special Rules

Section 817.—Treatment of Variable Contracts

26 CFR 1.801–8: Contracts with reserves based on segregated asset accounts.

A life insurance company is not prohibited from transferring assets other than cash from its general asset account to a segregated asset account for qualified pension plans. Rev. Rul. 73–67 revoked. See Rev. Rul. 97–46, page 72.

Insurance companies; segregated asset accounts. A life insurance company is not prohibited from transferring assets other than cash from its general asset account to a segregated asset account for qualified pension plans. Rev. Rul. 73–67 revoked.

Rev. Rul. 97–46

Rev. Rul. 73–67, 1973–1 C.B. 330, held that asset transfers between a life insurance company's general asset account and its segregated asset account for qualified pension plans may be made only in cash. Rev. Rul. 73–67 is hereby revoked.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 73–67 is revoked.

Part III.—Provisions of General Application

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subchapter N.—Tax Based on Income From Sources Within or Without the United States

Part I.—Determination of Sources of Income

Section 861.—Income From Sources Within the United States

26 CFR 1.861–2: Interest.

Guidance is provided to the payors of U.S. source substitute interest payments made after November 13, 1997, and before January 1, 1999, for complying with the statement requirement of § 871(h)(5) in order to qualify as portfolio interest. See Notice 97–66, page 328.

26 CFR 1.861–2: Interest.

T.D. 8735

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Certain Payments Made Pursuant To A Securities Lending Transaction

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations relating to the taxation of certain payments made pursuant to a cross-border securities lending transaction. These regulations provide guidance concerning the source, character, and income tax treaty treatment of such payments and affect United States payors and recipients and foreign payors and recipients.

DATES: These regulations are effective October 14, 1997.

Applicability: These regulations are applicable to payments made after November 13, 1997.

SUPPLEMENTARY INFORMATION:

Background

On January 9, 1992, the IRS published proposed amendments (INTL–106–89) to

the Income Tax Regulations (26 CFR part 1) under sections 861, 871, 881, 894, and 1441 of the Internal Revenue Code of 1986 (Code) in the **Federal Register** (57 FR 860). A public hearing was scheduled but was subsequently cancelled because no one requested to testify. However, several written comments were received. After consideration of all of the comments, the regulations proposed by INTL–106–89 are adopted by this Treasury decision, as modified.

Explanation of Provisions

I. *The 1992 Proposed Regulations*

On January 9, 1992, the Internal Revenue Service (IRS) issued proposed regulations that provided guidance on the source and character of substitute payments made in cross-border securities lending transactions. In general, the regulations proposed to source substitute payments by reference to the source of the payments (dividend or interest) for which they substitute. In addition, the regulations proposed to characterize substitute payments under a transparency rule. Under the transparency rule, substitute payments are treated as having the same character as the dividend or interest income for which they substitute.

Under the proposed regulations, the source rule applies for all purposes of the Code in cross-border securities lending transactions. In contrast, the transparency rule addressing the character of substitute payments applies only for purposes of determining the tax liability under sections 871 and 881 and nonresident alien withholding under chapter 3 of the Code and for treaty purposes. Generally, public comments welcomed the transparency rule because it eliminated unjustifiable tax biases between similar economic investments. After considering all the public comments, the proposed regulations are adopted as final regulations by this Treasury decision, substantially as proposed.

II. *The Final Regulations*

1. General rule

The final regulations, like the proposed regulations, provide that a substitute payment made with respect to a securities lending or sale-repurchase transaction is sourced using the general rules governing the source of interest or dividend income contained in sections 861 and 862. The definitions of securities lending transactions and sale-repurchase transactions are provided in §§1.861–2(a)(7) and 1.861–3(a)(6) of the regulations. These provisions define a substitute payment as a payment made to the transferor of a security of an amount equal to any distributions of dividends or interest which the owner of the transferred security would normally receive. The regulations also provide that substitute interest or dividend payments have the same character as interest or dividend income, respectively, for purposes of applying sections 864(c)(4)(B), 871, 881, 894, 4948(a) and the withholding provisions under chapter 3 of the Internal Revenue Code.

2. Scope of regulation

Some commentators questioned whether a sale-repurchase transaction is considered a transaction that is substantially similar to a securities lending transaction for purposes of the proposed regulations. They noted that most sale-repurchase transactions contractually permit the purchaser to deal freely with the underlying securities, specifying only that substantially identical securities be returned on the repurchase date. In such cases the purchaser must also make substitute payments to the seller. The final regulations clarify that substitute payments made in a sale-repurchase transaction are sourced and characterized in the same manner that substitute payments are sourced and characterized in securities lending transactions.

The final regulations only address the tax treatment of substitute payments received by the transferor in securities lending or sale-repurchase transactions. The regulations do not address the treatment of fees or interest paid to the transferee in such transactions. For example, the transparency rule does not extend to characterize the interest component of the repurchase price of a sale-repurchase agreement, which is treated as interest and sourced under the general source rules for interest contained in sections 861 and 862. See Rev. Rul. 74-27 (1974–1 C.B. 24); Rev. Rul. 77–59 (1977–1 C.B. 196); *Nebraska Department of Revenue v. Loewenstein*, 115 S. Ct. 557 (1994).

In response to comments, the final regulations apply for purposes of determining the source of substitute payments, regardless of whether the recipient of the income is U.S. or foreign. When source is determined under these regulations, it applies for all purposes of the Code (e.g., foreign tax credit limitations under sections 904 and 906). However, with respect to the characterization of substitute payments, the IRS and Treasury believe that it is appropriate, and more consistent with existing guidance regarding the treatment of substitute payments, to apply the transparency rule only with respect to foreign taxpayers and only for limited purposes. Accordingly, the transparency rule applies to determine character only for certain purposes of sections 864, 871, 881, 894, 4948(a) and chapter 3 of the Code. For example, under this rule, substitute payments to a foreign person with respect to stocks and securities that, absent the securities lending transaction, would give rise to foreign source effectively connected income in the hands of such person, will retain their character as dividend or interest income for purposes of determining whether the income is effectively connected to the U.S. trade or business of such person.

The transparency rule does not apply, however, to characterize the U.S. source income of U.S. trades or businesses of foreign taxpayers. Accordingly, U.S. source effectively connected income of foreign taxpayers and U.S. source income of U.S. taxpayers will be treated the same. In this regard, the final regulations do not affect existing guidance applicable to both U.S. and foreign taxpayers concerning the characterization of substitute payments for purposes of other sections not specifically identified in these final regulations. See, e.g., Rev. Rul. 60–177 (1960–1 C.B. 9), (substitute payments are ineligible for the dividends received deduction under section 243); Rev. Rul. 80–135 (1980–1 C.B. 18), (substitute payments are ineligible for the tax-exemption on state and local bonds under section 103).

Because the transparency rule does not apply for purposes of sections 901 and 903, nothing in the final regulations affects the determination required under §1.901–2(f) concerning the identity of the person by whom a foreign tax is considered paid for purposes of sections 901 and 903.

3. Substitute payments on portfolio debt instruments

Under the final regulations, substitute interest payments made with respect to a debt instrument, the interest on which qualifies as portfolio interest under section 871(h) or section 881(c) in the hands of the lender, is characterized as portfolio interest if, in the case of an obligation in registered form, the lender provides the withholding agent with a beneficial owner withholding certificate or documentary evidence in accordance with §1.871–14(c) and no exception from the portfolio interest exemption applies. For example, if a bank lends securities in a transaction that the facts and circumstances indicate in substance is an extension of credit pursuant to a loan agreement in the ordinary course of the bank's trade or business, the substitute payment may be characterized as interest which would not qualify as portfolio interest under section 881(c)(3)(A).

4. Tax treaties

Some commentators noted that the transparency rule adversely affects foreign taxpayers that might otherwise rely on a different characterization of substitute payments in order to claim benefits under certain income tax treaties. The transparency rule would eliminate these benefits in a number of cases. Those commentators questioned the government's authority to issue regulations that would characterize substitute payments as dividend or interest income in light of U.S. income tax treaty provisions.

The IRS and Treasury believe that the transparency rule in general is properly issued pursuant to the general grant of authority under section 7805 because it eliminates opportunities for abuse that arise from a rule that would characterize substitute payments in a manner different from the treatment of the underlying payment. A transparency approach provides uniform results for economically similar investments.

Moreover, the IRS and Treasury believe that, in the absence of a transparency rule, many taxpayers would use securities lending transactions in order to avoid tax under tax treaties or under the Code. For this reason, authority to characterize substitute payments for Code and treaty purposes in the manner proposed in 1992 also is amply provided in section 7701(l), which was enacted after these comments were received. Section 7701(l) provides a broad grant of authority to issue regulations recharacterizing multiple party financing arrangements to prevent the avoidance of any tax.

In this regard, the legislative history provides that "the committee seeks to bolster the Treasury's ability to prevent unwarranted avoidance of tax through multiple-party financial engineering as well as to provide a mechanism for issuing additional guidance to taxpayers entering into financial transactions." See H.R. Rep. No. 103–111, 103rd Cong., 1st Sess. 729 (1993). The committee also made clear that this authority was not limited to the types of back-to-back loan transactions addressed in prior rulings. See Rev. Rul. 84–152 (1984–2 C.B. 381); Rev. Rul. 84–153 (1984–2 C.B. 383); Rev. Rul. 87–89 (1987–2 C.B. 195). Section 7701(l) in fact has been applied to a broad range of financial transactions. See, e.g., Prop. Regs. §1.7701(l)–2 (treatment of obligation-shifting transactions); and Notice 97–21 (IRB 1997–11, March 17, 1997), (tax avoidance using self-amortizing investments in conduit financing entities).

The 1992 proposed regulation under section 894 provided that where an income tax convention refers to United States law, the relevant law is the section or sections of the Internal Revenue Code and regulations thereunder governing the tax which is the subject of the provision. Some commentators have suggested that the proposed securities lending regulations would be invalid for purposes of characterizing dividends that are specifically defined by treaties. However, under conduit principles and additional authority to characterize payments pursuant to section 7701(l), the regulations adopted under §1.894–1(c) address the identity of the owner of dividend and interest income for treaty purposes as opposed to the character of the payments received under varying treaty definitions. These regulations therefore are consistent with the government's authority under treaties to determine the identity of the beneficial owner of income.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. Accordingly, a regulatory flexibility analysis is not required. This certification is based on the information that follows. These regulations affect entities engaged in cross-border multiple-party financing arrangements. These regulations affect the tax treatment of substitute payments made with respect to stocks and debt securities. The primary participants who engage in cross-border multiple party financing arrangements of this type are large regulated commercial banks and brokerage firms. In addition, comments received in response to the notice of proposed rulemaking were from law associations, other associations that represent large regulated financial companies or from individuals. Accordingly, Treasury and IRS do not believe that a substantial number of small entities engages in cross-border multiple party financing arrangements of the type covered by these regulations. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.861–2 also issued under 26 U.S.C. 863(a).

Section 1.861–3 also issued under 26 U.S.C. 863(a). * * *

Section 1.864–5 also issued under 26 U.S.C. 7701(l). * * *

Section 1.871–7 also issued under 26 U.S.C. 7701(l). * * *

Section 1.881–2 also issued under 26 U.S.C. 7701(l). * * *

Section 1.894–1 also issued under 26 U.S.C. 7701(l). * * *

Par. 2. Section 1.861–2 is amended by adding a sentence at the end of paragraph (a)(1); adding paragraph (a)(7); and revising paragraph (e) to read as follows:

§1.861–2 Interest.

(a) * * * (1) * * * See paragraph (a)(7) of this section for special rules concerning substitute interest paid or accrued pursuant to a securities lending transaction.

* * * * *

(7) A substitute interest payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to an interest payment which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A substitute interest payment shall be sourced in the same manner as the interest accruing on the transferred security for purposes of this section and §1.862–1. See also §§1.864–5(b)(2)(iii), 1.871–7(b)(2), 1.881–2(b)(2) and for the character of such payments and §1.894–1(c) for the application tax treaties to these transactions.

* * * * *

(e) *Effective dates.* Except as otherwise provided, this section applies with respect to taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (a)(7) of this section is applicable to payments made after November 13, 1997.

Par. 3. Section 1.861–3 is amended by adding a sentence at the end of paragraph (a)(1); adding paragraph (a)(6); and removing the first sentence of paragraph (d) and adding three sentences in its place to read as follows:

§1.861–3 Dividends.

(a) * * * (1) * * * See also paragraph (a)(6) of this section for special rules concerning substitute dividend payments received pursuant to a securities lending transaction.

* * * * *

(6) *Substitute dividend payments.* A substitute dividend payment is a payment, made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction, of an amount equivalent to a dividend distribution which the owner of the transferred security is entitled to receive during the term of the transaction. A securities lending transaction is a transfer of one or more securities that is described in section 1058(a) or a substantially similar transaction. A sale-repurchase transaction is an agreement under which a person transfers a security in exchange for cash and simultaneously agrees to receive substantially identical securities from the transferee in the future in exchange for cash. A substitute dividend payment shall be sourced in the same manner as the distributions with respect to the transferred security for purposes of this section and §1.862–1. See also §§1.864–5(b)(2)(iii), 1.871–7(b)(2) and 1.881–2(b)(2) for the character of such payments and §1.894–1(c) for the application of tax treaties to these transactions.

* * * * *

(d) * * * Except as otherwise provided in this paragraph this section applies with respect to dividends received or accrued after December 31, 1966. Paragraph (a)(5) of this section applies to certain dividends from a DISC or former DISC in taxable years ending after December 31, 1971. Paragraph (a)(6) of this section is applicable to payments made after November 13, 1997. * * *

Par. 4. Section 1.864–5 is amended by redesignating paragraph (b)(2)(ii) as paragraph (b)(2)(iii) and adding new paragraph (b)(2)(ii) to read as follows:

§1.864–5 Foreign source income effectively connected with U.S. business.

* * * * *

(b) * * *

(2) * * *

(ii) *Substitute payments.* For purposes of this paragraph (b)(2), a substitute interest payment (as defined in §1.861–2(a)(7)) received by a foreign person subject to tax under this paragraph (b) pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–2(a)(7)) with respect to a security (as defined in §1.864–6(b)(2)(ii)(c)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this paragraph (b)(2), a substitute dividend payment (as defined in §1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–3(a)(6)) with respect to a stock shall have the same character as a distribution received with respect to the transferred security. This paragraph (b)(2)(ii) is applicable to payments made after November 13, 1997.

* * * * *

Par. 5. Section 1.871–7 is amended by redesignating the text of paragraph (b) as paragraph (b)(1); adding a paragraph heading for newly designated paragraph (b)(1); adding paragraph (b)(2); and removing the first sentence of paragraph (f) and adding two sentences in its place to read as follows:

§1.871–7 Taxation of nonresident alien individuals not engaged in U.S. business.

* * * * *

(b) *Fixed or determinable annual or periodical income*—(1) General rule. * * *

(2) *Substitute payments.* For purposes of this section, a substitute interest payment (as defined in §1.861–2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–2(a)(7)) shall have the same character as interest income paid or accrued with respect to the terms of the transferred security. Similarly, for purposes of this section, a substitute dividend payment (as defined in §1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–3(a)(6)) shall have the same character as a distribution received with respect to the transferred security. Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person

transfers to another person a security the interest on which would qualify as portfolio interest under section 871(h) in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest, provided that in the case of interest on an obligation in registered form (as defined in §1.871–14(c)(1)(i)), the transferor complies with the documentation requirement described in §1.871–14(c)(1)(ii)(C) with respect to the payment of the substitute interest and none of the exceptions to the portfolio interest exemption in sections 871(h)(3) and (4) apply. See also §§1.861–2(b)(2) and 1.894–1(c).

* * * * *

(f) * * * Except as otherwise provided in this paragraph, this section shall apply for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. * * *

Par. 6. Section 1.881–2 is amended by redesignating the text of paragraph (b) as paragraph (b)(1); adding a paragraph heading for newly designated paragraph (b)(1); adding a paragraph (b)(2); and removing the first sentence of paragraph (e) and adding two sentences in its place to read as follows:

§1.881–2 Taxation of foreign corporations not engaged in U.S. business.

* * * * *

(b) *Fixed or determinable annual or periodical income—(1) General rule.* * * *

(2) *Substitute payments.* For purposes of this section, a substitute interest payment (as defined in §1.861–2(a)(7)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–2(a)(7)) shall have the same character as interest income received pursuant to the terms of the transferred security. Similarly, for purposes of this section, a substitute dividend payment (as defined in §1.861–3(a)(6)) received by a foreign person pursuant to a securities lending transaction or a sale-repurchase transaction (as defined in §1.861–2(a)(7)) shall have the same character as a distribution received with respect to the transferred security. Where, pursuant to a securities lending transaction or a sale-repurchase transaction, a foreign person transfers to another person a security the interest on which would qualify as portfolio interest under section 881(c) in the hands of the lender, substitute interest payments made with respect to the transferred security will be treated as portfolio interest, provided that in the case of interest on an obligation in registered form (as defined in §1.871–14(c)(1)(i)), the transferor complies with the documentation requirement described in §1.871–14(c)(1)(ii)(C) with respect to the payment of substitute interest and none of the exceptions to the portfolio interest exemption in sections 881(c)(3) and (4) apply. See also §§1.871–7(b)(2) and 1.894–1(c).

* * * * *

(e) * * * Except as otherwise provide in this paragraph, this section applies for taxable years beginning after December 31, 1966. Paragraph (b)(2) of this section is applicable to payments made after November 13, 1997. * * *

Par. 7. Section 1.894–1 is amended by revising paragraph (c) and adding paragraph (d) to read as follows:

§1.894–1 Income affected by treaty.

* * * * *

(c) *Substitute interest and dividend payments.* The provisions of an income tax convention dealing with interest or dividends paid to or derived by a foreign person include substitute interest or dividend payments that have the same character as interest or dividends under §1.864–5(b)(2)(ii), 1.871–7(b)(2) or 1.881–2(b)(2). The provisions of this paragraph (c) shall apply for purposes of securities lending transactions or sale-repurchase transactions as defined in §1.861–2(a)(7) and §1.861–3(a)(6).

(d) *Effective dates.* Paragraphs (a) and (b) of this section apply for taxable years beginning after December 31, 1966. For corresponding rules applicable to taxable years beginning before January 1, 1967, (see 26 CFR part 1 revised April 1, 1971). Paragraph (c) of this section is applicable to payments made after November 13, 1997.

§1.7701(l)–1 [Amended]

Par. 10. Section 1.7701(l)–1 is amended as follows:

1. Paragraph (a) is amended by removing the paragraph designation (a) and the heading.

2. Paragraph (b) is removed.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved August 28, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 14, 1997, 62 F.R. 53498)

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26 CFR 1.861–3: Dividends.

Guidance is provided on the determination of the amount of tax imposed under §§ 871 and 881 on U.S. source substitute dividend payments which are made by a foreign person to another foreign person ("foreign-to-foreign" payments).

Section 864.—Definitions and Special Rules

26 CFR 1.864–5: General provisions relating to withholding agent.

A general election to defer the effective date of final securities lending regulations (published October 14, 1997, TD 8735, 62 FR 53498) for substitute payments made after November 13, 1997, to January 1, 1999, does not apply for substitute interest and substitute dividend payments received that are foreign source effectively connected income under § 1.864–5(b)(2) of the final regulations. Notice 97–66, page 328.

Part II.—Nonresident Aliens and Foreign Corporations

Subpart A.—Nonresident Alien Individuals

Section 871.—Tax on Nonresident Alien Individuals

26 CFR 1.871–7: Taxation of nonresident alien individuals not engaged in U.S. business.

Guidance is provided as to the amount of tax to be imposed under § 1.871–7(b)(2) with respect to substitute interest or substitute dividend payments made by one foreign person to another foreign person. See Notice 97–66, page 328.

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26 CFR 1.871–14: Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

Guidance is provided to payors of substitute interest payments made after November 13, 1997, and

before January 1, 1999, *i.e.*, prior to the effective date of §1.871–14, for complying with the statement requirement of § 871(h)(5) in order to qualify the payments as portfolio interest payments for purposes of the tax imposed under §§ 871 and 881. See Notice 97–66, page 328.

Section 872.—Gross Income

(Also Section 883; 1.883–1; 894.)

International operation of ships and aircraft; income exempt from tax. Those countries that currently provide exemptions from tax to U.S. persons for income from the internaitonal operation of ships and aircraft through income tax conventions, diplomatic notes, or the country's domestic law are listed. Rev. Rul. 89–42 supplemented.

Rev. Rul. 97–31

PURPOSE

The purpose of this revenue ruling is to supplement Rev. Rul. 89–42, 1989–1 C.B. 234, by providing a current list of countries that grant United States persons equivalent exemptions from tax for income from the international operation of ships and aircraft for purposes of section 872(b) of the Internal Revenue Code, section 883 of the Code, and the shipping and air transport articles in United States income tax conventins.

A foreign country may grant an equivalent exemption from tax through an income tax convention or exchange of diplomatic notes, by not imposing a tax, or by a decree or specific statutory exemption if a tax is generally imposed. The following Table includes a current list of such countries and summarizes the types of income that qualify for examption.

Part I of the Table summarizes equivalent exemptions under shipping and aircraft articles and capital gains articles of income tax conventions to which the United States is a party. Part I includes a summary of the requirements for the exemption, such as whether the exemption is based solely on residence or has an additional requirement of documentation or registration. Part I generally does not set forth other benefities that may be provided under articles covering business profits, rentals and royalties, and other income.

Part II of the Table summarizes exemptions available in countries that have exchanged diplomatic notes with the United States that cover shipping and aircraft income.

Finally, Part III of the Table provides a list of the countries for which the Service has determined, upon examination of their laws, that an equivalent exemption is granted by statute or decree, or by not imposing a tax on such income.

This determination is made on a country by country basis and relies upon information submitted to the Internal Revenue Service by the foreign country regarding the foreign law in effect at the time of the submission. The date of the Service's review is reflected in the first column of Part III of the Table. Since its initial review, the Service has not attempted to determine whether any of the foreign laws of the countries listed in Part III have been amended or repealed. Therefore, taxpayers should independently verify the accuracy of the information in Part III of the Table at such time that a determination is relevant.

In addition, this list does not represent an exclusive list of countries whose domestic law provides an equivalent exemption. Other countries that have not submitted the information necessary for the Service to make a determination also may grant an exemption. In those cases, a corporation organized in, or an individual resident of, such a soreign country may qualify for an exemption even though the Internal Revenue Service has not yet made a determination to include the country in Part III of the Table.

The Table is intended only as a summary. The full text of any relevant income tax convention, diplomatic note, or foreign law should be consulted. It may be necessary to consult the technical explanation of an income tax convention, a protocol, or a diplomatic note accompanying a convention to determine the items of income exempted. Income tax conventions and diplomatic notes are published in the Cumulative Bulletin. The Table will be updated periodically.

CHANGES TO REV. RUL. 89–42

The changes to the Table published in Rev. Rul. 89–42 are summarized as follows. In Part I, the following countries have been added to the list of countries that provide an exemption under an income tax convention: Czech Republic, India, Indonesia, Israel, Mexico, Portugal, the Russian Federation, the Slovak Republic, Spain, Sweden, and Tunisia. The following countries have entered into new income tax conventions with the United States that supersede prior income tax conventions reported in Rev. Rul. 89–42; Finland, France, Germany, Kazakhstan, and the Netherlands. The Income tax conventions between the United States and the Netherlands, as extended to the Netherlands Antilles and Aruba, and between the United States and Malta have been terminated, in relevant part, effective January 1, 1988, and January 1, 1997, respectively, and have been deleted from the list.

In Part II, new diplomatic notes have been exchanged with Chile, Hong Kong, India, Isle of Man, Japan, Luxembourg, Malaysia, Malta, Marshall Islands, Norway, Pakistan, Peru, and St. Vincent and the Grenadines. After the publication of Rev. Rul. 89–42, Mexico entered into a diplomatic note with the United States effective retroactively to January 1, 1987.[1] This note, however, terminated on January 1, 1994, the general effective date of the new U.S. — Mexico Income Tax Convention. In addition, the Russian Federation entered into a diplomatic note effective retroactivity to January 1, 1991.[2] This note also terminated on January 1, 1994, the general effective date of the New U.S. — Russian Federation Income Tax Convention. Although a diplomatic not was signed with Boliva, that note has never entered into force. Therefore Boliva has been removed from the list.

In Part III, Antigua and Barbuda, Barbados, Ecuador (shipping only), Israel, Qata (aircraft only), Turks and Caicos, and the U.S. Virgin Islands have been added to the list of countries whose domestic law has been determined to provide an equivalent exemption.

Consistent with past practice, the Service will entertain a request from a foreign government to make a determination that the domestic law of the country provides an equivalent exemption. However, the Service will not accept requests from individual taxpayers; instead, taxpayers should seek to have the relevant foreign government request a determination that

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[1]This note is published at 1990–2 C.B. 322.
[2]This note is published at 1996–36 I.R.B. 6.

the particular country qualifies as an equivalent exemption jurisdiction.

Taxpayers claiming an exemption under the terms of an income tax convention, or under section 872(b) or section 883 of the Code, must file a return on Form 1040NR (U.S. Nonresident Alien Income Tax Return) or Form 1120F (U.S. Income Tax Return of a Foreign Corporation) and comply with the provisions of section 8 of Rev. Proc. 91–12, 1991–1 C.B. 473.

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 89–42 is supplemented.

TABLE

Countries Currently Granting Equivalent Exemptions for Income From the International Operation of Ships and Aircraft

Countries and Territories	*Basis for Exemption*			*TYPES OF SHIPPING AND AIRCRAFT INCOME EXEMPTED*[2]				
	Residence Based No Flag	Residence & Flag Reciprocal	Residence & Flag Unilateral	Operating Income	Full Rental (Time or voyage charter)	Bare-Boat Rental	Container Rental	Capital Gains
PART I TREATIES[1]								
Australia	X			X	X[4]	X[27]	X[27]	X[5/6]
Austria	X			X[3]	—	—	—	—
Barbados	X			X	X[15]	X[15]	X	X
Belgium		X[7]		X	X[5]	X[5]	X[5]	X[5]
Canada	X			X	X	X	X	X
China[29] (Peoples Republic)	X			X	X[15]	X[15]	X	X
Cyprus	X			X	X[15]	X[15]	X	X
Czech Republic	X			X	X	X[5]	X	X
Denmark		X		X[3]	—	—	—	—
Egypt	X			X	X[5]	X[5]	X[5]	—
Finland[22]	X			X	X[5]	X[5]	X[28]	X
France	X			X	X	X[15]	X[5]	X[5]
Germany[22/24]	X			X	X	—	X	X
Greece		X		X[3]	—	—	—	—
Hungary	X			X	X[5]	X[5]	X	X
Iceland			X[8]	X	X[5]	X[5]	X[5]	X
India[22]	X			X	X[5]	X[5]	X	X[5/9]
Indonesia[22]	X			X	X	X[10]	X[5]	X
Ireland		X		X[3]	—	—	—	—
Israel	X			X	X[5]	X[5]	X[5]	X[5]
Italy[11]			X[8]	X	X[21]	X[5]	X	X[5]
Jamaica	X			X	X[15]	X[15]	X	X[5]
Japan[11]		X[12]		X	X[5]	X[5]	X[5]	X[5]
Kazakhstan	X			X	X	X[15]	X	X
Korea	X			X	X[13]	—	X[5]	—
Luxembourg		X		X[3]	—	—	—	—
Mexico[22]	X			X	X	X[28]	X	X
Morocco		X[7]		X[3]	—	—	—	X[5]
Netherlands[22]	X			X	X[5]	X[5]	—	X
New Zealand	X			X	X	X[5]	X[5]	X[6]
Norway[11]	X			X	X[13]	X[5]	X[5]	X
Pakistan[14]		X		X[3]	—	—	—	—
PART I TREATIES[1]								
Philippines[16]	X			—	—	—	—	X[5]
Poland			X[8]	X	X[5]	X[5]	X[5]	X
Portugal[22]	X			X	X	X[5]	—	X
Romania		X		X	X[5]	X[5]	X[5]	X
Russian[22] Federation	X			X	X	X[15]	X	X

TABLE—CONTINUED

Countries and Territories	*Basis for Exemption*			*TYPES OF SHIPPING AND AIRCRAFT INCOME EXEMPTED*[2]				
	Residence Based No Flag	Residence & Flag Reciprocal	Residence & Flag Unilateral	Operating Income	Full Rental (Time or voyage charter)	Bare-Boat Rental	Container Rental	Capital Gains
Slovak Republic[22]	X			X	X	X[5]	X	X
Spain[22]	X			X	X	X[5]	X	X
Sweden[22]	X			X	X	X[5]	X	X
Switzerland		X		X[3]	—	—	—	—
Trinidad & Tobago			X[8]	X	X[5]	X[5]	—	X
Tunisia[22]	X			X	X[15]	X[15]	X[5]	X
USSR[25]		X		X[3]	—	—	—	X[5]
U.K.			X[8]	X	X	X[5]	X	X[5]

Countries and Territories	*Cumulative Bulletin Citation*	*TYPES OF SHIPPING AND AIRCRAFT INCOME EXEMPTED*[2]				
		Operating Income	Full Rental (Time or voyage charter)	Bare-Boat Rental	Incidental Container Rental	Incidental Capital Gains
PART II EXCHANGE OF NOTES[23]						
Argentina	1988–1 C.B. 456	X	X	X	X	X
Bahamas	1988–1 C.B. 458	X	X	X	X	—
Belgium	1988–1 C.B. 459	X	X	—	X	—
Chile[14]	1991–1 C.B. 304	X	X	X[5]	X	—
Colombia	1988–1 C.B. 461	X	X	X	X	—
Cyprus	1989–2 C.B. 332	X	X	X	X	—
Denmark	1988–1 C.B. 462	X	X	X	X	—
El Salvador[14]	1988–1 C.B. 463	X	X	X	X	X
Fiji	1996–40 I.R.B. 8	X	X	X	X	X
Finland	1989–2 C.B. 334	X	X	X	X	—
Greece	1988–2 C.B. 366	X	X	X	X	—
Hong Hong[16/31]	1995–1 C.B. 228	X	X	X	X	X
India	1990–2 C.B. 316	X	X	X[5]	X	X
Isle of Man[16]	1990–2 C.B. 317	X	X	X	X	X
Japan	1990–2 C.B. 318	X	X	X	X	—
Jordan	1996–50 I.R.B. 8	X	X	X	X	—
Liberia	1988–1 C.B. 463	X	X	X	X	X
Luxembourg	1996–28 I.R.B. 36	X	X	X	X	—
Malaysia	1990–2 C.B. 319	X	X	X[5]	X	X
Malta	1997–17 I.R.B. 5	X	X	X	X	X
Marshall Islands	1990–2 C.B. 321	X	X	X	X	X
Norway	1991–1 C.B. 304	X	X	X	X	X
Pakistan[16]	1991–1 C.B. 305	X[3]	—	—	—	—
PART II EXCHANGE OF NOTES[23]						
Panama	1988–2 C.B. 366	X	X	X	X	—
Peru[16]	1989–2 C.B. 335	X	X	X[5]	X	—
St. Vincent & Grenadines	1989–2 C.B. 336	X	X	X	X	—
Singapore	1990–2 C.B. 323	X	X	—[30]	X	—
Sweden	1988–1 C.B. 466	X	X	X[5]	X	—
Taiwan	1989–2 C.B. 337	X	X	X	X	—
Venezuela	1988–1 C.B. 467	X	X	X[5]	X	X

Countries and Territories	Date Foreign Law Reviewed	TYPES OF SHIPPING AND AIRCRAFT INCOME EXEMPTED[2] Operating Income	Full Rental (Time or voyage charter)	Bare-Boat Rental	Incidental Container Rental	Incidental Capital Gains
PART III DOMESTIC LAW						
Antigua & Barbuda[16]	NOV 1991	X	X	X	X	X
Barbados	OCT 1989	X	X	X	X	X
Bermuda	NOV 1988	X	X	X	X	X
Brazil[18]	DEC 1988	X	X	X[5]	X	—
Bulgaria	— 1989	X	X	X	X	X
Cayman Islands[26]	JAN 1987	X	X	X	X	X
Chile[16]	OCT 1988	X	X	X	X	X
Ecuador[16/17]	DEC 1989	X	X	X[5]	X	X
Israel	FEB 1991	X	X	X	X	X
Netherlands	OCT 1988	X	X	X[5]	X	—
Netherlands Antilles	MAY 1988	X	X	X	X	X
Portugal[14] ships	JUNE 1989	X	X	X	—	—
aircraft	FEB 1989					
Qatar[14]	AUG 1994	X[3]	—	—	—	—
Spain[19]	DEC 1988	X	X	—	X	—
Turkey[20]	JAN 1987	X	—	—	X	—
Turks & Caicos[26]	FEB 1990	X	X	X	X	X
U.S. Virgin Islands	OCT 1988	X	X	X	X	X
Vanuatu	MAY 1987	X	X	X	X	X

[1]A reciprocal exemption based on treaty relief is limited to the circumstances in which the treaty itself would be available. In such cases the exemption is based on section 894 and the treaty itself, rather than on section 872(b) or section 883.

[2]Unless otherwise footnoted, an X indicates full exemption whether or not there is a permanent establishment.

[3]Operating income is not defined.

[4]Lessor must either regularly lease ships or aircraft on a full basis or operate them in international traffic.

[5]The U.S. tax exemption is available only if the income is incidental to operating income.

[6]Except to the extent depreciation has been allowed in the other country.

[7]In the case of aircraft only, the registration may be in the country of residence or in any country with a treaty providing for such exemption between such country and the country of residence.

[8]Documentation or registration required for ships or aircraft of United States residents only.

[9]This treaty exempts gains derived by an enterprise of a Contracting State if the ships, aircraft or containers are owned and operated by the enterprise and the income from them is taxable only in that State.

[10]Income from the bareboat rental of aircraft used in international traffic is exempt. Income from the bareboat rental of ships is also exempt if the ship is operated in international traffic and if the lessee is not a resident of, or does not have a permanent establishment in, the other Contracting State.

[11]See also the diplomatic notes or protocol accompanying this treaty.

[12]With regard to residents of Japan, the ships or aircraft need not be registered in Japan if the ships or aircraft are leased by such a resident.

[13]As a result of correspondence, it was clarified that income from the international operation of ships or aircraft includes this category of income.

[14]This exemption applies to aircraft only.

[15]This exemption applies if the ships or aircraft are operated in international traffic by the lessee, or the rental income is incidental to the operation of ships or aircraft in international traffic by the lessor.

[16]This exemption applies to shipping only.

[17]This exemption is generally effective for all open years beginning on or after January 1, 1987.

[18]Brazilian and Portuguese laws exempt only companies.

[19]The Spanish statute exempts only corporations.

[20]See Rev. Rul. 87–18, 1987–1 C.B. 178.

[21]This exemption applies if the ship or aircraft is operated in international traffic or if the rental income is incidential to income from such international operation.

[22]The following income tax treaties were ratified after the publication of Rev. Rul. 89–42 and were generally effective on the following dates:

Czech Republic ..... January 1, 1993
Finland ..... January 1, 1991
France ..... January 1, 1996
Germany ..... January 1, 1990

India	January 1, 1991
Indonesia	January 1, 1990
Israel	January 1, 1995
Kazakhstan	January 1, 1996
Mexico	January 1, 1994
Netherlands	January 1, 1994
Portugal	January 1, 1996
Russian Federation	January 1, 1994
Slovak Republic	January 1, 1993
Spain	January 1, 1991
Sweden	January 1, 1996
Tunisia	January 1, 1990

[23]Notes signed prior to the Technical and Miscellaneous Revenue Act of 1988, will be interpreted in accordance with Technical Corrections.
[24]This treaty is effective for the eastern States of Germany (the former East Germany) from January 1, 1991.
[25]The U.S. — U.S.S.R. income tax treaty signed June 20, 1973, continues to apply to the countries of Armenia, Azerbaijan, Belarus, Georgia, Kyrgyzstan, Moldova, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
[26]The country generally imposes no income tax.
[27]This exemption applies if the ships or aircraft are operated in international traffic by the lessee, and the rental income is incidental to the operation of ships or aircraft in international traffic by the lessor.
[28]The exemption applies except where the containers are used solely between places within the other Contracting State.
[29]Pursuant to Notice 97–40, 1997–28 I.R.B. 6 dated July 14, 1997, the treaty between the United States and the People's Republic of China (China) will continue to apply only to China and will not apply to the Hong Kong Special Administrative Region of the People's Republic of China.
[30]A dialogue is currently taking place between the Government of the United States and Singapore concerning the scope of the reciprocal exemption.
[31]This diplomatic note applies to Hong Kong before July 1, 1997, and pursuant to Notice 97–40, 1997–28 I.R.B. 6 dated July 14, 1997, to the Hong Kong Special Administrative Region of the People's Republic of China on or after July 1, 1997. The note does not apply with respect to the People's Republic of China, which will continue to be treated as a separate country for purposes of the Internal Revenue Code.

Section 877.—Expatriation to Avoid Tax

The Service provides an inflation adjustment to amounts used to determine whether an individual's loss of United States citizenship had the avoidance of United States taxes as one of its principal purposes for calendar year 1998. See Rev. Proc. 97–57, page 584.

Subpart B.—Foreign Corporations

Section 881.—Tax on Income of Foreign Corporations Not Connected With United States Business

26 CFR 1.881–2: Income of foreign corporations treated as effectively connected with U.S. business.

Guidance is provided as to the amount of tax to be imposed under § 1.881–2(b)(2) with respect to substitute interest or substitute dividend payments made by one foreign person to another foreign person. See Notice 97–66, page 328.

Subpart D.—Miscellaneous Provisions

Section 894.—Income Affected By Treaty

For periods on or after July 1, 1997, when China resumes the exercise of sovereignty over Hong Kong, the Internal Revenue Service will continue to treat Hong Kong and China as two separate countries for purposes of certain bilateral agreements and the Internal Revenue Code and Income Tax Regulations. See Notice 97–40, page 287.

26 CFR 1.894–1T: Income affected by treaty (temporary).

T.D. 8722

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Guidance Regarding Claims for Certain Income Tax Convention Benefits

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to eligibility for benefits under income tax treaties for payments to entities. The regulations set forth rules for determining whether U.S. source payments made to entities, including entities that are fiscally transparent in the United States and/or the applicable treaty jurisdiction, are eligible for treaty-reduced tax rates. The regulations affect the determination of tax treaty benefits with respect to U.S. source income of foreign persons. The text of these temporary regulations also serves as the text of REG–104893–97, page 646.

DATES: These regulations are effective July 2, 1997.

These regulations apply to amounts paid on or after January 1, 1998.

SUPPLEMENTARY INFORMATION:

Background

This document contains temporary regulations relating to the Income Tax Regulations (CFR part 1) under section 894 of the Internal Revenue Code (Code).

Explanation of Provisions

These regulations prescribe rules for determining whether U.S. source income paid to an entity is eligible for a reduced rate of U.S. tax under an income tax treaty. The regulations are designed principally to clarify the availability of treaty-reduced tax rates for a payment of U.S. source income to an entity that is treated as fiscally transparent, including a hybrid entity (i.e., an entity that is treated as fiscally transparent in either (but not both) the United States or the jurisdiction of residence of the person that seeks to claim treaty benefits).

The regulations address only the treatment of U.S. source income that is not effectively connected with the conduct of a U.S. trade or business. Treasury and the IRS may issue additional regulations addressing the availability of other tax treaty benefits, such as the application of business profits provisions, with respect to income of fiscally transparent entities.

Under the regulations, payments of U.S. source income to an entity that is treated as fiscally transparent for U.S. federal income tax purposes are eligible for reduced tax rates under a tax treaty between the United States and another jurisdiction (the applicable treaty jurisdiction) if the entity itself is a resident of the applicable treaty jurisdiction, or if, and only to the extent that, the interest holders of the entity are residents of the applicable treaty jurisdiction and the entity is treated as fiscally transparent for purposes of the tax laws of such jurisdiction.

Accordingly, payments of U.S. source income to an entity that is treated as fiscally transparent for U.S. federal income tax purposes but as non-fiscally transparent for purposes of the tax laws of the applicable treaty jurisdiction are not eligible for a treaty-reduced tax rate under the relevant treaty unless the entity itself is a resident of the applicable treaty jurisdiction. Conversely, under the regulations, a payment of U.S. source income to an entity that is treated as non-fiscally transparent for U.S. federal income tax purposes (other than a domestic corporation) is eligible for a reduced tax rate under the relevant treaty if the entity itself is a resident of the applicable treaty jurisdiction or if, and only to the extent that, interest holders of the entity are residents of the applicable treaty jurisdiction and the entity is treated as fiscally transparent for purposes of the tax laws of such jurisdiction.

Under these temporary regulations, an entity is treated as fiscally transparent by a jurisdiction only if the jurisdiction requires interest holders in the entity to take into account separately their respective shares of the various items of income of the entity on a current basis and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of the jurisdiction). Accordingly, entities treated as fiscally transparent by a jurisdiction are entities subject in that jurisdiction to rules analogous to the U.S. rules applicable to entities that are treated as partnerships for U.S. federal income tax purposes.

These regulations are consistent with U.S. tax treaty obligations and basic tax treaty principles. The regulations as applied to hybrid entities are based on the principles discussed below. Treasury and the Service will continue to coordinate these issues with U.S. tax treaty partners in order to resolve any difficulty arising from the application of the principles set forth in these regulations.

Problems Arising From Dual Classification

The United States generally applies its tax rules to determine the classification of both domestic and foreign entities. When U.S. and foreign laws differ on classification principles, a hybrid entity may result. If income is paid to a hybrid entity, the entity may be considered as deriving the income under U.S. tax principles (e.g., as an association taxable as a corporation under U.S. tax principles), but its interest holders, rather than the entity, may be considered to derive the income under foreign tax principles (e.g., as an entity equivalent to a U.S. partnership). This dual classification may give rise to inappropriate and unintended results under tax treaties, such as double exemptions or double taxation, unless the tax treaties are interpreted so as to take into account the conflict of laws.

To avoid inappropriate and unintended tax treaty results with respect to payments to hybrid entities, these regulations rely on the basic principle that income tax treaties are designed to relieve double taxation or excessive taxation. This objective is generally achieved with provisions in treaties that limit the tax that a country may impose on income arising from sources within its borders to the extent that the income is derived by a resident of a jurisdiction with which the source country has an income tax treaty in effect (an applicable treaty jurisdiction). However, the agreement by the source country to cede part or all of its taxation rights to the treaty partner is predicated on a mutual understanding that the treaty partner is asserting tax jurisdiction over the income. Stated simply, tax treaties contemplate that income relieved from taxation in the source country will be subject to tax in the treaty country. This principle is central to the interpretation of treaty provisions in determining the extent to which payments received by a hybrid entity are eligible for benefits under tax treaties. Some treaties have specific rules reflecting this principle that are helpful in deciding how the treaties should be applied in such cases. However, the lack of specific rules in a treaty does not suggest that this principle does not apply under that treaty.

In order to implement this principle, virtually all U.S. income tax treaties limit the eligibility for treaty benefits on the condition that the person deriving the income must be a resident of the applicable treaty country. Typical of this condition, for example, is Article 12 of the U.S.–German treaty, which provides that "Royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State." Sometimes, the term paid to is used instead of the term derived by. However, those terms are used interchangeably and a different choice of words does not indicate that a different result is intended. Generally, a resident is defined as a person who is liable to tax in the treaty country as a resident of that country. See, for example, Article 4.1 of the U.S.–German tax convention, which provides that "the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...."

Limiting eligibility for treaty benefits to residents provides assurance to the source country that, when it limits its taxation rights on income arising from within its borders, it does so with the expectation that the income derived by a resident of the treaty country is subject to tax in the residence country.

Application of Principle to Hybrid Entities Generally

Based on the typical residence provisions of U.S. tax treaties, if income is paid to an entity that is treated as fiscally transparent in the treaty country in which it is organized, the entity itself is not eligible for benefits under the applicable treaty because it is not a resident of the treaty country (i.e., by virtue of not being liable to tax in that country). Whether the entity is a resident of the treaty country is determined under the laws of that country and not under the laws of the source country. This observation is important if the entity is a hybrid (i.e., an entity that is treated as fiscally transparent in one jurisdiction and treated as non-fiscally transparent in another jurisdiction). If the entity, treated as

fiscally transparent in the treaty country, is treated as a taxable entity in the source country, the entity is considered by the source country as being liable to tax. However, this determination under the source country tax laws does not render the entity a resident of the treaty country. In order for the entity to be a resident of the treaty country, it must be liable to tax in that country, as determined under the laws of that country.

Where the entity is not eligible for treaty benefits (for lack of residence in the treaty country), there is a question as to whether the owners of the entity may be eligible for benefits under an applicable income tax treaty. As stated above, the guiding principle is that income is eligible for a rate reduction or an exemption in the source country if "derived by" or "paid to" a resident of that country. Where the entity is treated as fiscally transparent, the question is whether the income can be considered "derived by" or "paid to" the owner of the entity.

If the entity is treated as fiscally transparent by all tax jurisdictions involved (i.e., the source country, the country where the entity is organized, and the country where the owners are resident), it is well established under U.S. income tax treaties that the entity is ignored and a look-through approach is intended, with the result that the entity's owners are treated as the persons who derive the income. This result is consistent with the general principle that eligibility for treaty benefits is conditioned upon the income being subject to tax in the treaty country as the income of a resident of that country. In fact, some treaties clarify this point. For example, Article 4.1(b) of the U.S.–German income tax convention provides, like several other U.S. tax conventions, that "in the case of income derived or paid by a partnership, estate, or trust, this term [resident] applies only to the extent that the income derived by such partnership, estate, or trust is subject to tax in that State [the State other than the source State] as the income of a resident, either in its hands or in the hands of its partners or beneficiaries." Further, even where no provisions are included, the Technical Explanation sometimes explains that the look-through rule applies without the need for a specific provision. See the U.S. Treasury Department's Technical Explanation of U.S.–Japan Income Tax Convention signed March 8, 1971, Article 3 (Fiscal Domicile).

Application of Principle to Reverse Hybrid Entity

If an entity is a "reverse" hybrid entity, meaning that it is treated as a taxable entity under the tax laws of the source country but as a fiscally transparent entity in the applicable treaty country, a conflict arises because, under the source country's tax laws, the entity's owners are not treated as deriving the income. Yet, under the tax laws of the jurisdiction where the entity's owners are resident, the owners are treated as deriving the income paid to the entity. Thus, the question is whether the source country's laws or the laws of each owner's jurisdiction of residence should govern the determination of who is the person deriving the income for tax treaty purposes. Making that determination under the tax laws of the applicable treaty jurisdiction where the owners are resident leads to results consistent with the principle discussed earlier that the source country cedes its tax jurisdiction to the treaty partner based on the understanding that the treaty partner asserts tax jurisdiction over the income by insuring that it is taxable in the hands of a resident. In this case, the entity's owners are resident in a treaty country that treats them as liable to tax on the items of income paid to the entity. On the other hand, applying the tax laws of the source country would lead to results inconsistent with that principle. In other words, tax benefits would be denied under the applicable treaty (because, under the source country's tax laws, the entity's owners are not treated as deriving the income paid to the entity), even though the income arising in the source country is subject to tax in the hands of persons who are resident in the applicable treaty jurisdiction.

Application of Principle to Regular Hybrid Entity

The same principle applies to a "regular" hybrid entity, i.e., an entity that is treated as fiscally transparent in the source country and as a non-fiscally transparent entity in the applicable treaty jurisdiction. If the entity is organized in a treaty jurisdiction, the applicable treaty with that country generally would treat the entity as a resident. Therefore, under that treaty, the entity should be eligible for treaty benefits as an entity deriving the income as a resident of the treaty jurisdiction. On the other hand, the entity's owners who are resident in that jurisdiction (or in any other jurisdiction that treats the entity as non-fiscally transparent) should not be eligible for treaty benefits under that treaty (or a treaty with the country where they are resident that treats the entity as non-fiscally transparent). This result should occur irrespective of the fact that the source country considers that the taxpayers with respect to the income are the entity's owners and not the entity (by virtue of treating the entity as fiscally transparent under its own tax laws). Again, applying the laws of the applicable treaty jurisdiction to determine whether the entity or its owners are deriving the income as residents of that country leads to results consistent with the basic principle that the source country cedes its tax jurisdiction over income to the extent the income is subject to tax in the hands of a resident of the applicable treaty country.

Applying the tax laws of the source country to determine the person deriving the income for treaty purposes would not only be inconsistent with the basic principle that income should be treated as derived by the person in the treaty country who is liable to tax on that income, it also potentially leads to tax avoidance under tax conventions, including an inappropriate double exemption. For example, if the entity does not fall within the taxing jurisdiction of the applicable treaty jurisdiction (e.g., because the entity is organized in a third country or as a fiscally transparent entity in the source country), the income could be eligible for a treaty-reduced tax rate in the source country and yet not be subject to tax in the jurisdiction where the owners are resident.

In such a case, the owners may eventually be taxed on the income when the entity makes a distribution of the income derived from the source country. The Treasury and IRS believe that the potential for later taxation should not affect the results under the treaty for two reasons: first, the interposition of a hybrid entity between the income and the owner of the entity allows the taxation event in the treaty jurisdiction to be deferred, perhaps

indefinitely; second, the income, when distributed or deemed distributed (for example, pursuant to anti-deferral rules of the treaty jurisdiction), may be transformed. In other words, the income derived by the partner will be treated in the partner's residence country as a distribution (or deemed distribution) of profits from the entity and not as the type of income derived by the entity from the source country. This disparity in treatment may lead to a double exemption if, for example, the dividend distribution is exempt from tax in the country where the entity's owners reside due to double tax relief or a corporate integration regime that grants preferential tax treatment to corporate distributions. Interpreting conventions in a way that allows such a double exemption would not be consistent with the primary goal of treaties to relieve double or excessive taxation. This is especially true where, as is the case here, an alternative interpretation exists that would produce results consistent with basic tax convention principles.

Certain taxpayers have expressed the view that this analysis of the treatment of payments to hybrid entities under tax treaties is inconsistent with the treatment of so-called hybrid securities that are treated differently under the tax laws of the source country and the relevant treaty jurisdiction (e.g., an instrument that is treated as a debt instrument in the source country but as an equity interest in the relevant treaty jurisdiction). In certain cases, the use of hybrid securities can lead to double exemptions, analogous to the double exemptions possible with respect to "regular" hybrid entities, based on the availability of an exemption from tax in the relevant treaty jurisdiction. Treasury and the IRS recognize that hybrid securities can produce inappropriate and unintended results under income tax treaties. Although the residence concept of tax treaties, which incorporates the basic "subject to tax" principle, generally is satisfied with respect to payments on a hybrid security for the reasons discussed above, Treasury and the IRS are considering whether inappropriate and unintended tax treaty consequences, including both double exemptions and double taxation, can arise with respect to hybrid securities and, if so, what alternative avenues exist for addressing them.

The hybrid entity analysis applies regardless of where the entity is organized and where the owners are resident. One example involves an entity organized in one country and owned by persons residing in a third country. If the third country and the source country treat the entity as fiscally transparent, both the source country and the third country can ignore the entity for purposes of granting treaty benefits under the third country's convention with the source country. In such a case, the entity's owners resident in the third country are treated as deriving the income received by the entity, under both the source country tax laws and the tax laws of the third country. In a three-country situation, there may also be simultaneous application of two treaties to the same flow of income: the treaty with the country where the entity is organized, and the treaty with the country where the entity's owners are resident.

The analysis applicable to fiscally transparent entities does not depend on whether the entity has multiple owners or a single owner. Accordingly, the analysis applies to a wholly-owned entity that is disregarded for federal tax purposes as an entity separate from its owner.

Application of Principle to Entity Organized in Source Country

The same analysis generally applies to entities organized in the source country. If both the source country and the treaty jurisdiction where the entity's owners are resident treat the entity as fiscally transparent, then the entity is ignored and the eligibility for treaty benefits is tested at the owners' level. If the entity, however, is treated as non-fiscally transparent in the treaty jurisdiction, then the income is not treated by the treaty jurisdiction as being derived by the owners. Therefore, the owners are not eligible for benefits under the treaty since they are not deriving the income for purposes of the applicable treaty.

Taxpayers may argue that treaty benefits should be allowed to the owners residing in the treaty country because, viewed from the source country's point of view, the owners are deriving the income from the source country and are resident in the treaty country. While the provisions in current treaties do not explicitly provide for this situation, the situation raises exactly the same issues as in the cases discussed above. For this purpose, it is immaterial that the entity is organized in the country of the owner, in a third country, or in the source country.

The analysis does not apply, however, if the entity is a reverse hybrid organized in the United States because, in such a case, the United States treats the entity as a corporate entity, liable to tax in the United States at the entity level. The right of the United States to tax a domestic corporation is established under the "savings clause" of all U.S. tax treaties which preserves the right of the United States to tax its residents and citizens under its domestic law. Distributions from a domestic corporation that is a reverse hybrid are also subject to U.S. tax in the hands of the foreign owners who are treated as shareholders for U.S. tax purposes.

Beneficial Ownership

The principles relied upon in these temporary regulations are consistent with the proposed withholding tax regulations issued under §§1.1441–1(c)(6)(ii)(B) and 1.1441–6(b)(4) regarding claims of treaty-reduced withholding rates for U.S. source payments through foreign entities. The temporary regulations, however, do not utilize the same terminology as the proposed withholding tax regulations.

The proposed withholding tax regulations condition eligibility for treaty-based withholding rates for payments to an entity on a determination of "beneficial owner" status for the entity or the interest holders of the entity pursuant to the laws of the applicable treaty jurisdiction. Accordingly, under the proposed withholding tax regulations, the term beneficial owner functions as a surrogate for the principle that a person is eligible for tax treaty benefits with respect to a payment received by an entity only if the person is a resident with respect to such payment.

The term beneficial owner as used in the proposed withholding tax regulations may be confusing because this term has other meaning in the tax treaty context. Accordingly, the temporary regulations do not utilize the term beneficial owner in the same manner as the proposed withholding regulations. Rather, they condition eligibility for treaty-reduced tax rates for income paid to an entity on a determi-

nation that the income is "treated as derived by a resident" of the applicable treaty jurisdiction. Like the determination of beneficial owner status required in the proposed withholding tax regulations, the determination of whether a payment to an entity is "treated as derived by a resident" is determined under the principles in effect under the laws of the applicable treaty jurisdiction. Treasury and the Service intend to conform the final withholding tax regulations to the temporary regulations.

The temporary regulations reflect the fact that the concept of beneficial ownership is an important separate condition for claiming tax treaty benefits. In order to address difficulties where the recipient acts as a "nominee" or "conduit" for another person or in other situations involving a disconnect between legal and economic ownership, most income tax treaties require that the resident be a beneficial owner of the income. This requirement is entirely separate from the beneficial ownership requirement with respect to U.S. source payments to foreign entities reflected in the proposed withholding tax regulations and the residence requirement with respect to U.S. source payments to all entities reflected in these temporary regulations. As used in tax treaties, the term beneficial owner is meant to address "conduit", "nominee" and comparable situations in which the person receives the payment in form (and may even be taxed on that income in the jurisdiction in which it resides), but is nevertheless not treated as beneficially owning the income for purposes of a particular treaty because, under the beneficial owner rules of the source country, the income is deemed to belong to another person who is determined to have a stronger economic nexus to the income. See, for example, section 7701(l) and §§1.7701–(l)–1(b) and 1.881–3. Thus, the temporary regulations utilize the term beneficial owner in a manner consistent with the treaty approach.

Mutual Agreement

Treasury and IRS intend that the principles of the regulations should be applied in a reciprocal manner by U.S. tax treaty partners. For this reason, the regulations include a special rule that provides that, irrespective of any contrary rules in the regulations, a reduced rate under a tax treaty for a payment of U.S. source income will not be available to the extent that the applicable treaty partner does not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or a public notice of the treaty partner. Denial of benefits under this provision would be effective on a prospective basis only.

Effective Date

The temporary regulations apply on a prospective basis only to amounts paid on or after January 1, 1998. Withholding agents should consider the effect of these regulations on their withholding obligations, including the need to obtain a new withholding certificate to confirm claims of treaty benefits for payments made on or after the effective date. Treasury and the IRS recognize that the applicable principles for determining eligibility of reduced treaty rates for income paid to hybrid entities may have been uncertain in the past. Accordingly, the IRS does not intend to challenge any claim of treaty benefits for payments to hybrid entities made before the effective date of these regulations on the basis that the claim was based on principles inconsistent with those upon which these regulations are based.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) 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. Because of rapidly increasing use of hybrid entities for cross-border transactions, immediate guidance is needed on rules for determining whether U.S. source payments made to entities, including entities that are fiscally transparent in the United States and/or the applicable treaty jurisdiction, are eligible for treaty-reduced tax rates. Therefore, good cause is found to dispense with the notice requirement of section 553(b) of the Administrative Procedure Act. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

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Adoption of Amendments to the Regulations

Accordingly, CFR 26 part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. §1.894–1T is added to read as follows:

§1.894–1T: Income affected by treaty (temporary).

(a) through (c) [Reserved]. For further guidance, see §1.894–1(a) through (c).

(d) *Determination of tax on income paid to entities*—(1) *In general.* The tax imposed by sections 871(a), 881(a), 1461, and 4948(a) on a payment received by an entity organized in any country (including the United States) shall be eligible for reduction under the terms of an income tax treaty to which the United States is a party if such payment is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner of the payment, and all other applicable requirements for benefits under the treaty are satisfied. A payment received by an entity is treated as derived by a resident of an applicable treaty jurisdiction only to the extent the payment is subject to tax in the hands of a resident of such jurisdiction. For this purpose, a payment received by an entity that is treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in thehands of a resident of the jurisdiction only to the extent that the interest holders in the entity are residents of the jurisdiction. For purposes of the preceding sentence, interest holders shall not include any direct or indirect interest holders that are themselves treated as fiscally transparent entities by the applicable treaty jurisdiction. A payment received by an entity that is not treated as fiscally

transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of such jurisdiction only if the entity is itself a resident of that jurisdiction.

(2) *Application of beneficial ownership requirement in respect of certain payments received by entities*—(i) *Entities treated as fiscally transparent for U.S. tax purposes.* An entity that is treated as fiscally transparent under the laws of the United States and that is resident in an applicable treaty jurisdiction shall be treated as the beneficial owner of a payment if the entity would be treated as the beneficial owner if it were treated as nonfiscally transparent by the United States.

(ii) *Entity's owners as beneficial owners*—(A) A resident of an applicable treaty jurisdiction that derives a payment received by an entity that is fiscally transparent under the laws of the applicable tax jurisdiction shall be treated as the beneficial owner of the payment unless—

(*1*) Such resident would not have been treated as the beneficial owner of the payment had such payment been received directly by the resident; or

(*2*) The entity receiving the payment is not treated as a beneficial owner of the payment.

(B) For example, persons residing in treaty Country X and treated under the laws of Country X as interest holders in a fiscally transparent entity created under the laws of Country Y are treated as the beneficial owners of the payments received by the entity from sources within the United States unless the interest holders would not have been treated as beneficial owners had they received the payment directly (e.g., the partners act as nominees or conduits for other persons). However, if the entity itself is acting as a nominee or conduit for another person and, therefore, is not itself a beneficial owner, then none of the interest holders can be treated as beneficial owners, even if the interest holders own their interests in the entity as beneficial owners. For this purpose, the determination of whether a person is a beneficial owner of a payment shall be made under U.S. tax laws.

(3) *Application to certain domestic entities.* Notwithstanding paragraph (d)(1) of this section, an income tax treaty may not apply to reduce the amount of tax on income received by an entity that is treated as a domestic corporation for U.S. tax purposes. Therefore, neither the domestic corporation nor its shareholders are entitled to the benefits of a reduction of U.S. income tax on income received from U.S. sources by the corporation.

(4) *Definitions*—(i) *Entity.* For purposes of this paragraph (d), the term entity shall mean any person that is treated by the United States or the applicable treaty jurisdiction as other than an individual.

(ii) *Fiscally transparent.* For purposes of this paragraph (d), an entity is treated as *fiscally transparent* by a jurisdiction to the extent the jurisdiction requires interest holders in the entity to take into account separately on a current basis their respective shares of the items of income paid to the entity and to determine the character of such items as if such items were realized directly from the source from which realized by the entity (for purposes of the tax laws of the jurisdiction). Entities that are fiscally transparent for U.S. federal income tax purposes include partnerships, common trust funds described under section 584, simple trusts, grantor trusts, as well as certain other entities (including entities that have a single interest holder) that are treated as partnerships or as disregarded entities for U.S. federal income tax purposes.

(iii) *Applicable treaty jurisdiction.* The term *applicable treaty jurisdiction* means the jurisdiction whose income tax treaty with the United States is invoked for purposes of reducing the rate of tax imposed under section 871(a), 881(a), 1461, and 4948(a).

(iv) *Resident.* The term *resident* shall have the meaning assigned to such term in the applicable income tax treaty.

(5) *Application to all income tax treaties.* Unless otherwise explicitly agreed upon in the text of an income tax treaty, the rules contained in this paragraph (d) shall apply in respect of all income tax treaties to which the United States is a party. However, a reduced rate under a tax treaty for a payment of U.S. source income will not be available irrespective of the provisions in this paragraph (d) to the extent that the applicable treaty partner would not grant a reduced rate under the tax treaty to a U.S. resident in similar circumstances, as evidenced by a mutual agreement between the relevant competent authorities or by a public notice of the treaty partner. The Internal Revenue Service shall announce the terms of any such mutual agreement or treaty partner's position. Any denial of tax treaty benefits as a consequence of such a mutual agreement or treaty partner's position shall affect only U.S. source payments made after announcement of the terms of the agreement or of the position.

(6) *Examples.* This paragraph (d) is illustrated by the following examples. Unless stated otherwise, each example assumes that all conditions for claiming a treaty-reduced tax rate under a U.S. income tax treaty with respect to a payment of U.S. source income are satisfied (other than the condition that the income is treated as derived by a resident of the applicable treaty jurisdiction), including the beneficial ownership requirement and all requirements relating to applicable limitation on benefits provisions. The examples are as follows:

Example 1. (i) Facts. Entity A is a business organization formed under the laws of Country X that has an income tax treaty with the United States. Under the laws of Country X, A is liable to tax at the entity level. A is treated as a partnership for U.S. income tax purposes and receives royalties from U.S. sources that are not effectively connected with the conduct of a trade or business in the United States. Some of A's partners are resident in Country X and the other partners are resident in Country Y. Country Y has no income tax treaty in effect with the United States. Article 12 of the U.S.–X tax treaty provides that "royalties derived from sources within a Contracting State by a resident of the other Contracting State shall not exceed 5 percent of the gross amount thereof...". Article 4.1 of the treaty provides that for purposes of the treaty, "a 'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". Article 4.2 of the treaty provides that in the case of income "derived or paid by a partnership...", the term *resident* applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners.

(ii) *Analysis.* Under the U.S.–X income tax treaty, A is a *resident* of Country X within the meaning of Article 4.1 of the treaty. Also, as a resident of Country X taxable on the U.S. source royalty under the tax laws of Country X, A meets the condition under Article 12 of the treaty that it derive the income from sources within the United States. Accordingly, the U.S. source royalty income is treated as derived by a resident of X. Further, A is a beneficial owner of the royalty income, as determined under paragraph (d)(2)(i) of this section. The fact that A's interest holders are also beneficial owners of the royalty income under U.S. tax principles (as partners of A) does not preclude A from qualifying

as a beneficial owner for purposes of the treaty. In addition, A may claim benefits under the U.S.–X income tax treaty even though some of its interest holders do not reside in X or reside in a country that does not have an income tax treaty in effect with the United States.

Example 2. (i) *Facts.* The facts are the same as under *Example 1* except that Article 12 of the U.S.–X income tax treaty provides that royalties "paid" to a resident of a treaty country from sources within the other may be taxed in both countries but the tax is limited to 10 percent of the gross amount of the royalties in the source country. Further the U.S.–X income tax treaty includes no provision relating to income paid or derived through a partnership.

(ii) *Analysis.* As in *Example 1,* A is entitled to claim the benefit of the U.S.–X income tax treaty with respect to the U.S. source royalty income paid to A. The term paid and the term derived are used interchangeably in U.S. income tax treaties. Accordingly, the U.S. source royalty income is treated as derived by a resident of X. It is irrelevant that the U.S.–X treaty does not include a provision relating to income paid or derived through a partnership.

Example 3. (i) *Facts.* The facts are the same as under *Example 2,* except that Country Y has an income tax treaty in effect with the United States. Article 12 of the U.S.–Y income tax treaty reduces the rate on U.S. source royalty income to zero if the income is paid to a resident of Country Y who beneficially owns the income. Article 4.1 of the U.S.–Y treaty provides that for purposes of the treaty, "a 'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". The U.S.–Y treaty does not include a provision relating to income paid or derived through a partnership. Under the laws of Country Y, A is treated as fiscally transparent entity. Thus, A's partner, T, a corporation organized in Country Y is required to include in income on a current basis its allocable share of A's income. T is a beneficial owner of the income paid to A, as determined under paragraph (d)(2)(ii) of this section.

(ii) *Analysis.* As in *Example 2,* A is entitled to claim the benefit of the U.S.–X income tax treaty with respect to the U.S. source royalty income paid to A. However, T is also entitled to claim the benefit of the exemption under the U.S.–Y treaty for its allocable share of the U.S. source royalty income. T meets the conditions of Article 12 because it is a resident of Country Y within the meaning of Article 4.1 of the treaty. Also, as a resident of Country Y taxable on the U.S. source royalty under the tax laws of Country Y, it meets the condition under Article 12 of the treaty that income from sources within the United States be paid to a resident. Accordingly, T's allocable share of the U.S. source royalty income is treated as derived by a resident of Y. It is irrelevant that the U.S.–Y treaty does not include a provision relating to income paid or derived through a partnership.

Example 4. (i) *Facts.* Entity A is a business organization organized under the laws of Country V that has no income tax treaty with the United States. A is treated as a partnership for U.S. tax purposes and receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States. G, one of A's interest holders, is a corporation organized under the laws of Country X. X treats A as an entity taxable at the entity level and not as a fiscally transparent entity. Therefore, G is not required to include in income on a current basis its share of A's income. Instead, G is taxed in X on its share of A's profits when distributed by A and such distribution is taxed to G as a dividend. H, A's other interest holder, is a corporation organized in Country Y. Y treats A as a fiscally transparent entity and requires H to include in income on a current basis its allocable share of A's income. Both X and Y have an income tax treaty in effect with the United States. Article 12 of the U.S.–X income tax treaty provides that royalties paid to a resident of a treaty country from sources within the other may be taxed in both countries but the tax is limited to 5 percent of the gross amount of the royalties in the source country. Article 4.1 of the U.S.–X treaty provides that for purposes of the treaty, a "'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". The U.S.–X treaty does not include a provision relating to income paid or derived through a partnership. Article 12 of the U.S.–Y treaty provides that "royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State." Article 4.1 of the U.S.–Y treaty provides that, for purposes of the treaty, a "'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". Article 4.2 of the U.S.–Y treaty provides that in the case of income "derived or paid by a partnership...", the term resident applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either, in its hands or in the hands of its partners.

(ii) *Analysis.* A may not claim the benefit of any income tax treaty since it is not a resident of a country with which the United States has such a treaty. This result occurs regardless of how A is treated for U.S. tax purposes or for purposes of the tax laws of Country V. G may not claim the benefits of Article 12 of the U.S.–X treaty. Under the tax laws of X, G's share of the U.S. source royalty income paid to A is not treated as derived by a resident of X since, under X's tax laws, A, rather than G, is required to account for income received by A. This result occurs even if A distributes the royalty amount immediately after receiving it because, in such a case, G would be taxable on an amount treated as a profit distribution from A and not on royalty income received from sources within the United States. The fact that, for U.S. tax purposes, G is treated as the taxpayer for its allocable share of A's income is not relevant for purposes of determining whether, for purposes of Article 12 of the U.S.–X income tax treaty, G's share of the income paid to A is treated as derived by a resident of X. For this purpose, the laws of Country X govern the determination of whether G meets this condition. On the other hand, H may claim an exemption from U.S. tax on its share of the royalty income received by A under Article 12 of the U.S.–Y treaty because, under the tax laws of Y, H rather than A, is required to account for income received by A. Accordingly, H's share of the U.S. source royalty income paid to A is treated as derived by a resident of Y.

Example 5. The facts are the same as in *Example 4,* except that A is a business organization formed under the laws of a U.S. State as a limited liability company. The consequences are the same as described in *Example 4.* G is not eligible for benefits under Article 12 of the U.S.–X income tax treaty since, under X's tax laws, A, rather than G, is required to account for income received by A. Under section 881(a), G is liable for U.S. income tax on its allocable share of A's U.S. source royalty income at a 30 percent rate and A must withhold 30 percent from G's allocable share under section 1442. Similarly, H may claim an exemption from U.S. tax on its share of the royalty income received by A under Article 12 of the U.S.–Y treaty because, under the tax laws of Y, H rather than A, is required to account for income received by A.

Example 6. The facts are the same as in *Example 4,* except that A is a so-called dual organized entity. In addition to being organized under the laws of Country V, A has also been organized under the laws of the United States pursuant to the State Z domestication statute. Accordingly, both Country V and the United States regard entity A as a domestic entity existing only in that jurisdiction. Further, Country X and Country Y regard A as a Country V entity. A is treated as a partnership for U.S. tax purposes. The fact that A is a dual organized entity that is regarded differently in Countries X or Y and the United States does not impact the relevant tax treaty analysis. As in *Example 4,* A may not claim the benefit of any income tax treaty since it is not a resident of a country with which the United States has such a treaty. Similarly, G is not eligible for benefits under Article 12 of the U.S.–X income tax treaty since, under X's tax laws, A, rather than G, is required to account for income received by A. Under section 881(a), G is liable for U.S. income tax on its allocable share of A's U.S. source royalty income at a 30 percent rate. Because A is treated as a U.S. partnership for U.S. tax purposes, A must withhold 30 percent from G's allocable share under section 1442. H may claim an exemption from U.S. tax on its share of the royalty income received by A under Article 12 of the U.S.–Y income tax treaty because, under the tax laws of Y, H rather than A, is required to account for the income received by A.

Example 7. The facts are the same as in *Example 5,* except that A distributes all U.S. source royalty income to its interest holders immediately following A's receipt of such income. The consequences are the same as described in *Example 5.* G remains ineligible for benefits under Article 12 of the U.S.–X income tax treaty since, under X's tax laws, A, rather than G, is required to account for the royalty income received by A. The fact that A distributes income on a current basis to G is irrelevant even if Country X taxes G on such distributions on a current basis. Country X regards such distributions to G as a distribution of profits from A to G rather than an item of U.S. source royalty income of G. H remains eligible for benefits under Article 12 of the U.S.–Y income tax treaty with respect to H's allocable share of the U.S. source royalty treatment received by A.

Example 8. The facts are the same as in *Example 5,* except that Country X pursuant to a Country X anti-deferral regime requires that G account for on a

at basis as a deemed distribution G's pro rata e of A's net passive income. For purposes of the i-deferral regime, the U.S. source royalty income f G is regarded as passive income. The consequences are the same as described in *Example 5.* G remains ineligible for benefits under Article 12 of the U.S.–X income tax treaty because, under X's tax laws, A, rather than G, is required to account for the royalty income received by A. The fact that G receives a current deemed distribution of net passive income is irrelevant even if Country X taxes G on such deemed distributions on a current basis. Country X regards such deemed distributions to G as a distribution of profits from A to G rather than an allocation to G of G's share of A's U.S. source royalty income. H remains eligible for benefits under Article 12 of the U.S.–Y income tax treaty with respect to H's allocable share of the U.S. source royalty treatment received by A.

Example 9. (i) *Facts.* Entity A is a business organization formed under the laws of Country X that has an income tax treaty with the United States. A has made a valid election under §301.7701–3(c) of this chapter to be treated as a corporation for U.S. tax purposes and receives royalty income from sources within the United States that is not effectively connected with the conduct of a trade or business in the United States. G, A's sole shareholder, is a corporation organized under the laws of Country X. Under the tax laws of X, A is treated as a fiscally transparent entity and, therefore, G is required to include in income on a current basis its share of A's income. Article 12 of the U.S.–X tax treaty provides that "royalties derived from sources within a Contracting State by a resident of the other Contracting State shall not exceed 5 percent of the gross amount thereof...". Article 4.1 of the treaty provides that for purposes of the treaty, a "'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". Article 4.2 of the treaty provides that in the case of income "derived or paid by a partnership...", the term resident applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either, in its hands or in the hands of its partners.

(ii) *Analysis.* A does not qualify for benefits under the U.S.-X income tax treaty because A is treated as a fiscally transparent entity under the tax laws of X and thus is not a resident of X for purposes of the treaty. G, on the other hand, qualifies for benefits under the U.S.–X treaty with respect to the U.S. source royalty income received by A because, under the tax laws of X, G is required to account for the income received by A on a current basis. This result applies even though, for U.S. tax purposes, A is treated as a corporate entity. Accordingly, the U.S. royalty income paid to A is treated as derived by G, a resident of X, as determined under the tax laws of X. Based on G's qualification for treaty benefits with respect to the U.S. source royalty income, A, as the taxpayer under U.S. tax laws, may claim that the income that it receives for U.S. tax purposes is eligible for benefit under the U.S.–X treaty.

Example 10. The facts are the same as in *Example 9,* except that A is a corporation organized under the laws of a U.S. State and is, therefore, a domestic corporation. A may not claim under the U.S.–X income tax treaty a reduction of the rate of U.S. tax otherwise imposed on its income under section 11. A reduced rate of tax is unavailable under the U.S.–X treaty based upon the savings clause in Article 1 of the U.S.–X treaty. Thus, A remains fully taxable under U.S. tax laws as a domestic corporation.

Example 11. (i) *Facts.* Entity A is a business organization organized under the laws of Country V that has no income tax treaty with the United States. A is treated as a partnership for U.S. tax purposes and receives royalty income from U.S. sources that is not effectively connected with the conduct of a trade or business in the United States. A is directly owned by H and J. J is a corporation organized in Country Z which treats A as fiscally transparent and J as an entity taxable at the entity level. Accordingly, Country Z requires J to include in income on a current basis J's share of A's U.S. source royalty income. H, A's other direct interest holder, is a corporation organized in Country Y. H, in turn is owned by E and F, both of which are entities organized in Country X. E and F are each wholly owned by C which is a corporation organized in Country V. Y treats both A and H as fiscally transparent entities. X treats A, H, and E as fiscally transparent entities. X treats F as an entity taxable at the entity level. Accordingly, X requires F to include in income on a current basis F's indirect share of A's U.S. source royalty income. H and J are treated as corporations for U.S. federal income tax purposes while E, F, and C are treated as partnerships for U.S. federal tax purposes. X, Y and Z each have in effect an income tax treaty with the United States. Article 12 of the U.S.–X and the U.S.–Z income tax treaty provides that royalties paid to a resident of a treaty country from sources within the other may be taxed in both countries but the tax is limited to 5 percent of the gross amount of the royalties in the source country. Article 4.1 of the U.S.–X and the U.S.–Z treaty provides that for purposes of the treaty, a "'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". Article 4.2 of the U.S.–X and the U.S.–Z treaty provides that in the case of income "derived or paid by a partnership...", the term *resident* applies only to the extent that the income derived by such partnership is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners. Article 12 of the U.S.–Y treaty provides that "royalties derived and beneficially owned by a resident of a Contracting State shall be taxable only in that State." Article 4.1 of the U.S.-Y treaty provides that, for purposes of the treaty, a "'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". The U.S.–Y treaty does not include a provision relating to income paid or derived through a partnership.

(ii) *Analysis.* A may not claim, based on its own status, the benefit of any income tax treaty since it is not a resident of a country with which the United States has such a treaty. This result occurs regardless of how A is treated for U.S. tax purposes or for purposes of the tax laws of Country V. H may not claim the benefits of any treaty, including the benefits of Article 12 of the U.S.–Y treaty, because H does not qualify as a resident of Y or any other treaty jurisdiction. Similarly, neither E nor C may claim the benefits of any income tax treaty, since neither entity qualifies as a resident of X or any other treaty jurisdiction. F, however, may claim the benefit of Article 12 of the U.S.–X treaty with respect to F's indirect share of the U.S. source royalty income received by A. Such income is treated as derived by F, a resident of X, because X qualifies as a resident of X and, under the tax laws of X, F is the first entity in the A, H, F chain that is not itself treated as fiscally transparent in X. J may claim the benefits of Article 12 of the U.S.–Z treaty with respect to J's indirect share of the U.S. source royalty income paid to A because, under the tax laws of Z, J rather than A, is required to account for income received by A. Accordingly, J's share of the U.S. source royalty income paid to A is treated as derived by a resident of Z. As illustrated in this example, the U.S. federal income tax treatment of A, J, H, E, F and C is irrelevant for purposes of determining the extent to which U.S. source royalty income paid to A is eligible for treaty-reduced tax rates under the U.S. income tax treaty with X, Y or Z.

Example 12. (i) *Facts.* Entity A is a business organization formed under the laws of Country X that has an income tax treaty in effect with the United States. A owns all of the stock of a U.S. corporation B. Under the tax laws of X, A is subject to tax at the entity level. For U.S. tax purposes, A is treated as a branch of its single owner, G. G is a corporation organized under the laws of X. A receives dividends from B that are from U.S. sources and are not effectively connected with the conduct of a trade or business in the United States. Article 10 of the U.S.–X tax treaty provides that "dividends derived from sources within a Contracting State by a resident of the other Contracting State shall not exceed 5 percent of the gross amount thereof...". Article 4.1 of the treaty provides that for purposes of the treaty, a "'resident' of a Contracting State means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature...". The U.S.–X treaty contains no provision regarding income paid or derived through a partnership.

(ii) *Analysis.* For U.S. tax purposes, A is treated as a wholly-owned business entity that is disregarded for federal income tax purposes. However, because, under the laws of X and under X's application of the treaty, A is treated as deriving the dividend income as a resident of X, A qualifies for benefits under the treaty with respect to the U.S. source dividend. Thus, G, as the taxable person for U.S. tax purposes, may claim the benefit of a reduced rate under Article 10 of the U.S.–X treaty based on A's eligibility for tax treaty benefits.

(7) *Effective date.* This paragraph (d) applies to amounts paid on or after January 1, 1998.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved June 26, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

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Part III.—Income from Sources Without the United States
Subpart B.—Earned Income of Citizens or Residents of United States

Section 911.—Citizens or Residents of the United States Living Abroad

26 CFR 1.911–1: Partial exclusion for earned income from sources within a foreign country and foreign housing costs.

Guidance is provided to individuals who fail to meet the eligibility requirements of section 911(d)(1) of the Internal Revenue Code because adverse conditions in a foreign country preclude the individual from meeting those requirements. A current list of countries and the dates those countries are subject to the section 911(d)(4) waiver is provided. See Rev. Proc. 97–51, page 526.

Subpart F.—Controlled Foreign Corporations

Section 954.—Foreign Base Company Income

26 CFR 1.954–3: Foreign base company sales income.
(Also sections 7805, 301.7805–1.)

This ruling revokes Rev. Rul. 75–7, 1975–1 C.B. 244, and holds that the activities of a contract manufacturer cannot be attributed to a controlled foreign corporation for purposes of either section 954(d)(1) or section 954(d)(2) of the Code to determine whether the income of a controlled foreign corporation is foreign base company sales income. The ruling, however, provides 7805(b) relief for taxable years of a controlled foreign corporation beginning before December 8, 1997.

Rev. Rul. 97–48

In Rev. Rul. 75–7, 1975–1 C.B. 244, a controlled foreign corporation entered into an arm's length contract with an unrelated contract manufacturer located outside of its country of incorporation. Under the contract, the unrelated contract manufacturer agreed to perform manufacturing services for the controlled foreign corporation. Under the facts described in Rev. Rul. 75–7, the processing activities of the unrelated contract manufacturer were considered to be performed by the controlled foreign corporation outside its country of incorporation through a branch or similar establishment for purposes of section 954(d)(1) and (2) of the Internal Revenue Code.

In *Ashland Oil Co. v. Commissioner*, 95 T.C. 348 (1990), the Tax Court held that a manufacturing corporation unrelated to a controlled foreign corporation cannot be a branch or similar establishment of the controlled foreign corporation. *See also, Vetco, Inc. v. Commissioner*, 95 T.C. 579 (1990) (wholly-owned subsidiary of a controlled foreign corporation cannot be a branch or similar establishment of the controlled foreign corporation).

The Service will follow the *Ashland* and *Vetco* opinions. The activities of a contract manufacturer cannot be attributed to a controlled foreign corporation for purposes of either section 954(d)(1) or section 954(d)(2) of the Code to determine whether the income of a controlled foreign corporation is foreign base company sales income. Accordingly, Rev. Rul. 75–7 is revoked.

Pursuant to the authority of section 7805(b), for taxable years of a controlled foreign corporation beginning before December 8, 1997, the principles of Rev. Rul. 75–7 may be relied upon to attribute the activities of a contract manufacturer to the controlled foreign corporation. A taxpayer that relies on Rev. Rul. 75–7 to attribute the activities of a contract manufacturer to a controlled foreign corporation for purposes of section 954(d)(1), however, must treat the contract manufacturing activities as being performed through a branch or similar establishment of the controlled foreign corporation for purposes of section 954(d)(2). The Service has never been of the view that Rev. Rul. 75–7 allows the activities of a contract manufacturer performed outside the controlled foreign corporation's country of incorporation to be attributed to the controlled foreign corporation without treating those activities as performed through a branch or similar establishment of the controlled foreign corporation.

With the revocation of Rev. Rul. 75–7, the Service's position on the treatment of contract manufacturing for purposes section 954(d) is harmonized with its position on the treatment of contract manufacturing for purposes of section 863(b) (see § 1.863–3(c) of the Income Tax Regulations (production activity limited to activity conducted directly by taxpayer)).

EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 75–7, 1975–1 C.B. 244, is revoked effective December 8, 1997.

Part IV.—Domestic International Sales Corporations
Subpart B.—Treatment of Distributions to Shareholders

Section 995.—Taxation of DISC Income to Shareholders

1997 base period T-bill rate. The "base period T-bill rate" for the period ending September 30, 1997, is published, as required by section 995(f)(4) of the Code.

Rev. Rul. 97–49

Section 995(f)(l) of the Internal Revenue Code provides that a shareholder of a DISC shall pay interest each taxable year in an amount equal to the product of the shareholder's DISC-related deferred tax liability for the year and the "base period T-bill rate." Under section 995(f)(4), the base period T-bill rate is the annual rate of interest determined by the Secretary to be equivalent to the average investment yield of United States Treasury bills with maturities of 52 weeks which were auctioned during the one-year period ending on September 30 of the calendar year ending with (or of the most recent calendar year ending before) the close of the taxable year of the shareholder. The base period T-bill rate for the period ending September 30, 1997, is 5.68 percent.

Pursuant to section 6622 of the Code, interest must be compounded daily. The table below provides factors for compounding the base period T-bill rate daily for any number of days in the shareholder's taxable year (including a 52–53 week accounting period) for the 1997 base period T-bill rate. To compute the amount of the interest charge for the shareholder's taxable year, multiply the

amount of the shareholder's DISC-related deferred tax liability (as defined in section 995(f)(2)) for that year by the base period T-bill rate factor corresponding to the number of days in the shareholder's taxable year for which the interest charge is being computed. Generally, one would use the factor for 365 days. One would use a different factor only if the shareholder's taxable year for which the interest charge being determined is a short taxable year, if the shareholder uses the 52-53 week taxable year, or if the shareholder's taxable year is a leap year.

For the base period T-bill rates for the periods ending in prior years, *see*: Rev. Rul. 86–132, 1986–2 C.B. 137; Rev. Rul. 87–129, 1987–2 C.B. 196; Rev. Rul. 88–94, 1988–2 C.B. 301; Rev. Rul. 89–116, 1989–2 C.B. 197; Rev. Rul. 90–96, 1990–2 C.B. 188; Rev. Rul. 91–59, 1991–2 C.B. 347; Rev. Rul. 92–98, 1992–2 C.B. 201; Rev. Rul. 93–77, 1993–2 C.B. 253; Rev. Rul. 94–68, 1994–2 C.B. 177; Rev. Rul. 95–77, 1995–2 C.B. 122; and Rev. Rul. 96–55, 1996–2 C.B. 57.

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
1	.000155616
2	.000311257
3	.000466922
4	.000622611
5	.000778324
6	.000934062
7	.001089824
8	.001245610
9	.001401420
10	.001557255
11	.001713113
12	.001868996
13	.002024904
14	.002180835
15	.002336791
16	.002492771
17	.002648775
18	.002804804
19	.002960857
20	.003116934
21	.003273036
22	.003429161
23	.003585312

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
24	.003741486
25	.003897685
26	.004053908
27	.004210155
28	.004366426
29	.004522722
30	.004679043
31	.004835387
32	.004991756
33	.005148149
34	.005304567
35	.005461009
36	.005617475
37	.005773966
38	.005930481
39	.006087020
40	.006243584
41	.006400172
42	.006556784
43	.006713421
44	.006870082
45	.007026768
46	.007183478
47	.007340212
48	.007496971
49	.007653754
50	.007810561
51	.007967393
52	.008124249
53	.008281130
54	.008438035
55	.008594965
56	.008751919
57	.008908897
58	.009065900
59	.009222927
60	.009379979
61	.009537055
62	.009694155
63	.009851280
64	.010008430
65	.010165604
66	.010322802
67	.010480025
68	.010637272
69	.010794544

1997 ANNUAL RATE, COMPOUNDED DAILY

DAYS	5.68 PERCENT FACTOR
70	.010951840
71	.011109161
72	.011266506
73	.011423876
74	.011581270
75	.011738689
76	.011896132
77	.012053600
78	.012211092
79	.012368608
80	.012526150
81	.012683715
82	.012841306
83	.012998920
84	.013156560
85	.013314223
86	.013471912
87	.013629625
88	.013787362
89	.013945124
90	.014102911
91	.014260722
92	.014418557
93	.014576418
94	.014734302
95	.014892212
96	.015050146
97	.015208104
98	.015366087
99	.015524095
100	.015682127
101	.015840184
102	.015998265
103	.016156371
104	.016314502
105	.016472657
106	.016630837
107	.016789042
108	.016947271
109	.017105524
110	.017263803
111	.017422106
112	.017580433
113	.017738786
114	.017897162
115	.018055564

1997 ANNUAL RATE, COMPOUNDED DAILY		1997 ANNUAL RATE, COMPOUNDED DAILY		1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR	DAYS	5.68 PERCENT FACTOR	DAYS	5.68 PERCENT FACTOR
116	.018213990	162	.025528307	208	.032895167
117	.018372441	163	.025687896	209	.033055902
118	.018530916	164	.025847510	210	.033216663
119	.018689417	165	.026007149		
120	.018847941			211	.033377448
		166	.026166813	212	.033538259
121	.019006491	167	.026326501	213	.033699094
122	.019165065	168	.026486214	214	.033859955
123	.019323664	169	.026645953	215	.034020841
124	.019482287	170	.026805716		
125	.019640936			216	.034181751
		171	.026965503	217	.034342687
126	.019799609	172	.027125316	218	.034503648
127	.019958306	173	.027285154	219	.034664633
128	.020117028	174	.027445016	220	.034825644
129	.020275775	175	.027604903		
130	.020434547			221	.034986680
		176	.027764816	222	.035147741
131	.020593343	177	.027924753	223	.035308827
132	.020752165	178	.028084715	224	.035469938
133	.020911010	179	.028244702	225	.035631074
134	.021069881	180	.028404713		
135	.021228776			226	.035792236
		181	.028564750	227	.035953422
136	.021387696	182	.028724812	228	.036114633
137	.021546641	183	.028884898	229	.036275870
138	.021705610	184	.029045010	230	.036437131
139	.021864604	185	.029205146		
140	.022023623			231	.036598418
		186	.029365307	232	.036759730
141	.022182667	187	.029525493	233	.036921067
142	.022341736	188	.029685704	234	.037082428
143	.022500829	189	.029845940	235	.037243816
144	.022659947	190	.030006201		
145	.022819089			236	.037405228
		191	.030166487	237	.037566665
146	.022978257	192	.030326798	238	.037728127
147	.023137449	193	.030487134	239	.037889615
148	.023296666	194	.030647495	240	.038051128
149	.023455908	195	.030807880		
150	.023615174			241	.038212666
		196	.030968291	242	.038374229
151	.023774466	197	.031128727	243	.038535817
152	.023933782	198	.031289187	244	.038697430
153	.024093123	199	.031449673	245	.038859068
154	.024252489	200	.031610183		
155	.024411879			246	.039020732
		201	.031770719	247	.039182420
156	.024571294	202	.031931279	248	.039344134
157	.024730734	203	.032091865	249	.039505873
158	.024890199	204	.032252475	250	.039667638
159	.025049689	205	.032413111		
160	.025209204			251	.039829427
		206	.032573771	252	.039991242
161	.025368743	207	.032734457	253	.040153081

1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR
254	.040314946
255	.040476836
256	.040638752
257	.040800692
258	.040962658
259	.041124649
260	.041286665
261	.041448706
262	.041610773
263	.041772864
264	.041934981
265	.042097124
266	.042259291
267	.042421484
268	.042583702
269	.042745945
270	.042908213
271	.043070507
272	.043232826
273	.043395170
274	.043557539
275	.043719934
276	.043882354
277	.044044799
278	.044207270
279	.044369766
280	.044532287
281	.044694833
282	.044857405
283	.045020002
284	.045182624
285	.045345272
286	.045507945
287	.045670643
288	.045833366
289	.045996115
290	.046158889
291	.046321689
292	.046484514
293	.046647364
294	.046810240
295	.046973140
296	.047136067
297	.047299018
298	.047461995
299	.047624998

1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR
299	.047624998
300	.047788025
301	.047951078
302	.048114157
303	.048277260
304	.048440390
305	.048603544
306	.048766724
307	.048929929
308	.049093160
309	.049256416
310	.049419698
311	.049583005
312	.049746337
313	.049909695
314	.050073078
315	.050236487
316	.050399921
317	.050563380
318	.050726865
319	.050890376
320	.051053912
321	.051217473
322	.051381060
323	.051544672
324	.051708309
325	.051871972
326	.052035661
327	.052199375
328	.052363115
329	.052526880
330	.052690670
331	.052854486
332	.053018327
333	.053182194
334	.053346087
335	.053510005
336	.053673948
337	.053837917
338	.054001912
339	.054165932
340	.054329977
341	.054494048
342	.054658145
343	.054822267
344	.054986415
345	.055150588

1997 ANNUAL RATE, COMPOUNDED DAILY	
DAYS	5.68 PERCENT FACTOR
346	.055314787
347	.055479011
348	.055643261
349	.055807537
350	.055971838
351	.056136164
352	.056300516
353	.056464894
354	.056629297
355	.056793726
356	.056958181
357	.057122661
358	.057287166
359	.057451698
360	.057616255
361	.057780837
362	.057945445
363	.058110079
364	.058274738
365	.058439423
366	.058604134
367	.058768870
368	.058933632
369	.059098419
370	.059263232
371	.059428071

Subchapter O.—Gain or Loss on Disposition of Property
Part IV.—Special Rules

Section 1059.—Corporate Shareholder's Basis in Stock Reduced by Nontaxed Portion of Extraordinary Dividends

26 CFR 1.1059(e)–1: Non-pro rata redemptions.

T.D. 8724

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Section 1059 Extraordinary Dividends

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 1059(e) of the Internal Revenue Code. The final regulations clarify that certain distributions in redemption of stock held by a corporate shareholder are treated as extraordinary dividends notwithstanding provisions that otherwise might exempt the distributions from extraordinary dividend treatment. Corporations that receive a distribution in redemption of stock may be affected if the redemption is either part of a partial liquidation of the redeeming corporation or is not pro rata as to all shareholders. The final regulations also provide that section 1059(e)(1) applies to certain exchanges described in section 356.

DATES: This regulation is effective July 16, 1997.

For date of applicability, see §1.1059(e)–1(c).

SUPPLEMENTARY INFORMATION:

Background

On June 18, 1996, the IRS published in the **Federal Register** a notice of proposed rulemaking (CO–9–96), 61 F.R. 30845, concerning certain distributions under section 1059(e)(1) of the Internal Revenue Code. The proposed rules were based on the conclusion that applying the exceptions to extraordinary dividend treatment found in sections 1059(d)(6) and (e)(2) to amounts treated as extraordinary dividends under section 1059(e)(1) is inconsistent with the purposes of section 1059 and may create inappropriate consequences, such as basis shifting that eliminates gain or creates artificial loss.

The IRS received a few comments on the proposed regulations. No one requested to speak at the public hearing. After consideration of all the comments, the regulations are adopted as revised by this Treasury decision. The revisions and significant comments are discussed below.

Explanation of Revisions

Section 1.1059(e)–1(b) of the proposed regulations provides that for purposes of section 1059(e)(1), an exchange under section 356(a)(1) is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301. One practitioner questioned whether §1.1059(e)–1(b) applies to exchanges for section 306 stock that are treated as section 301 distributions under section 356(e). The final regulations clarify that for purposes of section 1059(e)(1), all exchanges under section 356 are treated as redemptions and all amounts treated as a dividend under section 356(a)(2) are treated as dividends under section 301. Accordingly, the final regulations delete the reference to subsection (a)(1) of section 356.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.1059(e)–1 also issued under 26 U.S.C. 1059(e)(1) and (e)(2). * * *

Par. 2. In §1.302–2, paragraph (c) introductory text is amended by adding a sentence immediately following the first sentence to read as follows:

§1.302–2 Redemptions not taxable as dividends.

* * * * *

(c) * * * (For adjustments to basis required for certain redemptions of corporate shareholders that are treated as extraordinary dividends, see section 1059 and the regulations thereunder.) * * *

* * * * *

Par. 3. Section 1.1059(e)–1 is added to read as follows:

§1.1059(e)–1 Non-pro rata redemptions.

(a) *In general.* Section 1059(d)(6) (exception where stock held during entire existence of corporation) and section 1059(e)(2) (qualifying dividends) do not apply to any distribution treated as an extraordinary dividend under section 1059(e)(1). For example, if a redemption of stock is not pro rata as to all shareholders, any amount treated as a dividend under section 301 is treated as an extraordinary dividend regardless of whether the dividend is a qualifying dividend.

(b) *Reorganizations.* For purposes of section 1059(e)(1), any exchange under section 356 is treated as a redemption and, to the extent any amount is treated as a dividend under section 356(a)(2), it is treated as a dividend under section 301.

(c) *Effective date.* This section applies to distributions announced (within the meaning of section 1059(d)(5)) on or after June 17, 1996.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved June 27, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 15, 1997, 8:45 a.m., and published in the issue of the Federal Register for July 16, 1997, 62 F.R. 38027)

Subchapter P.—Capital Gains and Losses
Part III.—General Rules For Determining Capital Gains and Losses

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Section 1222.—Other Terms Relating to Capital Gains and Losses

What are the rules for netting gains and losses under § 1(h), as amended by the Taxpayer Relief Act of 1997. See Notice 97–59, page 309.

Section 1223.—Holding Period of Property

How does § 1(h), as amended by the Taxpayer Relief Act of 1997, coordinate with the rules for determining the holding period of property under § 1223. See Notice 97–59, page 309.

Part IV.—Special Rules for Determining Capital Gains and Losses

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Section 1231.—Property Used in the Trade or Business and Involuntary Conversions

What are the rules for netting gains and losses under § 1(h), as amended by the Taxpayer Relief Act of 1997. See Notice 97–59, page 309.

Section 1235.—Sale or Exchange of Patents

How does § 1(h), as amended by the Taxpayer Relief Act of 1997, coordinate with the rules for the sale or exchange of patents under § 1235. See Notice 97–59, page 309.

Section 1245.—Gain From Dispositions of Certain Depreciable Property

26 CFR 1.1245–1: General rule for treatment of gain from dispositions of certain depreciable property.

T.D. 8730

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

Allocations of Depreciation Recapture Among Partners in a Partnership

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the allocation of depreciation recapture among partners in a partnership. The final regulations amend existing regulations to require that gain characterized as depreciation recapture be allocated, to the extent possible, to the partners who took the depreciation or amortization deductions. The final regulations affect partnerships (and their partners) that sell or dispose of certain depreciable or amortizable property.

DATES: These regulations are effective August 20, 1997.

For dates of applicability of these regulations, see §§ 1.704–3(f) and 1.1245–1(e)(2)(iv).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Income Tax Regulations (26 CFR part 1) relating to the characterization and allocation of depreciation recapture among partners in a partnership. Section 1245 of the Internal Revenue Code requires taxpayers to recharacterize as ordinary income some or all of the gain on the disposition of certain types of business properties. The amount recharacterized as ordinary income (depreciation recapture) is the lesser of (1) the gain realized on the disposition, or (2) the total deductions allowed or allowable for depreciation or amortization from the property.

On December 12, 1996, the IRS published in the **Federal Register** (61 F.R. 65371) a notice of proposed rulemaking (REG–209762–95) to provide guidance on partnership allocations of depreciation recapture. Although a public hearing was scheduled for March 27, 1997, the IRS cancelled the hearing because it received no requests to speak.

Explanation of Provisions

I. *General Background*

The regulations provide guidance on allocating depreciation recapture among partners, including depreciation recapture attributable to contributed property.

The regulations provide that a partner's share of depreciation recapture is equal to the lesser of (1) the partner's share of total gain arising from the disposition of the property (gain limitation) or (2) the partner's share of depreciation or amortization from the property (as defined in paragraph (e)(2)(ii) of the regulations). This rule seeks to insure, to the extent possible, that a partner recognizes recapture on the disposition of property in an amount equal to the depreciation or amortization deductions from the property previously taken by the partner. Any depreciation recapture that is not allocated to a partner due to the gain limitation is allocated among those partners whose shares of total gain on the disposition of the property exceed their shares of depreciation or amortization from the property. This unallocated depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain on the disposition of the property.

The regulations provide special rules for determining a partner's share of depreciation or amortization from contributed property subject to section 704(c). Under the regulations, a contributing partner's share of depreciation or amortization includes depreciation or amortization allowed or allowable prior to contribution. In addition, the regulations provide that curative and remedial allocations generally reduce the contributing partner's share of depreciation or amortization and increase the noncontributing partners' shares of depreciation or amortization.

II. *Changes in Response to Comments*

In response to comments, the regulations clarify the effect of curative and remedial allocations on the partners' shares of depreciation or amortization from contributed property. The examples now demonstrate that curative and remedial allocations can reduce the contributing partner's share of depreciation or amortization to zero, but not below zero. Once the contributing partner's share of depreciation or amortization has been reduced to zero, the curative or remedial allocations do not affect the contributing partner's share of depreciation or amortization. However, the curative or remedial allocations continue to affect the noncontributing partners' shares of depreciation or amortization.

The regulations have also been revised to make it clear that these amendments to the section 1245 regulations only affect how the depreciation recapture recognized by the partnership is allocated among the partners; they do not affect the computation of depreciation recapture at the partnership level. The regulations recognize that even absent a gain limitation, remedial and curative allocations may cause the total of the partners' shares of depreciation to exceed the amount of depreciation recapture recognized at the partnership level. In such a case, the partnership's depreciation recapture with respect to the contributed property is to be allocated among the partners in proportion to their relative shares of depreciation or amortization with respect to that prop-

erty. However, no partner's share of depreciation recapture from the property can exceed that partner's share of the total gain arising from the disposition of the property.

Example 2 of paragraph (e)(2)(iii) of the regulations has also been revised to demonstrate more thoroughly how recapture is allocated when a partner's share of depreciation recapture is capped by the partner's share of gain from the disposition of the property. As illustrated in the example, some partnerships may find it necessary to make multiple reallocations of depreciation recapture from a property if allocations under the general rule (allocations in proportion to the remaining partners' shares of gain from the disposition of the property) cause a remaining partner's share of depreciation to exceed the partner's share of gain from the disposition of the property.

One commentator requested that the regulations allow but not require that partnerships allocate depreciation recapture in proportion to the partners' shares of the gain from the disposition of the property. This change was not made because the IRS and Treasury continue to believe that matching depreciation recapture allocations to depreciation allocations most appropriately carries out the policies underlying section 1245.

A number of terminology and stylistic changes have also been made to these regulations. These changes were made for purposes of economy and should not be interpreted as substantive changes.

Special Analyses

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

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.704–3 is amended by:

(1) Adding new paragraph (a)(11).

(2) Revising paragraph (f).

The addition and revision read as follows:

§1.704–3 Contributed property.

(a) * * *

(11) *Contributing and noncontributing partners' recapture shares.* For special rules applicable to the allocation of depreciation recapture with respect to property contributed by a partner to a partnership, see §§1.1245–1(e)(2) and 1.1250–1(f).

* * * * *

(f) *Effective date.* With the exception of paragraph (a)(11) of this section, this section applies to properties contributed to a partnership and to restatements pursuant to §1.704–1(b)(2)(iv)(f) on or after December 21, 1993. Paragraph (a)(11) of this section applies to properties contributed by a partner to a partnership on or after August 20, 1997. However, partnerships may rely on paragraph (a)(11) of this section for properties contributed before August 20, 1997, and disposed of on or after August 20, 1997.

Par. 3. Section 1.1245–1 is amended by revising paragraph (e)(2) to read as follows:

§1.1245–1 General rule for treatment of gain from dispositions of certain depreciable property.

* * * * *

(e) * * *

(2)(i) Unless paragraph (e)(3) of this section applies, a partner's distributive share of gain recognized under section 1245(a)(1) by the partnership is equal to the lesser of the partner's share of total gain from the disposition of the property (gain limitation) or the partner's share of depreciation or amortization with respect to the property (as determined under paragraph (e)(2)(ii) of this section). Any gain recognized under section 1245(a)(1) by the partnership that is not allocated under the first sentence of this paragraph (e)(2)(i) (excess depreciation recapture) is allocated among the partners whose shares of total gain from the disposition of the property exceed their shares of depreciation or amortization with respect to the property. Excess depreciation recapture is allocated among those partners in proportion to their relative shares of the total gain (including gain recognized under section 1245(a)(1)) from the disposition of the property that is allocated to the partners who are not subject to the gain limitation. See *Example* 2 of paragraph (e)(2)(iii) of this section.

(ii)(A) Subject to the adjustments described in paragraphs (e)(2)(ii)(B) and (e)(2)(ii)(C) of this section, a partner's share of depreciation or amortization with respect to property equals the total amount of allowed or allowable depreciation or amortization previously allocated to that partner with respect to the property.

(B) If a partner transfers a partnership interest, a share of depreciation or amortization must be allocated to the transferee partner as it would have been allocated to the transferor partner. If the partner transfers a portion of the partnership interest, a share of depreciation or amortization proportionate to the interest transferred must be allocated to the transferee partner.

(C)(*1*) A partner's share of depreciation or amortization with respect to property contributed by the partner includes the amount of depreciation or amortization allowed or allowable to the partner for the period before the property is contributed

(*2*) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any curative allocations. (See §1.704–3(c) for a description of the traditional method with curative allocations.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partners with respect to that property. A non-

contributing partner's share of depreciation or amortization with respect to the contributed property is increased by the noncontributing partner's share of any curative allocation of ordinary income to the contributing partner with respect to that property and by the amount of any curative allocation of deduction or loss (other than capital loss) to the noncontributing partner with respect to that property. The partners' shares of depreciation or amortization with respect to property from which curative allocations of depreciation or amortization are taken is determined without regard to those curative allocations. See *Example* 3(iii) of paragraph (e)(2)(iii) of this section.

(*3*) A partner's share of depreciation or amortization with respect to property contributed by a partner is adjusted to account for any remedial allocations. (See §1.704–3(d) for a description of the remedial allocation method.) The contributing partner's share of depreciation or amortization with respect to the contributed property is decreased (but not below zero) by the amount of any remedial allocation of income to the contributing partner with respect to that property. A noncontributing partner's share of depreciation or amortization with respect to the contributed property is increased by the amount of any remedial allocation of depreciation or amortization to the noncontributing partner with respect to that property. See *Example* 3(iv) of paragraph (e)(2)(iii) of this section.

(*4*) If, under paragraphs (e)(2)(ii)(C)(*2*) and (e)(2)(ii)(C)(*3*) of this section, the partners' shares of depreciation or amortization with respect to a contributed property exceed the adjustments reflected in the adjusted basis of the property under §1.1245–2(a) at the partnership level, then the partnership's gain recognized under section 1245(a)(1) with respect to that property is allocated among the partners in proportion to their relative shares of depreciation or amortization (subject to any gain limitation that might apply).

(*5*) This paragraph (e)(2)(ii)(C) also applies in determining a partner's share of depreciation or amortization with respect to property for which differences between book value and adjusted tax basis are created when a partnership revalues partnership property pursuant to §1.704–1(b)(2)(iv)(*f*).

(iii) *Examples.* The application of this paragraph (e)(2) may be illustrated by the following examples:

Example 1. Recapture allocations. (i) *Facts.* A and B each contribute $5,000 cash to form AB, a general partnership. The partnership agreement provides that depreciation deductions will be allocated 90 percent to A and 10 percent to B, and, on the sale of depreciable property, A will first be allocated gain to the extent necessary to equalize A's and B's capital accounts. Any remaining gain will be allocated 50 percent to A and 50 percent to B. In its first year of operations, AB purchases depreciable equipment for $5,000. AB depreciates the equipment over its 5-year recovery period and elects to use the straight-line method. In its first year of operations, AB's operating income equals its expenses (other than depreciation). (To simplify this example, AB's depreciation deductions are determined without regard to any first-year depreciation conventions.)

(ii) *Year 1.* In its first year of operations, AB has $1,000 of depreciation from the partnership equipment. In accordance with the partnership agreement, AB allocates 90 percent ($900) of the depreciation to A and 10 percent ($100) of the depreciation to B. At the end of the year, AB sells the equipment for $5,200, recognizing $1,200 of gain ($5,200 amount realized less $4,000 adjusted tax basis). In accordance with the partnership agreement, the first $800 of gain is allocated to A to equalize the partners' capital accounts, and the remaining $400 of gain is allocated $200 to A and $200 to B.

(iii) *Recapture allocations.* $1,000 of the gain from the sale of the equipment is treated as section 1245(a)(1) gain. Under paragraph (e)(2)(i) of this section, each partner's share of the section 1245(a)(1) gain is equal to the lesser of the partner's share of total gain recognized on the sale of the equipment or the partner's share of total depreciation with respect to the equipment. Thus, A's share of the section 1245(a)(1) gain is $900 (the lesser of A's share of the total gain ($1,000) and A's share of depreciation ($900)). B's share of the section 1245(a)(1) gain is $100 (the lesser of B's share of the total gain ($200) and B's share of depreciation ($100)). Accordingly, $900 of the $1,000 of total gain allocated to A is treated as ordinary income and $100 of the $200 of total gain allocated to B is treated as ordinary income.

Example 2. Recapture allocation subject to gain limitation. (i) *Facts.* A, B, and C form general partnership ABC. The partnership agreement provides that depreciation deductions will be allocated equally among the partners, but that gain from the sale of depreciable property will be allocated 75 percent to A and 25 percent to B. ABC purchases depreciable personal property for $300 and subsequently allocates $100 of depreciation deductions each to A, B, and C, reducing the adjusted tax basis of the property to $0. ABC then sells the property for $440. ABC allocates $330 of the gain to A (75 percent of $440) and allocates $110 of the gain to B (25 percent of $440). No gain is allocated to C.

(ii) *Application of gain limitation.* Each partner's share of depreciation with respect to the property is $100. C's share of the total gain from the disposition of the property, however, is $0. As a result, under the gain limitation provision in paragraph (e)(2)(i) of this section, C's share of section 1245(a)(1) gain is limited to $0.

(iii) *Excess depreciation recapture.* Under paragraph (e)(2)(i) of this section, the $100 of section 1245(a)(1) gain that cannot be allocated to C under the gain limitation provision (excess depreciation recapture) is allocated to A and B (the partners not subject to the gain limitation at the time of the allocation) in proportion to their relative shares of total gain from the disposition of the property. A's relative share of the total gain allocated to A and B is 75 percent ($330 of $440 total gain). B's relative share of the total gain allocated to A and B is 25 percent ($110 of $440 total gain). However, under the gain limitation provision of paragraph (e)(2)(i) of this section, B cannot be allocated 25 percent of the excess depreciation recapture ($25) because that would result in a total allocation of $125 of depreciation recapture to B (a $100 allocation equal to B's share of depreciation plus a $25 allocation of excess depreciation recapture), which is in excess of B's share of the total gain from the disposition of the property ($110). Therefore, only $10 of excess depreciation recapture is allocated to B and the remaining $90 of excess depreciation recapture is allocated to A. A is not subject to the gain limitation because A's share of the total gain ($330) still exceeds A's share of section 1245(a)(1) gain ($190). Accordingly, all $110 of the total gain allocated to B is treated as ordinary income ($100 share of depreciation allocated to B plus $10 of excess depreciation recapture) and $190 of the total gain allocated to A is treated as ordinary income ($100 share of depreciation allocated to A plus $90 of excess depreciation recapture).

Example 3. Determination of partners' shares of depreciation with respect to contributed property. (i) *Facts.* C and D form partnership CD as equal partners. C contributes depreciable personal property C1 with an adjusted tax basis of $800 and a fair market value of $2,800. Prior to the contribution, C claimed $200 of depreciation from C1. At the time of the contribution, C1 is depreciable under the straight-line method and has four years remaining on its 5-year recovery period. D contributes $2,800 cash, which CD uses to purchase depreciable personal property D1, which is depreciable over seven years under the straight-line method. (To simplify the example, all depreciation is determined without regard to any first-year depreciation conventions.)

(ii) *Traditional method.* C1 generates $700 of book depreciation (1/4 of $2,800 book value) and $200 of tax depreciation (1/4 of $800 adjusted tax basis) each year. C and D will each be allocated $350 of book depreciation from C1 in year 1. Under the traditional method of making section 704(c) allocations, D will be allocated the entire $200 of tax depreciation from C1 in year 1. D1 generates $400 of book and tax depreciation each year (1/7 of $2,800 book value and adjusted tax basis). C and D will each be allocated $200 of book and tax depreciation from D1 in year 1. As a result, after the first year of partnership operations, C's share of depreciation with respect to C1 is $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 is $200 (the amount of tax depreciation allocated to D). C and D each have a $200 share of depreciation with respect to D1. At the end of four years, C's share of depreciation with respect to C1 will be $200 (the depreciation taken by C prior to contribution) and D's share of depreciation with respect to C1 will be $800 (four years of $200 depreciation per year). At the end of four years, C and D will each have an $800 share of depreciation with respect to D1 (four years of $200 depreciation per year).

(iii) *Effect of curative allocations.* (A) *Year 1.* If the partnership elects to make curative allocations under §1.704–3(c) using depreciation from D1, the results will be the same as under the traditional method, except that $150 of the $200 of tax depreciation from D1 that would be allocated to C under the traditional method will be allocated to D as additional depreciation with respect to C1. As a result, after the first year of partnership operations, C's

share of depreciation with respect to C1 will be reduced to $50 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the curative allocation to D ($150)). D's share of depreciation with respect to C1 will be $350 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the curative allocation to D ($150)). C and D will each have a $200 share of depreciation with respect to D1.

(B) *Year 4.* At the end of four years, C's share of depreciation with respect to C1 will be reduced to $0 (the total depreciation taken by C prior to contribution ($200) decreased, but not below zero, by the amount of the curative allocations to D ($600)), and D's share of depreciation with respect to C1 will be $1,400 (the total depreciation allocated to D under the traditional method ($800) increased by the amount of the curative allocations to D ($600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than $1,000 (CD's tax depreciation ($800) plus C's tax depreciation prior to contribution ($200)). Under paragraph (e)(2)(ii)(C)(4) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is $0, and D's share of depreciation with respect to C1 is $1,400, all of CD's $1,000 of section 1245(a)(1) gain will be allocated to D. At the end of four years, C and D will each have an $800 share of depreciation with respect to D1 (four years of $200 depreciation per year).

(iv) *Effect of remedial allocations.* (A) *Year 1.* If the partnership elects to make remedial allocations under §1.704-3(d), there will be $600 of book depreciation from C1 in year 1. (Under the remedial allocation method, the amount by which C1's book basis ($2,800) exceeds its tax basis ($800) is depreciated over a 5-year life, rather than a 4-year life.) C and D will each be allocated one-half ($300) of the total book depreciation. As under the traditional method, D will be allocated all $200 of tax depreciation from C1. Because the ceiling rule would cause a disparity of $100 between D's book and tax allocations of depreciation, D will also receive a $100 remedial allocation of depreciation with respect to C1, and C will receive a $100 remedial allocation of income with respect to C1. As a result, after the first year of partnership operations, D's share of depreciation with respect to C1 is $300 (the depreciation allocated to D under the traditional method ($200) increased by the amount of the remedial allocation ($100)). C's share of depreciation with respect to C1 is $100 (the total depreciation taken by C prior to contribution ($200) decreased by the amount of the remedial allocation of income ($100)). C and D will each have a $200 share of depreciation with respect to D1.

(B) *Year 5.* At the end of five years, C's share of depreciation with respect to C1 will be $0 (the total depreciation taken by C prior to contribution ($200) decreased, but not below zero, by the total amount of the remedial allocations of income to C ($600)). D's share of depreciation with respect to C1 will be $1,400 (the total depreciation allocated to D under the traditional method ($800) increased by the total amount of the remedial allocations of depreciation to D ($600)). However, CD's section 1245(a)(1) gain with respect to C1 will not be more than $1,000 (CD's tax depreciation ($800) plus C's tax depreciation prior to contribution ($200)). Under paragraph (e)(2)(ii)(C)(4) of this section, because the partners' shares of depreciation with respect to C1 exceed the adjustments reflected in the property's adjusted basis, CD's section 1245(a)(1) gain will be allocated in proportion to the partners' relative shares of depreciation with respect to C1. Because C's share of depreciation with respect to C1 is $0, and D's share of depreciation with respect to C1 is $1,400, all of CD's $1,000 of section 1245(a)(1) gain will be allocated to D. At the end of five years, C and D will each have a $1,000 share of depreciation with respect to D1 (five years of $200 depreciation per year).

(iv) *Effective date.* This paragraph (e)(2) is effective for properties acquired by a partnership on or after August 20, 1997. However, partnerships may rely on this paragraph (e)(2) for properties acquired before August 20, 1997, and disposed of on or after August 20, 1997.

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved July 8, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

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Section 1250.—Gains From Dispositions of Certain Depreciable Realty

What are the rules for netting gains and losses under § 1(h), as amended by the Taxpayer Relief Act of 1997. See Notice 97–59, page 309.

Section 1256.—Section 1256 Contracts Marked to Market

How does § 1(h), as amended by the Taxpayer Relief Act of 1997, coordinate with the rules for gain or loss from section 1256 contracts. See Notice 97–59, page 309.

Part V.—Special Rules for Bonds and Other Debt Instruments

Subpart A.—Original Issue Discount

Section 1273.—Determination of Amount of Original Issue Discount

26 CFR §1.1273–1: Definition of OID; 26 CFR §1.1273–2: Determination of issue price and issue date.

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for certain de minimis original issue discount. See Rev. Proc. 97–37, page 455.

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 1274, 1288, 382, and other sections of the Code, tables set forth the rates for July 1997.

Rev. Rul. 97–27

This revenue ruling provides various prescribed rates for federal income tax purposes for July 1997 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520. Finally, Table 6 contains the blended annual rate for purposes of section 7872.

REV. RUL. 97–27 TABLE 1

Applicable Federal Rates (AFR) for July 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	6.07%	5.98%	5.94%	5.91%
110% AFR	6.69%	6.58%	6.53%	6.49%
120% AFR	7.31%	7.18%	7.12%	7.07%
130% AFR	7.92%	7.77%	7.70%	7.65%
Mid-Term				
AFR	6.65%	6.54%	6.49%	6.45%
110% AFR	7.32%	7.19%	7.13%	7.08%
120% AFR	8.00%	7.85%	7.77%	7.72%
130% AFR	8.68%	8.50%	8.41%	8.35%
150% AFR	10.05%	9.81%	9.69%	9.62%
175% AFR	11.78%	11.45%	11.29%	11.19%
Long-Term				
AFR	6.99%	6.87%	6.81%	6.77%
110% AFR	7.70%	7.56%	7.49%	7.44%
120% AFR	8.41%	8.24%	8.16%	8.10%
130% AFR	9.13%	8.93%	8.83%	8.77%

REV. RUL. 97–27 TABLE 2

Adjusted AFR for July 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.99%	3.95%	3.93%	3.92%
Mid-term adjusted AFR	4.71%	4.66%	4.63%	4.62%
Long-term adjusted AFR	5.45%	5.38%	5.34%	5.32%

REV. RUL. 97–27 TABLE 3

Rates Under Section 382 for July 1997

Adjusted federal long-term rate for the current month	5.45%
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.)	5.64%

REV. RUL. 97–27 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for July 1998

Appropriate percentage for the 70% present value low-income housing credit	8.60%
Appropriate percentage for the 30% present value low-income housing credit	3.69%

REV. RUL. 97–27 TABLE 5

Rate Under Section 7520 for July 1997

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	8.0%

REV. RUL. 97–27 TABLE 6

Blended Annual Rate for 1997

Section 7872(e)(2) blended annual rate for 1997	5.85%

(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 1274, 1288, 382, and other sections of the Code, tables set forth the rates for August 1997.

Rev. Rul. 97–30

This revenue ruling provides various prescribed rates for federal income tax purposes for August 1997 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 97–30 TABLE 1
Applicable Federal Rates (AFR) for August 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.87%	5.79%	5.75%	5.72%
110% AFR	6.47%	6.37%	6.32%	6.29%
120% AFR	7.07%	6.95%	6.89%	6.85%
130% AFR	7.67%	7.53%	7.46%	7.41%
Mid-Term				
AFR	6.39%	6.29%	6.24%	6.21%
110% AFR	7.04%	6.92%	6.86%	6.82%

REV. RUL. 97–30 TABLE 1
Applicable Federal Rates (AFR) for August 1997—Continued

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Mid-Term (continued)				
120% AFR	7.69%	7.55%	7.48%	7.43%
130% AFR	8.35%	8.18%	8.10%	8.04%
150% AFR	9.66%	9.44%	9.33%	9.26%
175% AFR	11.31%	11.01%	10.86%	10.77%
Long-Term				
AFR	6.73%	6.62%	6.57%	6.53%
110% AFR	7.41%	7.28%	7.21%	7.17%
120% AFR	8.10%	7.94%	7.86%	7.81%
130% AFR	8.80%	8.61%	8.52%	8.46%

REV. RUL. 97–30 TABLE 2
Adjusted AFR for August 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	4.01%	3.97%	3.95%	3.94%
Mid-term adjusted AFR	4.54%	4.49%	4.47%	4.45%
Long-term adjusted AFR	5.33%	5.26%	5.23%	5.20%

REV. RUL. 97–30 TABLE 3
Rates Under Section 382 for August 1997

Adjusted federal long-term rate for the current month	5.33%
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.)	5.64%

REV. RUL. 97–30 TABLE 4
Appropriate Percentages Under Section 42(b)(2) for August 1997

Appropriate percentage for the 70% present value low-income housing credit	8.54%
Appropriate percentage for the 30% present value low-income housing credit	3.66%

REV. RUL. 97–30 TABLE 5

Rate Under Section 7520 for August 1997

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.6%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 section 1274, 1288, 382, and other sections of the Code, tables set forth the rates for September 1997.

Rev. Rul. 97–36

This revenue ruling provides various prescribed rates for federal income tax purposes for September 1997 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 97–36 TABLE 1

Applicable Federal Rates (AFR) for September 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.81%	5.73%	5.69%	5.66%
110% AFR	6.40%	6.30%	6.25%	6.22%
120% AFR	7.00%	6.88%	6.82%	6.78%
130% AFR	7.59%	7.45%	7.38%	7.34%
Mid-Term				
AFR	6.23%	6.14%	6.09%	6.06%
110% AFR	6.86%	6.75%	6.69%	6.66%
120% AFR	7.51%	7.37%	7.30%	7.26%
130% AFR	8.14%	7.98%	7.90%	7.85%
150% AFR	9.42%	9.21%	9.11%	9.04%
175% AFR	11.04%	10.75%	10.61%	10.52%
Long-Term				
AFR	6.55%	6.45%	6.40%	6.36%
110% AFR	7.23%	7.10%	7.04%	7.00%
120% AFR	7.89%	7.74%	7.67%	7.62%
130% AFR	8.57%	8.39%	8.30%	8.25%

REV. RUL. 97–36 TABLE 2
Adjusted AFR for September 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.94%	3.90%	3.88%	3.87%
Mid-term adjusted AFR	4.28%	4.24%	4.22%	4.20%
Long-term adjusted AFR	5.09%	5.03%	5.00%	4.98%

REV. RUL. 97–36 TABLE 3
Rates Under Section 382 for September 1997

Adjusted federal long-term rate for the current month	5.09%
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.)	5.45%

REV. RUL. 97–36 TABLE 4
Appropriate Percentages Under Section 42(b)(2) for September 1997

Appropriate percentage for the 70% present value low-income housing credit	8.50%
Appropriate percentage for the 30% present value low-income housing credit	3.64%

REV. RUL. 97–36 TABLE 5
Rate Under Section 7520 for September 1997

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.6%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1274, 1288, 382, and other sections of the Code, tables set forth the rates for October 1997.

Rev. Rul. 97–41

This revenue ruling provides various prescribed rates for federal income tax purposes for October 1997 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 97–41 TABLE 1

Applicable Federal Rates (AFR) for October 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.84%	5.76%	5.72%	5.69%
110% AFR	6.44%	6.34%	6.29%	6.26%
120% AFR	7.03%	6.91%	6.85%	6.81%
130% AFR	7.63%	7.49%	7.42%	7.38%
Mid-Term				
AFR	6.34%	6.24%	6.19%	6.16%
110% AFR	6.98%	6.86%	6.80%	6.76%
120% AFR	7.63%	7.49%	7.42%	7.38%
130% AFR	8.27%	8.11%	8.03%	7.98%
150% AFR	9.58%	9.36%	9.25%	9.18%
175% AFR	11.22%	10.92%	10.77%	10.68%
Long-Term				
AFR	6.68%	6.57%	6.52%	6.48%
110% AFR	7.36%	7.23%	7.17%	7.12%
120% AFR	8.04%	7.88%	7.80%	7.75%
130% AFR	8.72%	8.54%	8.45%	8.39%

REV. RUL. 97–41 TABLE 2

Adjusted AFR for October 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.98%	3.94%	3.92%	3.91%
Mid-term adjusted AFR	4.46%	4.41%	4.39%	4.37%
Long-term adjusted AFR	5.27%	5.20%	5.17%	5.14%

REV. RUL. 97–41 TABLE 3

Rates Under Section 382 for October 1997

Adjusted federal long-term rate for the current month	5.27%
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.)	5.33%

REV. RUL. 97–41 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for October 1997

Appropriate percentage for the 70% present value low-income housing credit	8.53%
Appropriate percentage for the 30% present value low-income housing credit	3.66%

REV. RUL. 97–41 TABLE 5

Rate Under Section 7520 for October 1997

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.6%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1274, 1288, 382, and other sections of the Code, tables set forth the rates for November 1997.

Rev. Rul. 97–44

This revenue ruling provides various prescribed rates for federal income tax purposes for November 1997 (the current month.) Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 97–44 TABLE 1

Applicable Federal Rates (AFR) for November 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-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%
Mid-Term				
AFR	6.10%	6.01%	5.97%	5.94%
110% AFR	6.72%	6.61%	6.56%	6.52%
120% AFR	7.34%	7.21%	7.15%	7.10%
130% AFR	7.96%	7.81%	7.74%	7.69%
150% AFR	9.22%	9.02%	8.92%	8.86%
175% AFR	10.80%	10.52%	10.39%	10.30%
Long-Term				
AFR	6.42%	6.32%	6.27%	6.24%
110% AFR	7.07%	6.95%	6.89%	6.85%
120% AFR	7.72%	7.58%	7.51%	7.46%
130% AFR	8.39%	8.22%	8.14%	8.08%

REV. RUL. 97–44 TABLE 2

Adjusted AFR for November 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.92%	3.88%	3.86%	3.85%
Mid-term adjusted AFR	4.35%	4.30%	4.28%	4.26%
Long-term adjusted AFR	5.15%	5.09%	5.06%	5.04%

REV. RUL. 97–44 TABLE 3

Rates Under Section 382 for November 1997

Adjusted federal long-term rate for the current month	5.15%
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.)	5.27%

REV. RUL. 97–44 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for November 1997

Appropriate percentage for the 70% present value low-income housing credit	8.47%
Appropriate percentage for the 30% present value low-income housing credit	3.63%

REV. RUL. 97–44 TABLE 5

Rate Under Section 7520 for November 1997

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.4%

(Also Sections 42, 280G, 382, 412, 467, 468, 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 1274, 1288, 382, and other sections of the Code, tables set forth the rates for December 1997.

Rev. Rul. 97–50

This revenue ruling provides various prescribed rates for federal income tax purposes for December 1997 (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 1998 interest rate for sections 846 and 807.

REV. RUL. 97–50 TABLE 1
Applicable Federal Rates (AFR) for December 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-Term				
AFR	5.68%	5.60%	5.56%	5.54%
110% AFR	6.25%	6.16%	6.11%	6.08%
120% AFR	6.83%	6.72%	6.66%	6.63%
130% AFR	7.41%	7.28%	7.21%	7.17%
Mid-Term				
AFR	6.02%	5.93%	5.89%	5.86%
110% AFR	6.63%	6.52%	6.47%	6.43%
120% AFR	7.25%	7.12%	7.06%	7.02%
130% AFR	7.86%	7.71%	7.64%	7.59%
150% AFR	9.10%	8.90%	8.80%	8.74%
175% AFR	10.65%	10.38%	10.25%	10.16%
Long-Term				
AFR	6.31%	6.21%	6.16%	6.13%
110% AFR	6.95%	6.83%	6.77%	6.73%
120% AFR	7.59%	7.45%	7.38%	7.34%
130% AFR	8.23%	8.07%	7.99%	7.94%

REV. RUL. 97–50 TABLE 2
Adjusted AFR for December 1997

	Period for Compounding			
	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.92%	3.88%	3.86%	3.85%
Mid-term adjusted AFR	4.37%	4.32%	4.30%	4.28%
Long-term adjusted AFR	5.23%	5.16%	5.13%	5.11%

REV. RUL. 97–50 TABLE 3
Rates Under Section 382 for December 1997

Adjusted federal long-term rate for the current month	5.23%
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.)	5.27%

REV. RUL. 97–50 TABLE 5
Rate Under Section 7520 for December 1997

Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	7.2%

REV. RUL. 97–50 TABLE 6
Rate under Sections 846 and 807

Applicable rate of interest for 1998 for purposes of sections 846 and 807	6.31%

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26 CFR 1.1274A–1: Special rules for certain transactions where stated principal amount does not exceed $2,800,000.

As defined by section 1274A, the definitions for both "qualified debt instruments" and "cash method debt instruments" have dollar ceilings on the stated principal amount. The limits to the stated principal amount are adjusted for inflation for sales or exchanges occurring in the 1998 calendar year. See Rev. Rul. 97–56, on this page.

Section 1274A.—Special Rules for Certain Transactions Where Stated Principal Amount Does Not Exceed $2,800,000

(Also §§ 1274, 483; 1.1274A–1)

Section 1274A inflation-adjusted numbers for 1998. This ruling provides the dollar amounts, increased by the 1998 inflation adjustment, for section 1274A of the Code. Rev. Rul. 96–63 supplemented and superseded.

Rev. Rul. 97–56

This revenue ruling provides the dollar amounts, increased by the 1998 inflation adjustment, for § 1274A of the Internal Revenue Code.

BACKGROUND

In general, §§ 483 and 1274 of the Code determine the principal amount of a debt instrument given in consideration for the sale or exchange of nonpublicly traded property. In addition, any interest on a debt instrument subject to § 1274 is taken into account under the original issue discount provisions of the Code. Section 1274A, however, modifies the rules under §§ 483 and 1274 for certain types of debt instruments.

In the case of a "qualified debt instrument," the discount rate used for purposes of §§ 483 and 1274 of the Code may not exceed 9 percent, compounded semiannually. Section 1274A(b) defines a qualified debt instrument as any debt instrument given in consideration for the sale or exchange of property (other than new § 38 property within the meaning of § 48(b), as in effect on the day before the date of enactment of the Revenue Reconciliation Act of 1990) if the stated principal amount of the instrument does not exceed the amount specified in § 1274A(b). For debt instruments arising out of sales or exchanges before January 1, 1990, this amount is $2,800,000.

In the case of a "cash method debt instrument," as defined in § 1274A(c) of the Code, the borrower and lender may elect to use the cash receipts and disbursements method of accounting. In particular, for any cash method debt instrument, § 1274 does not apply, and interest on the instrument is accounted for by both the borrower and the lender under the cash method of accounting. A cash method debt instrument is a qualified debt instrument that meets the fol-

lowing additional requirements: (A) In the case of instruments arising out of sales or exchanges before January 1, 1990, the stated principal amount does not exceed $2,000,000, (B) The lender does not use an accrual method of accounting and is not a dealer with respect to the property sold or exchanged, (C) Section 1274 would have applied to the debt instrument but for an election under § 1274A(c); and (D) An election under § 1274A(c) is jointly made with respect to the debt instrument by the borrower and lender. Section 1.1274A–1(c)(1) of the Income Tax Regulations provides rules concerning the time for, and manner of, making this election.

Section 1274A(d)(2) of the Code provides that, for any debt instrument arising out of a sale or exchange during any calendar year after 1989, the dollar amounts stated in § 1274A(b) and § 1274A(c)-(2)(A) are increased by the inflation adjustment for the calendar year. Any increase due to the inflation adjustment is rounded to the nearest multiple of $100 (or, if the increase is a multiple of $50 and not of $100, the increase is increased to the nearest multiple of $100). The inflation adjustment for any calendar year is the percentage (if any) by which the CPI for the preceding calendar year exceeds the CPI for calendar year 1988. Section 1274A(d)(2)(B) defines the CPI for any calendar year as the average of the Consumer Price Index as of the close of the 12-month period ending on September 30 of that calendar year.

INFLATION-ADJUSTED AMOUNTS

For debt instruments arising out of sales or exchanges after December 31, 1989, the inflation-adjusted amounts under § 1274A are shown in Table 1.

Rev. Rul. 97–56 Table 1
Inflation-Adjusted Amounts Under § 1274A

Calendar Year of Sale or Exchange	1274A(b) Amount (qualified debt instrument)	1274A(c)(2)(A) Amount (cash method debt instrument)
1990	$2,933,200	$2,095,100
1991	$3,079,600	$2,199,700
1992	$3,234,900	$2,310,600
1993	$3,332,400	$2,380,300
1994	$3,433,500	$2,452,500
1995	$3,523,600	$2,516,900
1996	$3,622,500	$2,587,500
1997	$3,723,800	$2,659,900
1998	$3,823,100	$2,730,800

Note: These inflation adjustments were computed using the All-Urban, Consumer Price Index, 1982-1984 base, published by the Bureau of Labor Statistics.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 96–63, 1996–2 C.B. 83, is supplemented and superseded.

Subpart C.—Discount on Short-Term Obligations

Section 1281.—Current Inclusion in Income of Discount on Certain Short-Term Obligations

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting for interest income on short-term obligations, or for stated interest on short-term loans of cash method banks in the Eighth Circuit. See Rev. Proc. 97–37, page 455.

Subpart D.—Miscellaneous Provisions

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

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Subchapter S.—Tax Treatment of S Corporations and Their Shareholders
Part I.—In General

Section 1362.—Election; Revocation; Termination

26 CFR 1.1362–6: Elections and consents.

If a taxpayer files an S corporation election after the statutory date, but within 6 months of that statu-

tory due date, may the taxpayer obtain relief under § 1362(b)(5) of the Internal Revenue Code without applying for a private letter ruling? See Rev. Proc. 97–40, page 488.

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26 CFR 1.1362–6: Elections and consents.

If a taxpayer applies for late S corporation election relief under §1362(b)(5) of the Internal Revenue Code under Rev. Proc. 97–48, who must file the consent to apply for late S corporation election relief? See Rev. Proc. 97–48, page 521.

Section 1363.—Effect of Election on Corporation

What procedures must a taxpayer use to obtain automatic consent of the Commissioner to change its method of accounting. See Rev. Proc. 97–37, page 455.

Chapter 3.—Withholding of Tax on Nonresident Aliens and Foreign Corporations
Subchapter A.—Nonresident Aliens and Foreign Corporations

Section 1441.—Withholding of Tax on Nonresident Aliens

26 CFR 1.1441–7: Requirement for the deduction and withholding of tax on payments to foreign persons.

Guidance is provided to payors of substitute interest and dividend concerning their obligations as withholding agents on payments made to foreign beneficial owners that are individuals. See Notice 97–66, page 328.

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26 CFR 1.1441–1: Requirement for the deduction and withholding of tax on payments to foreign persons.

T.D. 8734

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1, 31, 35a, 301, 502, 503, 509, 513, 514, 516, 517, 520, 521, and 602

General Revision of Regulations Relating to Withholding of Tax on Certain U.S. Source Income Paid to Foreign Persons and Related Collection, Refunds, and Credits; Revision of Information Reporting and Backup Withholding Regulations; and Removal of Regulations Under Part 35a and of Certain Regulations Under Income Tax Treaties

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the withholding of income tax under sections 1441, 1442, and 1443 on certain U.S. source income paid to foreign persons, the related tax deposit and reporting requirements under section 1461, and the related requirements governing collection, refunds, and credits of withheld amounts under sections 1461 through 1463 and sections 6402 and 6413. Additionally, this document contains final regulations relating to the statutory exemption under sections 871(h) and 881(c) for portfolio interest. This document removes temporary employment tax regulations under the Interest and Dividend Compliance Act of 1983 and amends existing regulations under sections 6041A and 6050N. This document finalizes changes to the proposed regulations contained in project number INTL–52–86 [1988–1 C.B. 892], published on February 29, 1988, under sections 6041, 6042, 6044, 6045, and 6049. This document also finalizes proposed regulations contained in project number IA–33–95 [1996–1 C.B. 772], published on December 21, 1995 , relating to the effective date of certain temporary employment tax regulations. This document finalizes related changes to the regulations under sections 163(f), 165(j), 3401, 3406, 6109, 6114, 6413, and 6724. This document removes certain regulations under income tax treaties.

EFFECTIVE DATES: These regulations are effective January 1, 1999, except the addition of §31.9999–0, the removal of §35a.9999–0T and the addition of §35a.9999–0, which are effective October 14, 1997.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545–1484. Responses to these collections of information are required to obtain a benefit (to claim an exemption to, or a reduction in, the withholding tax), and to facilitate tax compliance (to verify entitlement to an exemption or a reduced rate).

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.

The estimate of the reporting burden in these final regulations will be reflected in the burdens of Forms W–8, 1042, 1042S, 8233, 8833, and the income tax return of a foreign person filed for purposes of claiming a refund of tax.

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

Books or records relating to 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 final amendments to the Income Tax Regulations (CFR parts 1, 31, 35a and 301) under sections 163(f), 165(j), 871, 881, 1441, 1442, 1443, 1461, 1462, 1463, 3401, 3406, 6041, 6041A, 6042, 6045, 6049, 6050A, 6050N, 6109, 6114, 6402, 6413, and 6724 of the Internal Revenue Code (Code). This document also removes certain regulations under income tax treaties.

On April 15, 1996, (61 FR 17614) the IRS and Treasury published a notice of proposed rulemaking under a number of sections of the Code, dealing with the withholding of tax under section 1441, 1442, or 1443 on amounts paid to foreign persons, procedures for claiming foreign status to avoid backup withholding under section 3406 on certain payments, and the reporting to the IRS of payments to foreign persons. Reporting to the IRS may be required under sections 6011 and 1461 or

under the reporting provisions of chapter 61 of the Code, such as sections 6041, 6041A, 6042, 6044, 6045, 6049, 6050A, or 6050N, (the Form 1099 reporting provisions). Comments responding to the notice were received and a public hearing was held on July 24, 1996. After considering the comments submitted in writing and at the hearings, the proposed regulations are adopted as revised by this Treasury decision. The revisions are discussed below.

Payments to domestic and foreign persons create a number of withholding and information reporting obligations for both the payor and the recipient of these payments under various provisions of the Code. These procedures are important to the operation of IRS matching systems. Those systems are part of a compliance program that allows the IRS to match information provided by payors with income reported on a payee's income tax return and help detect U.S. taxpayers that fail to file returns or underreport income. The withholding of tax at source and the reporting of payments to foreign persons are also important to insure that foreign persons comply with their U.S. tax obligations. The final regulations contained in this document deal mostly with payments to foreign persons, and the U.S. income tax liability resulting from such payments.

Under sections 871(a) and 881(a) of the Code, nonresident alien individuals and foreign corporations are subject to a 30-percent tax on most items of income they receive from sources within the United States that are not effectively connected with the conduct of a trade or business in the United States. Income taxable under these provisions includes interest, dividends, royalties, compensation, other fixed or determinable annual or periodical (FDAP) income and certain gains. The tax liability imposed under sections 871(a) and 881(a) is generally collected by way of withholding at source under chapter 3 of the Code pursuant to section 1441(a) (for payments to nonresident alien individuals and foreign partnerships), section 1442(a) (for payments to foreign corporations), or section 1443(a) (for payments of certain income to foreign tax-exempt entities). Other special withholding provisions apply under section 1443(b) (dealing with the withholding of the 4-percent tax imposed under section 4948), section 1445 (dealing with gains from the disposition of U.S. real property) and section 1446 (dealing with effectively connected income of foreign partners in a partnership). The tax liability imposed under sections 871, 881, 1441, 1442, and 1443 also extends to payments to other foreign persons, including foreign trusts and estates.

The 30-percent rate is often reduced under the Code or an income tax treaty. Under current regulations, a withholding agent may generally rely on a statement furnished by, or for, the beneficial owner certifying eligibility for a reduced rate. The procedural requirements for claiming a reduced rate of withholding may vary depending upon the type of income, the status of the taxpayer, or whether an income tax treaty applies. For example, the portfolio interest exception under sections 871(h) and 881(c) for U.S. interest on an obligation in registered form is conditioned upon the beneficial owner of the interest providing a statement of foreign status to the U.S. withholding agent, which can be provided on a Form W–8. See §35a.9999–5(b), A–9. If a reduction is claimed under an income tax treaty, the withholding agent may generally rely on a Form 1001 provided by, or for, the beneficial owner claiming residence in a treaty country. For dividends, however, the current rules do not require certification of foreign status in order to obtain a reduced rate of withholding at source under an income tax treaty. Instead, the withholding agent may generally rely on the address of the payee and grant a reduced rate of withholding at source if the recipient's address is in a treaty country.

A withholding agent is generally required to file an annual income tax return on Form 1042 to report amounts upon which an amount was actually withheld under chapter 3 of the Code or would have been required to be withheld but for an exemption under the regulations, or an income tax treaty. An information return on a Form 1042–S must be attached to the Form 1042 and must report each recipient's name and address, amounts paid, and amounts withheld, if any. See §1.1461–2(b) and (c).

A payor making payments to foreign persons must also be aware of the information reporting provisions under chapter 61 of the Code and of other withholding regimes, such as section 3406 (backup withholding), section 3402 (wage withholding), and section 3405 (withholding on pensions, annuities, etc.). Payors subject to these reporting and withholding rules include both U.S. persons and foreign persons, subject to certain exceptions. Under chapter 61 of the Code, many types of payments, such as interest, dividends, royalties, broker proceeds, etc. (reportable payments) must be reported on a Form 1099 if paid to certain U.S. persons. The form is filed with the IRS and a copy is furnished to the recipient of the payment. In addition, section 3406 requires those same U.S. payees to furnish a taxpayer identifying number (TIN) to the payor, generally on a Form W–9, and, for reportable interest and dividends, a certification that the payee is not subject to notified payee underreporting. Failure to provide a TIN would generally require the payor to backup withhold on the payment at the rate of 31-percent. A payor that fails to obtain a TIN or other required information in the manner required or to backup withhold when required under section 3406 may also be liable, under section 3403, for interest and penalties, in addition to any amount that should have been withheld under section 3406.

Payments to foreign persons are exempt from Form 1099 information reporting and backup withholding. However, the exemption is generally conditioned upon the recipient furnishing a certificate supporting its foreign status. The existing regulations under the information reporting provisions of chapter 61 contain guidance to help payors determine when payments are made to a foreign person. Generally, depending upon the type of payment involved, a payor may rely on a certification of foreign status made on Form W–8, Form 1001, Form 4224, or, in the case of certain payments outside the United States, on alternative evidence of foreign status. See, for example, §35a.9999–3, A–34. Therefore, even if an amount paid to a foreign person is exempt from withholding under chapter 3 of the Code (e.g., gain from the sale of securities), a payor must nevertheless comply with specified certification procedures in order to avoid being subject to penalties for failure to comply with the information reporting and the backup withholding procedures (only amounts subject to reporting under the Form 1099 reporting

provisions are subject to backup withholding under section 3406; see section 3406(b) and §31.3406(a)–1(a) and, for example, §31.3406(b)(2)–1(a)).

As explained in the preamble to the proposed regulations, the IRS and Treasury have reviewed the current withholding and reporting procedures applicable to cross-border payment flows and have concluded that changes are necessary to accommodate the size and growth of international financial markets. The IRS and Treasury have concluded that allowing the benefit of the reduced rate at source, rather than through a refund procedure, continues to be desirable. A regime based on reduction of withholding at source avoids the administrative costs and delays that can occur when applying for a refund of overwithheld amounts. This regime, however, depends on withholding agents performing important compliance functions. They must obtain documentation substantiating claims of foreign status and of reduced rates of withholding and must provide information to the IRS.

One of the important objectives of the revisions is to eliminate unnecessary burdens that the lack of standardization and coordination of current procedures may impose on withholding agents. While it is unavoidable that different information be required for different types of income or recipients, the forms currently in use apply different standards of proof and are not uniform in the manner in which the information is furnished to withholding agents. The final regulations unify the documentation requirements and seek to facilitate compliance by clarifying uncertainties that may exist under current rules (e.g., the scope of due diligence standards imposed on withholding agents).

These regulations also address important issues relating to payments to intermediaries (e.g., nominees, agents, etc.), including whether intermediaries should certify status on behalf of beneficial owners and, if so, how. Intermediary procedures under current rules have proved difficult to implement in a number of cases. In particular, U.S. source interest on obligations in registered form do not qualify as portfolio interest under sections 871(h) and 881(c) unless the U.S. withholding agent receives a statement that the beneficial owner of the obligation is not a U.S. person (see section 871(h)(2)-(B)(ii)). When the payment is made to a foreign person acting as an intermediary on behalf of the beneficial owner or of other intermediaries, the current regulations require that the beneficial owner certification be passed up through the chain of intermediaries to the U.S. withholding agent. See §35a.9999–5(b), A–9. The final regulations offer alternative procedures and respond to the concerns expressed by various representatives of the financial community regarding compliance costs.

The final regulations are also responsive to the Congressional mandate in section 342 of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) that Treasury consider a range of options for replacing the address/self-certification method of administering income tax treaty benefits. The IRS and Treasury have studied several options for improving the withholding procedures to respond to this mandate, including a system of certification of residence in a treaty country and refund systems. At hearings held in February of 1985 on proposed regulations issued in 1984 under section 1441, comments from the public and several U.S. treaty partners made it apparent that certification requirements, as proposed, would create too many administrative problems for payments made through nominees. The final regulations reflect these comments. The procedures adopted for documenting eligibility for benefits under tax treaties are similar to those applicable to portfolio interest on obligations in registered form.

Streamlining the current procedures and implementing workable intermediary certification procedures represent a substantial simplification and reduction of burden. The IRS and Treasury expect that this, in turn, should result in greater compliance and improve the ability of withholding agents and the IRS to detect abusive claims of foreign status or of benefits under U.S. income tax treaties or under the Code.

On December 21, 1995, at 60 FR 66243, a notice of proposed rulemaking (IA–33–95) was published proposing to add §31.9999–0. This document finalizes the proposed regulations. The effective date of this addition is October 14, 1997.

Explanation of Provisions and Revisions

A. *Comments and Changes to §1.871–14 and Related Reporting Requirements Under Section 6049*

Consistent with the proposed regulations, the final regulations incorporate without substantive changes the relevant provisions from the existing temporary regulations implementing the repeal of the 30-percent tax on portfolio interest (Questions and Answers Relating to the Repeal of 30-percent Withholding by Section 127 of the Tax Reform Act of 1984 and to the Application of Information Reporting and Backup Withholding in Light of such Repeal). These provisions deal with bearer obligations, convertible obligations, and pass-through certificates. Section 1.871–14(b)(1) incorporates the provisions in §35a.9999–5(a), A–1 and the rules in §5f.103–1(c) defining a bearer obligation. It also reflects the rules in §5f.103–1(c) regarding obligations in registered form that are convertible into bearer form. At the request of commentators, the definition of an *obligation in registered form* contained in §5f.103–1(c) is restated in §1.871–14(c)(1)(i). The definition restates the rules in §35a.9999–5(c), A–18, regarding the effect of convertibility features on the status of an obligation as an obligation in bearer or registered form. Further, at the request of commentators, the provisions in §35a.9999–5(b), A–12 through 15 regarding obligations issued in registered form and targeted to foreign markets are retained without substantive changes. Comments received from U.S. agencies and instrumentalities indicate that they have relied on these procedures in the past and that they plan to do so again.

One commentator requested additional clarifications under §1.165–12(c). In response to these comments, the $1 million minimum denomination requirement under §1.165–12(c)(1)(ii) is eliminated in order to conform that provision to §1.165–12(c)(3)(iii). In addition, in §1.165–12(c), the term *United States* is replaced with the term *United States and its possessions* to coordinate the provisions with §1.163–5(c)(2)(i)(C) and (D). In §1.165–12(c)(1)(iii), a provision was added to explain that a holder delivering a bearer obligation to a financial institution or exempt organization may rely on a

written statement furnished by the institution or organization. Further, although the commentator suggested adding a sentence to §1.165–12(c)(1) to clarify that each of paragraphs (i) through (iii) must be satisfied in order to avoid holder sanctions, this change is unnecessary because the need to meet all of the requirements in each of these clauses is sufficiently clear. The commentator proposed various changes to the rules governing the foreign targeting of bearer obligations on original issuance. However, the final regulations do not address these changes which are outside the scope of this project.

The proposed regulations regarding the certification requirements for obligations in registered form are finalized without substantive changes. As in the proposed regulations, a TIN is not required to be stated on a Form W–8 used to claim the benefit of the portfolio interest exemption, regardless of whether the debt obligation is publicly traded.

Several commentators have asked that, in the case of portfolio interest on obligations in registered form, the provisions dealing with late-received documentation be conformed to similar provisions under proposed §1.1441–1(f)(5). Under proposed §§1.871–14(c)(3) and 1.1441–1(f)(5), the failure to timely receive appropriate documentation (i.e., in most cases, a Form W–8) may be cured by obtaining the documentation later. Under the proposed regulations, the cure procedures apply for purposes of withholding under section 1441 and for purposes of meeting the requirement under sections 871(h) and 881(d) that the U.S. withholding agent receive a statement. However, proposed §1.871–14(c)(3) requires that the documentation be received before the expiration of the limitations period of the *beneficial owner*. In contrast, proposed §1.1441–1(f)(5) requires that the documentation be received before the expiration of the limitations period of the *withholding agent*. Commentators have asked that the relevant limitations period for qualifying interest as portfolio interest under sections 871(h) and 881(d) be that of the withholding agent and not of the beneficial owner. This comment is not adopted because of the special conditions for interest to qualify as portfolio interest. Under section 871(h)(2)(B)(ii), interest on an obligation in registered form is portfolio interest only if the U.S. withholding agent receives a statement that the beneficial owner of the obligation is not a U.S. person. The legislative history to the amended provisions (see section 1810(d)(3)(B) of the Tax Reform Act of 1986 (Public Law 99–514)) specifies that the statement may be received late, but no later than the expiration of the beneficial owner's statute of limitation. This indicates that, if the required statement is received after the beneficial owner's statute of limitation has expired, the interest can no longer qualify as portfolio interest. Although the withholding agent is permitted to receive documentation at any time within its own limitations period and establish an applicable reduction in the withholding rate after the fact (e.g., under an income tax treaty), such cure procedure is not effective to confer portfolio interest status to the interest if it occurs after the beneficial owner's statute of limitations has expired. A cross-reference to §1.1441–1(b)(7) (i.e., proposed §1.1441–1(f)(5) as renumbered under the final regulations) is included in §1.871–14(c)(3) to clarify the difference between the two cure procedures.

B. *Comments and Changes to §1.1441–1*

1. Coordination With Other Withholding and Information Reporting Provisions

Commentators noted that withholding and information reporting requirements applicable to payments to foreign persons are governed by a complex web of statutory provisions and that the relationship of these provisions among themselves may be difficult to understand. In response to these comments, a number of changes have been made to help payors and their advisers locate relevant guidance.

As suggested, the table of contents in §1.1441–0 has been expanded. Section 1.1441–1(b)(4) and (5) has been added to provide an overview of how the withholding and reporting procedures under chapter 3 of the Code relate to the information reporting provisions under chapter 61 of the Code and other withholding regimes under sections 3402 (wage withholding), 3405 (withholding on pensions, annuities, etc.), and 3406 (backup withholding). Provisions explaining the interaction of applicable withholding and reporting provisions in the case of payments to foreign intermediaries or foreign partnerships have been added also. See explanation of those rules, under the heading "Clarification of Reporting and Withholding Obligations for Payments to and by Foreign Intermediaries" of this preamble. Where appropriate, additional cross references to chapter 61 and to sections 3402, 3405, and 3406 have been added in §1.1441–1 and cross-references in regulations under sections 3402, 3405 and 3406 have also been added.

As a general matter, a withholding agent (whether U.S. or foreign) must ascertain whether the payee is a U.S. or a foreign person. If the payee is a U.S. person, the withholding provisions under chapter 3 of the Code do not apply; however, information reporting under chapter 61 of the Code may apply; further, if a TIN is not furnished in the manner required under section 3406, backup withholding may also apply. If the payee is a foreign person, however, the withholding provisions under chapter 3 of the Code apply instead. To the extent withholding is required under chapter 3 of the Code, or is excused based on documentation that must be provided, none of the information reporting provisions under chapter 61 of the Code apply, nor do the provisions under section 3406. If, however, withholding under chapter 3 of the Code does not apply irrespective of documentation (e.g., in the case of foreign source income or gross proceeds dealt with under section 6045), documentation may nevertheless have to be furnished to the withholding agent under the provisions of chapter 61 of the Code in order to be excused from Form 1099 information reporting and, possibly, from backup withholding under section 3406. Determinations of payee's status are generally made at each level of the chain of payment, until, ultimately, the payment is made to the beneficial owner. The following example illustrates how these rules interact under the final regulations.

For example, assume that a U.S. bank acting as a paying agent of a U.S. issuer of an obligation pays interest to a U.S. brokerage firm. Chapter 3 withholding does not apply to that payment because the payee is a U.S. person. Form 1099 information reporting under section 6049 is not required because the brokerage firm is

an exempt recipient (i.e., a securities dealer), meaning that it is exempt from having the payment reported on a Form 1099. See §1.6049–4(c)(1)(i). The U.S. brokerage firm may or may not have to provide a Form W–9 to the U.S. bank to establish its exempt recipient status depending on whether it meets one of the "eyeball" tests under §1.6049–4(c)(1)(ii). Assume further that the U.S. brokerage firm credits the interest to the account of a customer. If the brokerage firm does not hold a Form W–9 (or a Form W–8) and cannot otherwise ascertain the exempt recipient status of the customer under §1.6049–4(c)(1)(ii), it is required to backup withhold 31-percent under section 3406. See §31.3406(a)–1(b). If it determines that the customer is a U.S. person (e.g., the firm holds a Form W–9 for the customer), then chapter 3 does not govern the payment. Instead, the payment is governed by sections 3406 and 6049. If, however, the U.S. brokerage firm determines that the customer is a foreign person (e.g., it holds a valid Form W–8), then chapter 3 governs the payment and the payment is not reportable for purposes of section 6049, meaning that it is also not subject to backup withholding under section 3406. Thus, Form 1042 reporting and withholding at a 30-percent rate are required unless the income is exempt under the Code or an income tax treaty. For example, if the interest is of a kind that may qualify as portfolio interest, then withholding is excused if the brokerage firm holds a valid Form W–8 from the customer (but would still be reportable on Form 1042–S).

If the payment to the customer is an amount exempt from withholding under chapter 3 of the Code without the need to furnish documentation (e.g., foreign source interest income), documentation may nevertheless be required for purposes of chapter 61 of the Code. In this example, the U.S. brokerage firm must report the payment of foreign source interest on a Form 1099 unless the customer is an exempt recipient or is a foreign person. If the customer's status as an exempt recipient cannot be ascertained on an "eyeball" basis under §1.6049–4(c)(1)(ii), the brokerage firm must obtain a Form W–9 or a Form W–8 from the customer. If the documentation that the brokerage firm receives reliably indicates an exempt recipient or foreign status, no information reporting or withholding is required. If documentation is not obtained or is not reliable, Form 1099 information reporting is required under section 6049 and backup withholding is required under section 3406.

Assume, however, that the customer is not the beneficial owner of the payment of U.S. and foreign source interest income. Instead, it is a foreign bank acting on behalf of the beneficial owner. With respect to the payment that is U.S. source interest, the brokerage firm would be permitted to pay the interest free of withholding (assuming it would qualify as portfolio interest if appropriate documentation were received) if it held a Form W–8 (or alternative documentary evidence) from the ultimate beneficial owner that is transmitted by the foreign bank or if it held a Form W–8 from the foreign bank as a qualified intermediary who, under the final regulations, is permitted to certify on behalf of its own customer. See §1.1441–1(e)(5). In either case, the brokerage firm must report the payment on a Form 1042 and must also make an information return on Form 1042–S. The Form 1042–S must state the name of the beneficial owner as shown on the Form W–8 (or alternative documentary evidence) or the name of the foreign bank if the bank is a qualified intermediary.

Continuing with the same example, the foreign bank also has obligations under sections 1441, 6049, and 3406 when it, in turn, makes a payment to its own customer. However, to the extent it received a valid Form W–8 (or alternative documentary evidence) from the beneficial owner and furnished a copy to the U.S. brokerage firm (or complied with the documentation requirements as a qualified intermediary), it would meet its obligation under applicable withholding and reporting provisions and, accordingly, would be exempt from withholding any amount from the payment and from reporting the payment. See §§1.1441–1(b)(6) and 1.6049–5(b)(14).

With respect to the foreign source interest paid to the foreign bank acting as an intermediary, the only requirement imposed on the U.S. brokerage firm is to obtain the Form W–8 of the foreign bank (and not of the beneficial owner). Because the exemption sought by the foreign bank is an exemption from Form 1099 information reporting and backup withholding, the foreign bank may do so by establishing its foreign status with a Form W–8 or by establishing its status as an exempt recipient. Under the final regulations, a foreign bank's status as an exempt recipient can be established on an "eyeball" test basis if the bank's name reasonably indicates that it is a bank. However, as is the case for U.S. income subject to chapter 3 withholding, the foreign bank, acting as an agent for its own customer, may be required to report the foreign source payment under section 6049 and to backup withhold under 3406 when it, in turn, pays the amount to its customer if the foreign bank is a U.S. payor (e.g., it is a controlled foreign corporation). If it is not a U.S. payor or a U.S. middleman, it has no withholding or reporting obligations under chapter 3 of the Code due to the nature of the payment (i.e., foreign source income), unless it makes the payment in the United States. If the foreign bank makes a payment to its customer in the United States, then the payment is reportable under section 6049 and the bank must obtain a Form W–8 or a Form W–9 from its customer, unless the exempt status of the customer can be established on an "eyeball" basis. If the customer is a U.S. person who is not an exempt recipient, the bank must report the payment on a Form 1099 and, if the customer has not provided a Form W–9 as required under section 3406, backup withholding is required. The provisions of §1.6049–5(b)(14) do not apply to exempt the foreign bank from its reporting and withholding obligations because it has not provided the required documentation to the U.S. withholding agent or certified on behalf of the beneficial owner.

These examples are illustrative only. Different rules may apply depending upon a number of factors, the most significant being the nature of the payment (FDAP or not FDAP, U.S. source or foreign source), the status of the payor (U.S. or foreign), the status of the payee (U.S. or foreign, beneficial owner or intermediary), where the payment is made (in the U.S. or outside the U.S.), and where the account is held (on-shore or offshore).

2. U.S. Agent of Foreign Person

Under the proposed regulations, a payment to a U.S. person gives rise to with-

holding liability if the payor has actual knowledge that the U.S. person is acting as an agent for a foreign person. Commentators suggested that the withholding liability should be imposed on the last U.S. person who makes the payment to a foreign person. At a minimum, commentators asked that the final regulations limit the obligation to withhold to situations where the withholding would seem jeopardized. This comment is accepted. Under the final regulations, a U.S. person making a payment to a U.S. financial institution is not required to withhold even if it knows that the payee is collecting the payment for a foreign person, if the U.S. person has no reason to believe that the financial institution will not comply with its obligation to withhold when it makes the payment to the foreign person. See §1.1441–1(b)(2)(ii).

3. Payments to Wholly-owned Entities

The final regulations under §1.1441–1(b)(2)(iii) provide guidance on applicable withholding procedures for payments to a domestic or foreign wholly-owned entity that is disregarded for federal tax purposes (i.e., treated as a branch of its single owner) under §301.7701–1(c)(2). As a general rule, a payment to a disregarded wholly-owned entity is treated as a payment to its owner. Thus, for example, if a foreign person owns a domestic disregarded entity, a person making a payment to the disregarded entity is treated as the withholding agent because the owner is a foreign person. However, because the fact that the entity is disregarded for tax purposes generally may not be apparent to a person making a payment to the entity, the person making the payment can rely on documentation received from the recipient to determine its withholding and reporting obligations. Thus, if the person receives a Form W–9 from the entity representing that the recipient is a domestic corporation, the person may rely on the form to treat the entity as a U.S. person unless it has actual knowledge or reason to know that the representation is incorrect. If the entity is a wholly-owned entity disregarded for federal tax purposes, then it must furnish documentation representing the status of its owner. For example, if the disregarded domestic entity is owned by a foreign person, it must furnish a Form W–8 from its single owner. In that case, a person making a payment to the entity may rely on the Form W–8 that the entity provides for its foreign owner and comply with withholding and reporting requirements accordingly. A domestic disregarded entity that does not furnish a certificate is subject to Form 1099 information reporting on payments that are reportable and subject to backup withholding under section 3406 because, lacking the words "inc.", "incorporated", "corp." or "corporation" in its name, it could not be treated as an exempt recipient on an "eyeball" basis. If the entity had one of these words in its name, it would be a per se corporation for U.S. tax purposes because any of these words would indicate that the entity is organized under a corporate statute; thus, it could not be a disregarded entity. The TIN to be stated on the Form W–9 or the Form W–8, if required, is that of the single owner and not that of the disregarded entity.

Different documentation procedures apply if the benefit of a reduced rate is claimed under an income tax treaty and the entity is not treated as fiscally transparent in the applicable treaty jurisdiction. See §§1.1441–6(b)(4) and 1.894–1T(d).

4. Payments to U.S. Branches of Foreign Institutions

Commentators also suggested that a payment to a U.S. branch of a foreign bank or other financial institution should not be subject to withholding. Instead, the U.S. branch should be responsible for withholding when it makes the payment to the foreign person. In addition, commentators have asked that the regulations eliminate the requirement for a U.S. branch to furnish a certificate representing that the payment it receives is effectively connected with the conduct of a U.S. trade or business. In response to these comments, the rules governing payments to the U.S. branch of certain foreign financial institutions have been modified to alleviate the certification burden for those U.S. branches that operate in a manner equivalent to U.S. companies.

Therefore, §1.1441–4(a)(2)(ii) of the final regulations provides that a payment to a U.S. branch of either a foreign financial institution that is registered with the Federal Reserve Board or of a foreign insurance company that is required to file an annual "NAIC" statement with a State Insurance Commissioner is presumed to be a payment of effectively connected income for withholding purposes. Section 1.1441–1(b)(2)(iv) has been added to provide that a U.S. branch may rebut this presumption by furnishing a Form W–8 to the withholding agent certifying that the payment that it receives is not effectively connected with its conduct of a U.S. trade or business. For a description of the form that a U.S. branch must furnish, see §1.1441–1(e)(3)(v). Under the final regulations, the U.S. branch that furnishes a Form W–8 may agree with the withholding agent to assume responsibility for all withholding and reporting obligations for the payments it receives from the withholding agent. In the absence of such an agreement, the withholding agent remains responsible for the withholding and reporting obligations associated with the payment. This means, for example, that, if the U.S. branch receives the payment on behalf of its home office and the home office is covered by a qualified intermediary agreement that the IRS has concluded with the foreign financial institution, the U.S. branch must give to the withholding agent the home office's Form W–8. If the branch receives the payment for its own customers, it must give to the withholding agent all of the required certificates for its customers.

Similar withholding procedures are available to other U.S. branches to the extent permitted by the district director or the Assistant Commissioner (International). Procedures for obtaining such permission existed under prior regulations under §1.1441–4(f). These provisions are restated in §1.1441–1(b)(2)(iv)(E) of the final regulations.

The final regulations do not eliminate the requirement to report on a Form 1042 or 1042–S payments to these branches, including payments for which the branch has assumed withholding and reporting responsibility. In such a case, however, the reporting is made to the branch as recipient of the amount for which it has assumed withholding responsibility rather than to the beneficial owner. See §1.1461–1(b)(2)(vi) and (c)(4)(v). Although commentators asked that these reporting requirements be eliminated for payments of effectively connected income, the IRS and Treasury believe that

the reporting serves an important compliance function.

5. Beneficial Owner

The definition of the term *beneficial owner* is clarified to indicate that ownership is determined on the basis of existing principles governing the determination of tax ownership, including substance-over-form principles, such as those reflected in section 7701(l) dealing with conduit transactions. The special definition of beneficial owner in proposed §1.1441–1(c)(6)(ii)(B) for purposes of tax treaties has been eliminated. See the explanation below under §1.1441–6 for claims of tax treaty-reduced rates for payments to entities that are treated as fiscally transparent in the U.S. or in the applicable treaty jurisdiction, or both.

6. Forms

a. Format and Design

Many comments were received regarding the format and design of the revised Form W–8. In particular, several commentators suggested that the IRS retain separate forms for effectively connected income and payments to foreign governments. The IRS is considering these comments and agrees that it may be more convenient to keep certain forms separate from the basic beneficial owner Form W–8. The revised forms will be released for public comments before they are finalized.

b. Content of Forms

The final regulations are modified in several respects regarding the Form W–8. A Form W–8 furnished by the beneficial owner is generally payee-specific and applies to all income received from the withholding agent to whom furnished, except to the extent provided in forms and instructions (e.g., effectively connected income). See §1.1441–1(e)(2)(i). Entitlement to different types of reduced rates may require different types of information or representations on a Form W–8. For example, entitlement to exemption from withholding on portfolio interest requires only proof of foreign status. Claims of treaty benefits may require a certified TIN (that is, a TIN that the IRS has certified as belonging to a person who is a resident of a country with which the U.S. has an income tax treaty in effect; see §1.1441–6(c) for procedures to have a TIN certified by the IRS). A withholding agent is responsible for making sure that the information or representations relevant to a particular type of income or applicable rate appear on the form and for requesting a new form where an existing form fails to support a claim of reduced rate for a different type of income. For example, a beneficial owner who furnishes a Form W–8 for portfolio interest (and therefore, does not complete the information on the form relating to claims of treaty benefits) would be required to furnish a new form to the withholding agent if it receives from the same withholding agent other income for which it claims a reduced rate of withholding under a tax treaty. The new form could serve both for portfolio interest and the other income for which treaty benefits are claimed.

In response to comments, the final regulations clarify that, where a person, other than an individual, does not have a tax residence in any country, the required permanent residence address is the address of the person's principal office, even though the principal office is not in its country of incorporation (as was required in the proposed regulations). Because of this change, the final regulations require that the entity's country of organization or incorporation be stated on the form. See §1.1441–1(e)(2)(ii).

c. Signature of Forms under Power of Attorney

Some commentators have asked that custodians be permitted to execute the Form W–8 on behalf of their customers, based upon a power of attorney. This suggestion is not adopted. Like a tax return, a Form W–8 must be signed under penalties of perjury. As such, the IRS and Treasury view the signature of a Form W–8 as governed by the same rules that govern the signature of a tax return. Therefore, the final regulations clarify in §1.1441–1(e)(4)(i) that a withholding certificate may be signed by any person authorized to sign a declaration under penalties of perjury on behalf of the person issuing the certificate as provided under section 6061 (for individuals), 6062 (for corporations), or 6063 (for partnerships).

d. Facsimile and Electronic Transmission

Commentators have asked that withholding agents be allowed to rely on a faxed copy or electronically transmitted Form W–8 as if they were original forms. The proposed regulations permit a faxed Form W–8 to indicate foreign status for purposes of the grace period under proposed §1.1441–1(f)(2)(i)(B), but do not allow it to be used for other purposes. The question of whether and to what extent a faxed certificate ought to be allowed instead of an original certificate arises because, under current law, a faxed document (like a photocopy) has weaker evidentiary value than an original document. This question is not unique to the Form W–8 and is currently under study by the IRS. Pending completion of the study, the final regulations allow a withholding agent to rely on a faxed form only for purposes of presuming foreign status in order to reduce the rate of withholding during a 90-day grace period. However, an original form must be provided before the grace period expires.

On the other hand, the proposed regulations provide general authority for the electronic transmission of Forms W–8, subject to procedures issued by the IRS. The final regulations retain this rule and, regulations issued together with these final regulation propose to amend §1.1441–1(e)(4)(iv) of the final regulations by prescribing the standards that electronic systems must meet in order to effect an acceptable transmission of Forms W–8. The IRS believes that the evidentiary value of documents transmitted with electronic systems meeting these standards would equate with that of an original document. See project REG–107872–97, page 658. The option to use electronic transmission systems should help alleviate the burden of having to mail original Forms W–8 in paper form.

e. Single Form for Related Withholding Agents

Commentators have asked that several withholding agents be allowed to rely on a single Form W–8. In response to this comment, a number of changes were made to the final regulations. First, under §1.1441–1(e)(4)(ix)(A), a withholding agent may rely on the Form W–8 fur-

nished for another account at the same branch location, at a different branch location of the same entity, or at a different branch location of a related person if the entity or group of entities uses a universal account system or uses another type of coordinated account information system that allows the withholding agent to easily access information regarding the nature of the certificate furnished, the information on the certificate, and its validity status. In addition, the system must allow the withholding agent to keep a record of how and when it accesses the information and, if applicable, of how and when it communicates relevant facts affecting the reliability of the certificate to the location where the certificate is kept. Second, the rule in proposed §1.1441–1(e)(2)(i) allowing the beneficial owner to provide a single Form W–8 with respect to a family of mutual funds is extended to investors in affiliated partnerships and corporations under §1.1441–1(e)(4)(ix)(B) of the final regulations. Further, the final regulations also adopt a suggestion that a withholding agent be able to rely on representations from a broker that it holds a valid withholding certificate from a beneficial owner. See §1.1441–1(e)(4)(ix)(C). The final regulations clarify that a withholding agent has knowledge of all information in the system. See §1.1441–7(b)(3).

f. Forms from Foreign Partnerships

In response to comments, the provisions under proposed §1.1441–1(e)(3)(iii) dealing with withholding certificates furnished by a foreign partnership have been moved to §1.1441–5(c), which contains most of the withholding provisions governing payments to foreign partnerships (see explanation of the changes under §1.1441–5).

g. Forms from Non-Qualified Intermediaries

In response to comments, provisions have been added to clarify the manner in which a non-QI must transmit documentation to the withholding agent and the information that it must contain. Proposed §1.1441–1(e)(3)(iv) (renumbered as §1.1441–1(e)(3)(iii) in the final regulations) is expanded to explain the manner in which withholding certificates or other appropriate documentation is passed up a chain of non-QIs. The final regulations allow the intermediary to furnish copies of an original Form W–8 so as to avoid requesting multiple originals for different accounts that the intermediary may hold on behalf of the same beneficial owner. See §1.1441–1(e)(3)(iii).

Also, proposed §1.1441–1(e)(3)(iv)(C) and (D) (renumbered as §1.1441–1(e)-(3)(iii)(C) and (D) in the final regulations) has been modified and paragraph (e)(3)-(iv) has been added in response to comments that the regulations should explain the information required from a non-qualified intermediary to insure proper withholding by a withholding agent making a payment to a non-qualified intermediary. In particular, if different withholding rates apply to different owners of the payment flowing through an intermediary, the withholding agent must know which rate applies to each portion of the payment. Where such information is necessary, the final regulations provide that the intermediary must, in a statement attached to the withholding certificate from the non-qualified intermediary, provide (and update as often as is necessary) sufficient information for the withholding agent or payor to determine the proportion of each payment subject to withholding that is attributable to each person to whom the intermediary certificate relates, including persons for whom the intermediary has not attached a withholding certificate or other appropriate documentation. Such statement is not necessary, however, if the allocation information is known to the withholding agent due to the account structure that it uses (for example, the withholding agent uses separate accounts for different categories of income and applicable withholding rates).

h. Validity Period

Comments were received under §1.1441–1(e)(4)(ii) regarding the period of validity of a properly executed Form W–8. Commentators requested that, irrespective of whether a Form W–8 includes a TIN, all forms should be valid indefinitely, or at least those furnished for a claim of effectively connected income. Some commentators suggested that a Form W–8 should not expire where a payor continues to send all correspondence to a mailing address that is also the permanent address on a Form W–8. These suggestions are not adopted because the IRS and Treasury believe that it is important for taxpayers to re-certify status periodically. Similar re-certification is also important for effectively connected income, since income may cease to be effectively connected due to a change in the taxpayer's business structure, without the withholding agent becoming aware of such changes. However, the final regulations provide relief by presuming that payments made to certain U.S. branches are effectively connected income, thereby avoiding the need to provide a certificate in such a case. See §1.1441–4(a)(2)(ii).

Also, §1.1441–1(e)(4)(ii)(B) is modified to make all intermediary certificates and certificates for non-withholding foreign partnerships valid indefinitely. (The indefinite validity period does not apply to the withholding certificates or documentary evidence required to be attached to a certificate from a non-qualified intermediary, a U.S. branch of a foreign institution, or a foreign non-withholding partnership.) In addition, Forms W–8 furnished by an integral part of a foreign government, a foreign central bank of issue, or the Bank for International Settlements are valid indefinitely. For these certificates, the information required is likely to change only infrequently. What may change more frequently is the withholding rate information that an intermediary or foreign partnership may have to furnish to a withholding agent on a separate statement, which the intermediary or partnership must update as often as is necessary to insure that the withholding agent withholds at the proper rates. See §1.1441–1(e)(3)(iv) and (5)(v) for a description of the statement and §1.1441–1(e)(4)(ii)(D) for related validity rules.

i. Effect of Changes in Circumstances

Proposed §1.1441–1(e)(4)(ii)(D), dealing with changes in circumstances affecting the validity of a Form W–8, is revised to clarify the due diligence imposed on a non-qualified intermediary who becomes aware of a change in the circumstances affecting the validity of a withholding certificate that it has received and transmitted to the U.S. withholding agent or another intermediary. The final regulations provide that, in such a case, the non-

qualified intermediary must inform the person to whom it provided the affected withholding certificate (i.e., the U.S. withholding agent or the other intermediary). It must also obtain a new withholding certificate or other documentation to replace the certificate or documentation that is no longer valid due to changes in circumstances. The same rules apply to foreign partnerships that are not withholding foreign partnerships and to a U.S. branch that passes through documentation to a U.S. withholding agent.

The final regulations also clarify that a withholding agent does not have a duty to inquire into possible changes of circumstances. In other words, a withholding agent may assume that circumstances have not changed unless it knows of facts suggesting that changes in circumstances have occurred that may affect the validity of documentation. Changes in circumstances relevant to the information and certification provided on a withholding certificate, a statement, or in documentary evidence affect the validity of the certificate, statement, or documentary evidence as of the date that the withholding agent has actual knowledge or reason to know of the changes. The final regulations are revised to clarify that point and give withholding agents the same 90-day period as is given for a new account for perfecting documentation (i.e., inquire into the change of circumstances and obtain a new certificate, if necessary). See §§1.1441–1(b)(3)(iv) and 1.6049–5(d)(2)(ii).

j. Acceptable Substitute Form

In addition, proposed §1.1441–1(e)-(4)(vi) is modified in response to comments that asked that the meaning of the cross-reference to §31.3406(h)-3(c)(1) defining an *acceptable substitute* form be clarified. The revised provisions enumerate the type of information and certifications that must appear on any substitute form for purposes of the regulations under chapter 3 of the Code. The rules are similar to the rules contained in §31.3406(h)–3(c)(1). Under the final regulations, a withholding agent must provide a copy of the instructions to the recipient only to the extent specified in the form and in the instructions to the official form. As is the case for the Form W–9, the IRS expects that the form instructions will waive the obligation to furnish the official Form W–8 instructions to customers. Further, withholding agents are also authorized to develop customized substitute Forms W–8 and incorporate them as part of account opening documents.

k. Guidance Regarding Reliance on Withholding Certificates

Several commentators asked for clearer guidance on the extent to which withholding agents may rely on forms and the extent of their duty to inquire into the truthfulness of information stated on forms. In response to these comments, the final regulations contain a number of clarifications. Section 1.1441–1(e)(4)(viii) has been added to provide that a withholding agent may rely on a foreign entity's certification of corporate (or other) status on a Form W–8. In the case of a withholding certificate by or for a foreign entity whose name is on the list of per se foreign corporations described in §301.7701–2(b)(8)(i) that claims to be a partnership, the certificate must represent that the entity's partnership status was grandfathered under the regulations and has not been terminated. Further, a withholding agent that receives a beneficial owner certificate from a foreign financial institution may rely on such certificate to treat the institution as the beneficial owner unless it has information in its records that would indicate otherwise, or unless the certificate contains information that would contradict such claim (e.g., sub-account numbers or names). If a foreign intermediary receives payments both in its capacity as an intermediary and for its own account, it must furnish two certificates in order to allow the withholding agent to apply the proper withholding rate and report the amounts accordingly. Additional reliance guidance has been added regarding claims of benefits under a tax treaty (see explanation under §1.1441–6, below). Further, the provisions dealing with a withholding agent's due diligence are also expanded and clarified (see explanation under §1.1441–7, below).

7. Non-qualified Intermediaries

Some commentators requested that the regulations eliminate the requirement that non-qualified intermediaries (non-QIs) pass through Forms W–8 to the U.S. withholding agent because investors and intermediaries will not disclose customer information to third parties. In particular, some commentators recommended that the regulations eliminate any reference to the intermediary procedures currently applicable under §35a.9999–5(b), A–9, dealing with certification required in order for interest to qualify as portfolio interest. These suggestions are not adopted. The qualified intermediary regime is designed to provide these benefits, but only where the intermediary follows procedures to insure adequate withholding compliance. In addition, as explained in the preamble to the proposed regulations, the intermediary procedures provided in §35a.9999–5(b), A–9 are retained because, if the qualified intermediary regime does not apply to the intermediary, these procedures may be useful.

The final regulations also do not adopt a suggestion that, for income for which no TIN needs to be provided, the intermediary only reports the aggregate amount on Form 1042 without having to report individual amounts for each beneficial owner on a Form 1042–S. Commentators have suggested that a financial institution acting as an intermediary should be required to indicate only the proportion of a payment subject to withholding and the applicable rate. Should the proportion change, the certificate furnished by the intermediary would have to be modified to reflect the change in circumstances. This suggestion is not adopted because permission to report aggregate amounts is limited to payments made to qualified intermediaries. In the case of a qualified intermediary, the IRS may rely on audit procedures in the qualified intermediary agreement described in §1.1441–1(e)(5)(iii) to determine whether the intermediary has properly advised the U.S. withholding agent regarding each portion of a payment to which different withholding rates should apply. The IRS' ability to check the representations made by a non-QI is limited, particularly if the non-QI is not owned by U.S. persons. In that case, it must rely on reconciling the amounts paid as reported on Forms 1042–S, disclosure of the identity of beneficial owners (or further intermediaries), and exchanges of information under tax treaties. In that context, disclosure of the exact amounts allocated to each beneficial owner (or further intermediary) is important to the compliance regime applicable to non-QIs.

8. Qualified Intermediaries

a. Scope of Qualified Intermediary Provisions

Under the proposed regulations, a withholding agent may rely on the certification of a foreign person made on behalf of others to reduce the rate of withholding. If the foreign person has a qualified intermediary agreement with the IRS, the intermediary may certify without having to furnish the certificates or other documentation of the persons for whom it acts. Many comments were received regarding the proposal, which are discussed below.

In response to comments, the final regulations are modified to allow a foreign branch of a U.S. financial institution to be a qualified intermediary (QI) in the same manner as a foreign financial institution. However, U.S. branches of U.S. or foreign financial institutions are not permitted to obtain QI status. Such difference in treatment conforms to the distinction in the final regulations between accounts maintained outside the United States and accounts maintained on-shore. See §1.1441–1(e)(5)(ii)(A) and (B). This distinction is appropriate because it reflects the policy that the Form W–8 (signed under penalties of perjury) is the preferred means of establishing foreign status for transactions in the United States. On the other hand, documentary evidence provides appropriate evidence of foreign status for transactions outside the United States, especially in those countries where financial institutions must document the identity of customers opening new accounts or for whom they process certain transactions.

At the request of commentators, the definition of a clearing organization for purposes of §1.1441–1(e)(5)(ii)(A) is revised so that clearing organizations that, as members of other clearing organizations, do not hold physical securities, are nevertheless considered to hold obligations for members and, therefore, qualify for QI status. Further, the final regulations allow QI status for foreign corporations that receive U.S. income for which the benefit of a reduced rate is claimed under an income tax treaty by their shareholders (because the shareholders derive the income as residents of an applicable treaty jurisdiction within the meaning of §1.894–1T(d)(1)). By allowing these corporate entities to be QIs, the regulations intend to facilitate the processing of treaty benefits claims by reverse hybrid entities with large shareholdings. See discussion under §1.1441–6, below. Also at the request of commentators, a transition rule is added to §1.1441–1(e)(5)(i) whereby institutions that are otherwise eligible for QI status and that satisfy certain criteria (as will be published by the IRS) are permitted to act as QIs while awaiting confirmation of their QI status.

Commentators were divided on whether the regulations should allow a QI to assume primary withholding responsibility as proposed in §1.1441–1(e)(5)(iv). In view of these comments, the final regulations retain the provisions that permit the shifting of primary responsibility for withholding and reporting under chapter 3 of the Code. However, because of IRS concerns regarding compliance and comments received from foreign institutions, the final regulations provide that the responsibility for Form 1099 information reporting and related backup withholding under section 3406 may not be assigned to a QI, unless the QI is a foreign branch of a U.S. bank or another U.S. person or establishes that the obligations related to information reporting and backup withholding can adequately be carried out by a U.S. branch of the QI (even though the branch itself cannot be a QI). Some commentators suggested that, if a QI is allowed to assume primary withholding responsibility, it should be allowed to do so only for all the payments that it receives from a payor with respect to a particular account. Permitting a QI to assume withholding responsibility with respect to some but not all payments to an account would make it difficult for payors to determine the correct amount of withholding on payments to a single account. This comment has been adopted and the final regulations are modified accordingly to provide that if a QI assumes primary withholding responsibility for an account, it must do so for all payments to the account. The decision to assume or not assume withholding responsibility may be made on an account-by-account basis. See §1.1441–1(e)(5)(iv).

As is the case for non-QIs, the regulations describe in greater detail the information that must be provided by a QI in order for the withholding agent or payor to comply with applicable reporting and withholding obligations. Section 1.1441–1(e)(3)(ii)(C) requires an allocation statement to be attached to the intermediary withholding certificate, if necessary to provide sufficient information to allow the withholding agent to determine the applicable withholding rate or rates on payments to the QI. Such a statement may not be necessary if the withholding agent allocates the assets among separate accounts for each type of income and applicable withholding rates, as directed by the intermediary at the time that the assets are acquired. The assets with respect to which payments of reportable amounts are received must be allocated to one of the three categories described below. If the withholding agent maintains a system of separate accounts to keep track of different withholding rates for different classes of income or payees, it would maintain at least three separate accounts corresponding to the three categories of assets. For this purpose, a reportable amount is defined in §1.1441–1(e)(3)(vi) as income subject to withholding under chapter 3 of the Code. For reasons explained under the heading "U.S. Source Bank Deposit Interest and Short-term OID" of this preamble, U.S. bank deposit interest and U.S. short-term OID amounts are also included in the definition of reportable amount. However, reportable amounts do not otherwise include amounts that are not subject to chapter 3 withholding (e.g., foreign source income, broker proceeds).

The three categories of assets are described in §1.1441–1(e)(5)(v). They are (1) assets related to documented non-U.S. payees; (2) assets related to documented U.S. payees (whether or not exempt recipients); and (3) assets related to undocumented payees (i.e., payees for whom the QI holds no documentation or holds documentation that is unreliable). Reportable amounts paid with respect to assets in category 1 (documented non-U.S. payees) may benefit from a reduced rate of withholding under the Code (e.g., portfolio interest) or under a treaty (i.e., to the extent the QI further indicates subcategories of assets associated with different withholding rates under an applicable treaty).

Reportable amounts paid with respect to category 2 (documented U.S. payees) are not subject to withholding or reporting

under chapter 3 of the Code. However, the payor must report the payment on a Form 1099 by treating the payment of a reportable amount as made directly to any U.S. person for whom it receives a Form W–9 to the extent the U.S. person is not an exempt recipient. The final regulations clarify that a QI must agree to disclose the identity of these U.S. persons, regardless of local secrecy laws. The identity of U.S. payees that are exempt recipients under an applicable provision of the regulations under chapter 61 of the Code need not be disclosed to the withholding agent. If a Form W–9 furnished by the QI to the payor on behalf of a U.S. payee that is not an exempt recipient is not reliable (e.g., missing information or obviously incorrect TIN), the U.S. payor must backup withhold under section 3406.

Reportable amounts paid with respect to assets in category 3 (undocumented owners) are treated as amounts paid to a foreign person if the payment is an amount subject to chapter 3 withholding. See §1.1441–1(b)(2)(v) and (3)(v)(B). Therefore, withholding applies at the unreduced 30-percent rate. Reportable amounts that are U.S. bank deposit interest or U.S. short-term original issue discount paid with respect to asserts in category 3 are treated as paid to a U.S. person who is not an exempt recipient. Therefore, 31-percent backup withholding applies to those amounts and reporting on Form 1099 is required. See §1.6049–5(d)(3)(iii) and explanation below under paragraph 10 (U.S. source bank deposit interest and short-term OID).

If a QI assumes primary withholding responsibility, it must also attach a statement to its withholding certificate if necessary for the U.S. withholding agent to determine how much of each payment is allocable to U.S. payees. All assets are presumed allocable to foreign persons unless the QI indicates that it is acting for U.S. persons. The QI must provide the same information about U.S. payees that are not exempt recipients as is required in the case of a QI that has not assumed primary withholding responsibility.

b. Agreements with Qualified Intermediaries

The IRS intends to finalize the revenue procedure published in Announcement 96–3 (1996–18 I.R.B. 7) dealing with agreements between the IRS and certain institutions that wish to be a qualified intermediary for purposes of the U.S. tax withholding and reporting provisions (including the provisions of the Announcement regarding the documentation of beneficial ownership or foreign payee status (section 4.03)). A preliminary review of applicable know-your-customer procedures in several countries indicates that these procedures will generally provide adequate information regarding the nationality and residence status of account holders and their status as owners or intermediaries. The IRS intends that the documentation requirements imposed on QIs under their agreements with the IRS will not be more burdensome than those imposed on withholding agents, payors, or middlemen under applicable withholding and reporting regulations.

The Announcement provides that a QI would generally be subject to the same Form 1042 and 1042–S reporting requirements as apply to withholding agents under §1.1461–1(b) and (c). After further review, the IRS intends to finalize the rules so that a QI will be required to file an annual Form 1042 return with the IRS. Generally, a Form 1042–S will not be required if a schedule in the form described below is attached to the Form 1042.

Reporting on a Form 1042 would consist of providing the following information to the IRS: the amount of reportable U.S. source income received by the QI during the calendar year, identified by pool, listing each payor's name, address, EIN, income type and rate of withholding; information regarding overpayments or balance due; a statement regarding the audit conducted by the QI's internal auditor, providing a description of the audit conducted and including the auditor's opinion and summary of findings. The audit statement should define the scope and objective of the audit and report on the QI's compliance with the terms of the QI agreement.

In addition, the Form 1042 must attach a schedule providing information on payments of reportable U.S. source income made by the QI and allocated to specified pools. Under a pool reporting system, separate pools would generally be required for each type of income (e.g., interest, dividends, etc.). These pools may have to be further subdivided into pools consisting of income allocable to one of the three assets categories identified in the regulations under §1.1441–1(e)(5)(v)(B). Additional pools may be required for other purposes, including differentiating among applicable withholding rates. For example, assume that a QI pays portfolio interest and U.S. source dividends in a calendar year. The rates applicable to portfolio interest are zero (interest allocable to pool of documented foreign owners), zero (interest allocable to pool of U.S. owners who are exempt recipients), and 30% (interest allocable to pool of undocumented owners), and the rates applicable to dividends are 30% (dividends allocable to pool of residents in non-treaty countries), 15% (dividends allocable to pool of residents in treaty country eligible for this rate), zero (dividends allocable to pool of U.S. owners that are exempt recipients), and zero (dividends allocable to pool of foreign pension fund owners claiming an exemption under a tax treaty). In such a case, the QI may have to report the interest and dividend income in seven different pools.

The IRS will not require a QI to report beneficial ownership information if this information is otherwise reasonably available in appropriate cases, either under exchange of information provisions, under income tax treaties or under other procedures stated in the agreement to verify compliance with conditions for benefits claimed under income tax treaties. Appropriate cases for which the IRS may require beneficial ownership information include cases in which the IRS needs to verify compliance with conditions under an applicable tax treaty for reduced rates. This includes, for example, whether an entity claiming benefits under a tax treaty is a resident of the applicable treaty country, derives the income (within the meaning of the regulations under §1.894–1T(d)), and meets any applicable conditions imposed under limitation on benefits provisions in the treaty. The IRS intends to limit requests for beneficial owner's identity to cases where compliance concerns are significant due to the size of investments involved or the extent of bank secrecy laws in effect in the local jurisdiction.

The QI will not be required to provide a Form 1042–S to its account holders. In fact, providing such a form would not be consistent with the collective-type refund

procedures which the IRS intends to develop. These procedures will allow QIs to request refunds of overwithheld amounts on behalf of their customers. In such a system, a Form 1042–S, which can also serve as proof of tax withheld at source, would have to be monitored by the IRS in order to insure that refunds are not claimed twice for the same amount. Collective-type refund procedures are intended to be the exclusive means by which taxpayers can obtain refund of overwithheld amounts that they have received through a QI. Special procedures will have to be developed in order to reconcile this regime with regular refund procedures applicable to U.S. taxpayers that receive U.S. source investment income in an account with a QI.

With respect to audits, the proposed regulations provide that the IRS may, in appropriate cases, agree to rely on an audit of a QI performed by an approved auditor where, for example, under an income tax treaty or local laws, the IRS would be given access to appropriate auditors' records to verify compliance. Records may include workpapers of, reports prepared by, and methodology employed by, the approved external auditors. An auditor is approved if it is subject to regulatory supervision under the laws of the country in which a significant part of the QI's activities are expected to occur, its internal procedures must require it to verify that the financial institution complies with the terms of the QI agreement and to report non-compliance findings under the QI agreement in the same manner as it is required to report other findings of non-compliance with applicable local laws and regulatory requirements, and its relevant records (i.e., workpapers and reports) must be available to the IRS.

Several comments were received asking that audits be performed solely by internal auditors. The IRS, however, does not believe that it is appropriate to rely solely on internal auditors to perform compliance checks. The IRS intends to permit internal auditors to certify that appropriate procedures, internal controls, and systems are in effect and are sufficient to insure the QI's compliance with the agreement, such as procedures to obtain documentation upon opening of accounts, to monitor that the address on an account does not change to a U.S. address or to an address outside the treaty country (if treaty benefits are claimed), to organize and process such information in a way relevant to U.S. tax withholding and reporting, to communicate the information to withholding agents timely and updating the pool information when necessary; procedures by which underwithholding and overwithholding are identified and addressed; and the existence of adequate manuals and programs for training and advising appropriate personnel in standard operating procedures. However, it is important that compliance with these procedures be verified periodically by persons who are not also employed by the QI. The IRS does not believe that internal auditors provide sufficient assurances that audits will be performed with required impartiality, even if internal auditors are required to operate independently and to report exclusively to the QI's board of directors. However, the IRS intends to use external audits only periodically, either when it becomes aware (e.g., based on a Form 1042 or an internal audit report) that there may be compliance problems or as part of its regular audit program.

In addition, with respect to collection of taxes due, the IRS intends to waive the requirement of a bond in appropriate cases, particularly where the QI has assets in the United States from which tax can be collected or where occurrences of underwithholding are expected to be minimal due to the nature of the QI's established procedures.

In QI agreements, the IRS intends to address the manner in which a QI may pay to, or receive a payment from, another intermediary. A QI making a payment to another intermediary must normally obtain the underlying beneficial owner information from the intermediary, unless the intermediary is itself a QI. In the alternative, the QI may agree to a private arrangement with the intermediary that would be identical to a QI agreement, except that it would not be concluded with the IRS and the intermediary would have no reporting obligations to the IRS. Under this regime, similar to that described for authorized foreign agents in §1.1441–7(c)(2), the QI assumes responsibility for failures by the intermediary to comply with the documentation and withholding procedures. The intermediary would agree, under its private arrangement with the QI, to be audited in the same manner as if it were a QI. Auditors reports would be furnished to the QI and be available for inspection by the IRS. A QI would normally obtain an indemnification from the intermediary as a protection against its own U.S. tax liability arising from failures by the intermediary.

Further, the IRS will permit QIs that assume primary withholding responsibility to be combined in a chain of payment with QIs that do not assume primary withholding responsibility. For example, a U.S. withholding agent may pay to a QI that assumes primary withholding responsibility (QI1) and withhold no amount. QI1 may, in turn, pay a customer that is a QI that does not assume primary withholding responsibility (QI2). In such a case, QI1 must withhold on payments to QI2 in the same manner that a U.S. withholding agent would have had to withhold if it were paying the amount to QI2. QI2 may also be dealing with a third tier, QI3, that assumes primary withholding responsibility. In such a case, QI2 would inform QI1 that the portion of the payment allocable to QI3 (without having to disclose QI3's identity to QI1) is allocable to a QI that has assumed primary withholding responsibility. Accordingly, neither QI1 nor QI2 would withhold on the portion of the payment allocable to QI3.

9. Clarification of Reporting and Withholding Obligations for Payments to and by Foreign Intermediaries

Commentators have asked for clarification of how the procedures applicable to payments to foreign intermediaries relate to the exempt recipient rules under chapter 61 and to a foreign intermediary's reporting and withholding obligations under chapter 61 of the Code and section 3406.

Under chapter 61 of the Code and section 3406, the reporting and backup withholding requirements depend, in part, upon the status of the payee as an exempt recipient. Generally, exempt recipients include corporations and financial institutions. See §1.6049–4(c)(1)(ii). The category of persons treated as exempt recipients may vary depending upon the type of income being paid. For this purpose, the payee is generally identified as the person to whom the payment is actually made. This person is not necessarily the beneficial owner of the income. For example, a

custodian receiving a payment may be a payee for purposes of chapter 61 of the Code, even though it is not the beneficial owner of the amounts that it receives on behalf of a customer. Under the final regulations, a payment to a nominee or agent is treated as a payment to an exempt recipient, which, as a result, is exempt from information reporting and backup withholding. See §1.6049–4(c)(1)(ii)(O). Treating a U.S. intermediary as an exempt recipient avoids multiple information reporting and insures that the liability for information reporting and, if applicable, backup withholding, falls upon the last person in a chain of intermediaries, that is the intermediary that has the direct relationship with the customer.

When a payment is made to a foreign intermediary, however, the IRS may not be able to obtain information and, thus, collect the tax that may be due from the ultimate owner if the payment to the foreign intermediary is exempt from information reporting (assuming that the intermediary is an exempt recipient). If the payment to the foreign intermediary involves amounts subject to withholding under chapter 3 of the Code (e.g., U.S. source dividends, U.S. source interest on obligations in registered form, or U.S. source royalties), a U.S. tax is collected at source at a 30-percent rate (assuming that the intermediary has furnished no reliable information concerning the beneficial owners of those payments; see applicable presumptions rules, as revised). If, however, the payment is not subject to chapter 3 withholding (e.g., broker proceeds or foreign source income) and the beneficial owner is a U.S. person, the lack of information regarding the beneficial owner is of greater concern to the IRS.

The regulations proposed in 1988 and in 1996 set forth procedures for payments to intermediaries that are, in part, designed to address some of these concerns (see, for example, the 1996 proposal to apply 30-percent withholding to U.S. source bank deposit interest unless beneficial owner documentation is obtained). The final regulations clarify how withholding and reporting under chapter 3 of the Code interacts with Form 1099 reporting and backup withholding.

Under §1.1441–1(b)(2)(v)(A), a payment to a foreign intermediary (if reliably identified as such by the payor) that has not assumed primary withholding responsibility, is treated as a payment made directly to the person or persons for whom the intermediary (whether or not a QI) collects the payment. If that person is undocumented (i.e., has not furnished a reliable withholding certificate or other appropriate documentation), the person is presumed to be foreign under §1.1441–1(b)(3)(v)(B) to the extent the payment consists of an amount subject to chapter 3 withholding. Therefore, for example, if a U.S. source dividend is paid to a foreign intermediary that furnishes a Form W–9 for another person and such U.S. person is not an exempt recipient, the payor must treat the U.S. person as the payee for purposes of the Form 1099 reporting provisions under section 6042 and backup withholding under section 3406. If the U.S. person is not an exempt recipient, the payment is reportable even though the person who actually receives the payment is the foreign intermediary. The foreign intermediary is an exempt person by virtue of being a foreign person and a nominee. However, as clarified under the final regulations, the fact that the intermediary may be an exempt person is not relevant because, under the final rules, it is not a payee with respect to a payment associated with underlying documentation attached to the certificate. See §§1.6049–5(d)(3)(i) and 1.1441–1(b)(3)(v)(B).

If, however, the amount paid to the person identified as a foreign intermediary is not of a type that is subject to chapter 3 withholding (e.g., foreign source income, broker proceeds), then §1.6049–5(d)-(3)(ii) provides that the amount is treated as paid to an exempt recipient and, as such, exempt from reporting and backup withholding under section 3406. This rule is subject to two exceptions. First, a U.S. payor with actual knowledge that the person for whom the intermediary collects the payment (including broker proceeds and foreign source income) is a U.S. person is required to report the payment (and backup withhold in the absence of a TIN) if the U.S. person is not an exempt recipient. See §1.6049–5(d)(3)(iv), *Example 7.* A second exception is made for U.S. source bank deposit interest and short-term OID. Because these amounts are not subject to withholding, this exception appears under §1.6049–5(d)(3)(iii) and not under section 1441. As explained under the heading "U.S. Source Bank Deposit Interest and Short-term OID" of this preamble, a payment of such amounts to a foreign intermediary (or certain foreign partnerships) is reportable unless the intermediary establishes that the payee (other than an intermediary or a flow-through entity) is a foreign person or an exempt recipient.

Further, provisions have been added to explain how the U.S. withholding and reporting requirements apply to payments made *by* a foreign intermediary, certain U.S. branches, or certain foreign partnerships. A foreign intermediary that furnishes a valid intermediary withholding certificate to the withholding agent is considered to have complied with its own reporting and withholding obligations under chapters 3 and 61 of the Code and sections 3402, 3405, or 3406. See, for example, §1.1441–1(b)(6) applicable to payments of amounts subject to chapter 3 withholding by a foreign intermediary or a U.S. branch and corresponding provisions in §1.6049–5(b)(14) for interest and §1.6042–3(b)(1)(vi) for dividends. Similar provisions are made under §1.1441–5(c)(3)(v) for payments by foreign partnerships that are not withholding foreign partnerships. For example, a foreign custodian bank that is not a qualified intermediary and acts as an agent for a nonresident alien individual who holds U.S. publicly traded obligations in registered form is not required to withhold under section 1441 when it credits the customer's account if it has furnished the individual's Form W–8 (or alternative documentary evidence) to the U.S. withholding agent in compliance with §1.1441–1(e)(3)(iii). If, however, the foreign custodian bank knows that the Form W–8 (or alternative documentary evidence) is not reliable and has not so informed the U.S. withholding agent who, as a result, has not withheld, then the bank is not relieved from its obligation to withhold under section 3406 because it has not acted in compliance with the regulations under section 1441.

These rules apply when the withholding agent/payor holds a valid intermediary withholding certificate. The final regulations add provisions to clarify applicable presumptions when the status of the intermediary is not reliably established or parts of the intermediary with-

holding certificate are not reliable. See a description of these provisions under the heading "Presumptions—Payments to Foreign Intermediaries" of this preamble.

10. U.S. Source Bank Deposit Interest and Short-Term OID

Some commentators objected to the requirement that eligibility for the exemption from U.S. tax on U.S. source bank deposit interest be subject to the same beneficial ownership documentation requirements that apply to portfolio interest, suggesting lack of statutory authority and an increase in burden in the context of interbank financing transactions.

In view of these comments, the final regulations do not require a withholding agent to withhold 30-percent on bank deposit interest under section 1441 in the absence of beneficial owner documentation. Instead, documentation regarding the beneficial owner is required under sections 6049 and 3406 for purposes of avoiding information reporting and backup withholding. This documentation requirement also applies to short-term OID. See §1.6049–5(d)(3)(iii). Therefore, the final regulations provide that a payment to a foreign intermediary of U.S. source short-term OID or of U.S. source interest on deposits with U.S. banks and other financial institutions described in sections 871(i)(2)(A) and 881(d) is treated as made to a foreign payee or an exempt recipient only to the extent that the payor can treat the payment as made to a foreign beneficial owner under §1.1441–1(d)(4) or (e)(1)(ii) or if the payment is made to a qualified intermediary that has assumed primary withholding responsibility or to a withholding foreign partnership. In all other cases, the foreign intermediary is not treated as an exempt recipient and its certification that it is a foreign person is not sufficient to make the payment non-reportable under §1.6049–5(b)(12). Under §1.6049–5(d)(3)(iii), the payment is treated as made directly to the unidentified owners for whom the intermediary receives the payment and, as such, is treated as made to a U.S. payee who is not an exempt recipient.

The regulations provide special rules to help a payor determine whether the person to whom it makes the payment is a foreign or a U.S. person, and, if presumed to be a foreign person under these rules, whether it is an intermediary or is acting for its own account. These presumptions are helpful if the payment is to a foreign person that qualifies as an exempt recipient on an "eyeball" basis (e.g., a foreign bank with the word "bank" in its name). In such a case, no documentation is required to be provided by such person and the payor may have no ability to determine whether the person is U.S. or foreign and whether it is acting as an intermediary or for its own account. A person receiving a payment is presumed to be a foreign person for the purpose of these rules if the payor has actual knowledge of the payee's employer identification number and that number begins with the two digits "98," if the payor's communications with the payee are mailed to an address in a foreign country, or if the name indicates that the payee is a per se corporation under §301–7701–2(b)(8)(i), or the payment is made outside the United States. The final regulations under §1.6049–5(d)(4)(iii) presume that a person receiving a payment of U.S. bank deposit interest or U.S. short-term OID is *not* acting for its own account (note that this presumption is different form the general presumption under §1.1441–1(b)(3)(v)(A) that presumes a foreign person to be acting for its own account unless it furnishes certain documentation establishing its status as an intermediary). Thus, in the absence of documentation and any evidence that the foreign person is acting for its own account, a payor would presume that the payment is made to unidentified owners for whom the person receives the payment, required to be reported under section 6049 and subject to 31-percent backup withholding under section 3406.

A payee may rebut this presumption by furnishing an indication of beneficial ownership to the payor. Such indication may be provided in any manner as the parties may choose, but must be reflected in the payor's records. An indication by a foreign person that it is not an intermediary does not have to be made under penalties of perjury.

In order to minimize disruptions to high-volume wholesale banking transactions and to the sale and repurchase (repo) market, the final regulations exempt from these documentation requirements deposits with banks and other financial institutions that remain on deposit for a period of two weeks or less, and amounts of original issue discount arising from any repo transaction that is completed within a period of two weeks or less. Further, amounts paid with respect to certain bearer obligations are also exempt.

11. Presumptions—In General

Proposed §1.1441–1(f), dealing with presumptions of U.S. or foreign status in the absence of reliable documentation, is restated with a number of clarifications, in §§1.1441–1(b)(3) and 1.6049–5(d)(2) through (5). The presumptions in §1.1441–1(b)(3) apply to amounts that are subject to chapter 3 withholding. The same presumptions apply under §1.6049-5(d)(2) to payments that are not subject to chapter 3 withholding (e.g., foreign source income, sales proceeds), with a few differences. As under the proposed regulations, payments that a payor or withholding agent cannot reliably associate with documentation are presumed to be made to a U.S. payee who is not an exempt recipient, in which case 31-percent backup withholding applies if the payment is otherwise a reportable payment (within the meaning of the applicable information reporting provisions under chapter 61 of the Code). As an exception to this rule, a payee is presumed to be foreign if it is an exempt recipient for whom indicia of foreign status exist. Special rules are also provided for scholarships and pensions, for which no backup withholding applies under section 3406, and for certain payments to offshore accounts. See §1.1441–1(b)(3)(iii).

In determining the extent to which the withholding agent can consider that it can rely on documentation to determine the extent of its withholding obligations, the final regulations rely on a concept of "reliable association" of a payment with withholding certificates or other documentation. This concept replaces the requirement under §1.1441–1(f)(1)(ii) of the proposed regulations that the withholding agent hold required documentation. The definition of "reliable association" is set forth in §1.1441–1(b)(2)(vii). As in the proposed regulations, a withholding agent cannot reliably associate a payment with documentation if the documentation is lacking or is unreliable. These provisions apply regardless of whether documentation is otherwise re-

quired. For example, a payment of U.S. source royalties to a corporation with the word "Inc." in its name requires no documentation from the payee under section 6050N because the payee's status as an exempt recipient is inferred from its name (i.e., on an "eyeball" basis) under §1.6049–4(c)(1)(ii)(A)(*1*). In such a case, the payor must consider that there is a per se lack of documentation. Therefore, under §1.1441–1(b)(3)(iii)(A), a payment to such an exempt recipient is presumed made to a foreign person if certain indicia of foreign status are present. If these indicia are present, the payor, if also a withholding agent, must withhold 30-percent from the payment under section 1441.

The final regulations modify the presumptions for certain payments to offshore accounts. Under the proposed regulations, a payment to a foreign account is presumed to be made to a U.S. person. Thus, the payor must file a Form 1099 for the payee, but the payment is not subject to backup withholding. See proposed §§1.1441– 1(f)-(2)(ii) and 31.3406(g)–1(e). The final regulations provide that, in the case of a payment to a foreign account of an amount subject to chapter 3 withholding, the payment is presumed to be made to a foreign person and not to a U.S. person. Thus, the withholding agent must withhold on the payment at a 30-percent rate. In that case, the foreign status presumption insures that a tax is paid on such amounts since, under §31.3406(g)–1(e), no backup withholding would apply to an undocumented account if the account holder were presumed to be a U.S. person. See §1.1441–1(b)(3)(iii)(D). The final regulations adopt the rule in the proposed regulations for payments involving amounts that are not subject to chapter 3 withholding (i.e., payee is presumed to be a U.S. person who is not an exempt recipient, subject to Form 1099 reporting but not to backup withholding). See §§1.1441–1(b)(3)(iii) and 1.6049-5(d)(2)(i).

The final regulations include presumptions regarding the characteristics of a payee so that a payor or withholding agent may determine whether to treat the payee as an owner of an account or as an intermediary (see §1.1441–1(b)(3)-(v)(A)), and as an individual, a trust, an estate, a corporation or a partnership. See §1.1441–1(b)(3)(ii). The final regulations also make a number of clarifications to the presumption provisions in response to comments. First, the revised rules clarify that the presumptions are mandatory. A payor that withholds a lesser amount or does not report a payment contrary to what the presumptions would require may be liable for the amount of the tax in addition to interest and penalties, even if the withholding agent acted on the basis of actual knowledge. Although the liability for the tax may be eliminated if the withholding agent establishes that it withheld the proper amount (based on its actual knowledge or otherwise), liability for interest and penalties may be assessed. This rule is consistent with the requirement under the regulations to provide documentation before a payment is made so that a withholding agent may not rely on actual knowledge to reduce a withholding or reporting obligation. Treating the presumptions as mandatory rather as mere safe harbors is necessary to avoid undermining the requirement that withholding agents obtain documentation prior to the time of a payment.

On the other hand, a withholding agent or payor may not rely on the presumptions if it has actual knowledge (or, in the case of amounts subject to chapter 3 withholding, reason to know) of facts that would require it to withhold an amount greater than would otherwise be required based upon an applicable presumption or to report a payment that would be exempt from reporting under an applicable presumption. See §1.1441–1(b)(3)(ix) and (b)(7).

The final regulations clarify that if, under the rules, a payment is presumed to be made to a U.S. payee, the determination of whether to report on a Form 1099 or backup withhold is governed by the provisions under chapter 61 of the Code and section 3406 and not by chapter 3 of the Code. See §1.1441–1(b)(3)(i). Also, the final regulations clarify that a withholding agent that withholds in accordance with an applicable presumption is not liable under another withholding provision for that payment, even if the payee is subsequently determined to have a status different from its presumed status. See §1.1441–1(b)(3)(ix)(A).

12. Presumptions—Grace Period

Several comments were received regarding the grace period provisions under proposed §1.1441–1(f)(2)(ii). Under the proposed rules, a withholding agent or payor may presume that an account holder for whom specified indicia of foreign status exist at the time that a payment is first credited to the account may be treated as a foreign person, even if no documentation has been received before the account is first credited. This presumption has two consequences: first, backup withholding is deferred until the end of the grace period (and may never be required if foreign status documentation is provided when or before the grace period terminates); second, an amount must be withheld under chapter 3 of the Code without the benefit of a reduced rate under the Code or an income tax treaty if the amount is income subject to chapter 3 withholding. At the expiration of the grace period, the account holder is treated as a U.S. or foreign person, depending upon whether documentation is furnished, and, if so, what type of documentation is furnished.

Commentators argued that a withholding agent should be allowed to rely on the apparent status of the beneficial owner to grant a reduced rate of withholding for payments made during the grace period. They point to the prohibition against depleting the account below 31-percent of the amounts paid and argue that this prohibition protects the government's interest that the proper amount of tax be collected upon expiration of the grace period if entitlement to a reduced rate is not confirmed. This comment is accepted but only if the withholding agent has received a faxed Form W–8. Thus, for example, a reduced rate of withholding for portfolio interest or under a tax treaty can apply to amounts credited during the grace period based on a faxed Form W–8.

Commentators also argued that any backup withholding should not be retroactively imposed after the expiration of the 90-day grace period when documentation is still lacking at that time, because of the difficulty to deduct and deposit a tax after the fact. In response to these comments, the final regulations are revised to impose backup withholding only to payments credited to the account after the expiration of the grace period if, at that time, documentation is still lacking or unreliable. The presumption that the account holder was a foreign person during the grace period is not reversed. Thus, if amounts credited during the grace period were subject to withholding at less than the full 30-

percent rate, and, at the end of the grace period, the documentation is still lacking or unreliable, then the payor must make an adjustment in order to correct the underwithholding, so that all amounts credited during the grace period are withheld upon at the full 30-percent rate (to the extent they are amounts subject to chapter 3 withholding). Under the final regulations, amounts credited to the account during the grace period could be subject to no or reduced withholding if the withholding agent receives a faxed Form W–8. Consistent with the 30-day grace period under §31.3406(d)–3(c), the provisions are revised to treat reinvestment as withdrawals. The grace period is terminated if withdrawals or other events leave a balance in the account that is insufficient to cover potential backup withholding liability. See §1.6049–5(d)(2)(ii) and §1.1441–1(b)(3)-(iv) of the final regulations, as renumbered.

For purposes of withholding under chapter 3 of the Code, the 90-day grace period applies to all payments that are exempted from the TIN requirement under §1.1441–6(b)(2)(ii). For purposes of information reporting on amounts not subject to withholding, the 90-day grace period applies to all payments reportable as dividends, interest, royalties, and broker proceeds. Although comments were received asking that the grace period be extended to existing accounts, the final regulations do not do so. A grace period should not be necessary for existing accounts where the expiration of withholding certificates is a predictable event for which withholding agents and payors can plan accordingly. On the other hand, the grace period is extended to situations where the validity of documentation expires because of a change of circumstances. In such a case, it is reasonable to allow time to obtain new or corrected documentation to account for changes affecting the validity of documentation in an unexpected manner. The final regulations also extend the availability of a grace period for purposes of payments for which a Form 8233 is required (i.e., claim of treaty benefits for compensation to nonresident alien for personal services). This benefit is intended to facilitate withholding on these payments to beneficial owners who are awaiting their social security number or ITIN. The final regulations clarify that the grace period provisions apply at the option of the payor or withholding agent. Therefore, a payor or withholding agent is not required to implement procedures offering a grace period to its customers.

13. Presumptions—Payments to Foreign Intermediaries

At the request of commentators, the final regulations clarify how the presumptions apply to payments to foreign intermediaries in the absence of reliable documentation both for purposes of chapter 3 and chapter 61 information, and sections 3402, 3405, and 3406. Under §1.1441–1(b)(3)(v)(A), a payee who has not provided a valid intermediary withholding certificate or whose intermediary withholding certificate is defective because, for example, the information on the certificate regarding the intermediary is lacking or unreliable, must generally be treated as an undocumented owner of the payment. Under §1.1441–1(b)(3)(ii), an undocumented owner is presumed to be an individual, a trust, or an estate, if the payee appears to be such a person. In the absence of reliable indication that the payee is an individual, a trust, or an estate, the payee is presumed to be a corporation if it can be treated as a corporation under the "eyeball" test described in §1.6049–4(c)(1)(ii)(A)(1) or is presumed to be one of the persons enumerated under §1.6049–4(c)(1)(ii)(B) through (Q) if it can be so treated under an "eyeball" test basis. If it cannot be so treated, then it is presumed to be a partnership.

If the payee is presumed to be an individual, a trust, an estate, or a partnership, it is presumed under §1.1441–1(b)(3)(iii) to be a U.S. person who is not an exempt recipient and the information reporting provisions under chapter 61 of the Code and section 3406 would govern the payor's reporting and withholding obligations with respect to the payment. If the payee is presumed to be a corporation or another exempt recipient under §1.6049–4(c)(1)(ii)(B) through (Q), then it is also presumed to be a U.S. person. However, if the amount paid consists of an amount that is subject to withholding under chapter 3 of the Code (e.g., U.S. source interest or dividends), the payee is presumed to be a foreign person if there are indicia of foreign status, in which case withholding at the 30-percent rate is required under chapter 3 of the Code. See §1.1441–1(b)(3)(iii)(A).

If the payment can be treated as made to a foreign intermediary but the intermediary's withholding certificate is unreliable either because the withholding agent or payor has not been given sufficient information to determine the proper amount of withholding or because some or all of the underlying certificates that are required to be attached are lacking or are unreliable, the payment is presumed made to a foreign nominee acting for an undocumented owner. Therefore, the payment is subject to withholding under chapter 3 of the Code at the unreduced 30-percent rate to the extent it consists of income subject to such withholding under chapter 3 of the Code. See §1.1441–1(b)(3)(v)-(B). Additional presumptions are provided under §1.1441–1(b)(3)(v)(C) and (D) to deal with lacking or unreliable information regarding the allocation of a payment among beneficial owners or other payees and lacking or unreliable information regarding whether the intermediary's certificate identifies all of the persons to whom the payment relates. Section 1.6049–5(d)(3)(ii) clarifies, however, that if the payment is not an amount subject to chapter 3 withholding, then the payment is presumed to be made to an exempt recipient not reportable under section 6042, 6045, or 6049 (except for certain payments of U.S. bank deposit interest or U.S. short-term OID under §1.6049–5(d)(3)(iii)).

The lack of reliable information regarding beneficial owners or the allocation of the payments among them raise an issue as to how the amounts should be reported on a Form 1099 (if, for example, the withholding agent has a Form W–9 from a beneficial owner but has no or unreliable information regarding how much the payment is allocable to such person) or on a Form 1042–S. The final regulations under §1.1461–1(c)(4)(iv) provide that payments to an intermediary or foreign partnership for the account of undocumented owners or partners are reportable on a single Form 1042–S made out to the intermediary, and bearing the mention "unknown owners." The final regulations, however, do not contain guidance for situations where the withholding agent or payor is lacking reliable allocation information. This matter is under consideration by the IRS and comments are so-

licited regarding appropriate procedures before guidance is issued.

The final regulations contain similar provisions for payments to foreign partnerships under §1.1441–5(d). See the explanation under §1.1441–5, below.

15. Late-received Form W–8—Cure Procedures

Generally, a Form W–8 or other applicable documentation must be furnished to the withholding agent or payor prior to the time of payment. The proposed regulations in §1.1441–1(f)(5) prescribe procedures allowing a Form W–8 or other documentation to be furnished late (i.e., after the 90-day grace period), subject to interest and penalties. They also contemplate the possibility that, upon examination, the IRS might require the withholding agent or payor to furnish additional proof in support of the claim of foreign status or eligibility for a reduced rate of withholding under the Code or a tax treaty. Commentators asked for an exemption from interest and penalties when it is determined that there is no underlying tax liability once the documentation has been provided or, at least, that the liability be abated where the withholding agent has acted in good faith.

The final regulations do not eliminate the possibility that interest and penalties may apply because the liability for those items is clearly contemplated under section 1463. However, several revisions are made to relieve liability in certain cases. See §1.1441–1(b)(7), restating the provisions of proposed §1.1441–1(f)(5). First, in order to eliminate the possibility of a double interest charge when the respective unsatisfied tax liabilities of the withholding agent and of the beneficial owner run concurrently, the regulations are modified to limit collection to one amount of interest only. In that regard, interest will not be assessed against the withholding agent if it otherwise is assessed or collected against the beneficial owner. Next, in order to clarify that the cure rules apply to all cases for which documentation must be provided to the withholding agent, cross references have been added under §§1.1441–4(f), 1.1441-5(f), 1.1441–6(f), 1.1441–8(e), 1.1441–9(c), and 1.1443–1(b)(3). In addition, the final regulations make this relief available on a retroactive basis for all open years. This action is intended to eliminate any ongoing controversy with the IRS regarding an issue that is unclear under current law. The final regulations clarify that the period for calculating penalties and interest is limited to the time that the liability remains outstanding, i.e., starting with the due date for filing the return under section 6601 (i.e., March 15 of the year following the year in which the payment was made) and ending with the date that the tax is considered paid (i.e., the time that the documentation is furnished establishing the proper amount of tax due or that the tax is actually paid, whichever is earlier). Also, commentators asked for a clarification of how late deposit penalties would apply when the withholding agent fails to withhold. This issue remains under consideration.

16. Due diligence with respect to information returns required under chapter 61 of the Code.

The Interest and Dividend Tax Compliance Act of 1983 provided that the penalty for the failure to file an information return, furnish a copy of it to a payee, or supply a TIN can be waived if it is shown that the filer exercised due diligence in filing the return, furnishing it to a payee, or supplying the payee's TIN. The due diligence standard applied to failures on information returns reporting dividends under section 6042, patronage dividends under section 6044, and interest or OID under section 6049. The IRS issued regulations in question and answer form providing the prerequisites to establish due diligence. See §§35a.9999–1 through 35a.9999–5.

The Omnibus Budget Reconciliation Act of 1989, Public. Law 101–239, 103 Stat. 2393, repealed sections 6676 and 6678 with the enactment of uniform information reporting penalties under sections 6721 through 6724 and replaced due diligence with a reasonable cause standard under newly enacted section 6724. However, Congress provided that the separate and higher due diligence waiver standard for returns filed under sections 6042, 6044, and 6049 be considered to meet reasonable cause. H. Rep. No. 247, 101st. Cong., 1st. Sess., at 1385 (1989).

These final regulations remove the Q/As under Part 35a, effective January 1, 1999. Because due diligence will remain in effect, the IRS will retain the relevant Q/As set forth in Part 35a. These final regulations redesignate the relevant Q/As under §301.6724–1(g).

17. Effective Dates

Many comments were received regarding the effective dates of the final regulations. Commentators argued that the January 1, 1998 effective date in the proposed regulations should be extended because of the anticipated time required to complete QI agreements and for withholding agents to make the administrative and operating systems changes that will be necessary to comply with the regulations. However, commentators have argued that provision should also be made for a financial institution to elect earlier adoption of the new requirements where possible.

The final regulations accommodate these concerns. The effective date is changed to January 1, 1999. In view of the later effective date and comments that staggered effective dates make system adjustments more difficult and costly, all special delayed effective dates rules are eliminated. Also, transition rules are modified for existing certificates. Valid withholding certificates that are held on December 31, 1998, remain valid until the earlier of December 31, 1999 or the due date of expiration of the certificate under rules currently in effect (unless otherwise invalidated due to changes in the circumstances of the person whose name is on the certificate). Further, certificates dated prior to January 1, 1998 that are valid as of January 1, 1998, remain valid until the end of 1998, irrespective of the fact that their validity expires during 1998 (other than by reason of changes in the circumstances of the person whose name is on the certificate).

The final regulations do not accelerate the effective date of certain provisions as had been requested by several commentators. Although doing so would provide relief to a number of taxpayers, it would also complicate the many system adjustments that withholding agents, particularly financial institutions with large volume of cross-border payments, must implement before the effective date of these regulations. The IRS and Treasury feel that the benefits of accelerating certain provisions would not sufficiently outweigh the added costs and burdens to many withholding agents.

C. *Comments and Changes to §1.1441–2*

1. Amounts subject to withholding

Under §1.1441–1 of current regulations, an amount is subject to withholding only if it is from sources within the United States. The final regulations under §1.1441–2(a) clarify that an amount can be sourced within the United States irrespective of the fact that the source is undetermined at the time of payment. This clarification addresses the Tax Court's ruling in *Albert J. Miller v. Commissioner*, T.C. Memo 1997–134, 73 T.C.M. (CCH) 2319, that an amount whose source cannot be determined at the time paid is sourced outside the United States for purposes of sections 871(a) or 881(a) and the withholding provisions of chapter 3 of the Code.

2. Fixed or Determinable Annual or Periodical Income

The definition of the term *fixed or determinable annual or periodical* (FDAP) income under existing regulations under section 1441 is retained in the final regulations and clarified. In particular, §1.1441–2(b)(1)(iii) addresses three types of uncertainties that a withholding agent may encounter: 1) the proportion of the payment that constitutes income cannot be determined when a payment is made (e.g., a payment made on an obligation that may include interest, but the exact amount of interest cannot be determined because the determination is contingent upon future events); 2) the proportion of the payment that constitutes U.S. source income cannot be determined at the time of payment; or 3) the fact that the payment may be income in the future cannot be anticipated at the time of payment. Only in the third case would the payment not constitute FDAP income. In the first two cases, income is actually being paid. The only uncertainty is the amount that the recipient should include in income and this uncertainty does not prevent the payment from constituting fixed or determinable annual or periodical income for purposes of section 871(a) or 881(a) and the withholding provisions of chapter 3 of the Code. See also the additional provisions under §§1.1441–2(b)(1)(iii) and 1.1441–3(d)(1) dealing with determinability and rules of withholding for items whose source cannot be determined at the time of payment.

3. Original Issue Discount

In response to comments, the final regulations regarding withholding on original issue discount (OID) are simplified. As a general principle, withholding is required on a payment that is treated as taxable OID under section 871(a)(1)(C) or 881(a)(3)(A) to the extent the withholding agent knows the amount that is OID. That amount is known to the withholding agent if it knows how long the beneficial owner has held the obligation on which a payment is made, the terms of the obligation, and the extent to which the beneficial owner purchased the obligation at a premium. A withholding agent has knowledge if the information is obtainable upon exercising reasonable efforts. The information is not considered obtainable in the case of payments with respect to publicly traded securities where the withholding agent, consistent with normal industry practices, does not have a direct customer relationship with the person who has actual knowledge of the relevant information or has no access to this information in the normal course of its business due to the manner in which the obligation is held (e.g., in street name or through intermediaries). In the case of a withholding agent maintaining a direct customer relationship with the beneficial owner, knowledge regarding the owner's holding period and acquisition premium is considered to be reasonably available to the withholding agent. Because of the complexities that may be involved in calculating the amount taxable to the owner and, thus, subject to withholding, withholding agents may rely on the most recently published "List of OID Instruments" or similar list published by the IRS (currently contained in IRS Publication 1212 (available from the IRS Forms Distribution Centers)).

Notwithstanding the rules described in the preceding paragraph, withholding is required with respect to OID that would qualify as portfolio interest except for the fact that documentation required under section 871(h)(5) is not furnished to the withholding agent. In the absence of information regarding the amount of OID, the withholding agent may rely on IRS Publication 1212. The final regulations clarify that no withholding applies to amounts that are not otherwise subject to chapter 3 withholding (e.g., OID on obligations in bearer form that qualifies as portfolio interest).

3. Securities Lending Transactions

The final regulations add paragraph (b)(4) to cross-reference the regulations under sections 871 and 881 dealing with securities lending transactions and equivalent transactions. Thus, the character of the income arising from these transactions applies for purposes of determining the amount of withholding under chapter 3 of the Code. Similar rules apply for purposes of information reporting and backup withholding on interest and dividends. See §§1.6042–3(a)(2) and 1.6049–5(a)(5). See §1.1441–1(b)(4)(i) for documenting interest equivalent amounts for which the beneficial owner claims a portfolio interest exemption.

4. Relief for Deemed Payments of Income

Several comments were received regarding the difficulty for a withholding agent to withhold on an amount of income that is not represented by cash or property (i.e., deemed payments of income). The final regulations in §1.1441–2(d) provide relief in cases in which the withholding agent does not have custody of, or control over, property of the taxpayer who is deemed to receive income under section 871(a) or 881(a) or does not have knowledge of the events that give rise to the deemed payment. Relief, however, does not apply for deemed payments arising between related parties or as part of a prearranged plan to avoid withholding. Therefore, a withholding obligation arising out of a deemed payment resulting from an allocation of income under section 482 is not eliminated because the parties are related. Examples are provided for cancellation of debt and constructive income arising from correcting prior underwithholding by paying the amount of tax due to the IRS. Withholding on deemed distributions with respect to stock is not excused under these rules. For these amounts, the IRS and Treasury believe that an exemption from withholding would be inappropriate in view of the ongoing investment or business relationship

between the parties. Under the final regulations, withholding is required at the time of the deemed distribution even if the income from the distribution is prorated over time (such as a redemption premium under section 305(c)). The IRS and Treasury considered comments asking that withholding be deferred until income is includable in the shareholder's income but concluded that the withholding procedures necessary to implement such an exception and insure proper withholding would be too complex.

D. *Comments and Changes to §1.1441–3*

1. Withholding on Interest Payments

No obligation to withhold is imposed under current law on the payment of stated interest on an obligation that was purchased between interest payment dates. Under §1.61–7(c), interest received on the interest payment date is treated as a return of basis to the extent it represents accrued unpaid interest as of the date of purchase as reflected in the new holder's basis for the obligation. Therefore, when the new holder receives a payment of the stated interest, the holder's tax liability is limited to the amount of interest accrued after the date of purchase (subject to additional adjustments reflecting possible acquisition premiums or market discounts). Because of the difficulty for a withholding agent to determine the amount accrued to the holder and other adjustments affecting the actual amount taxable to the holder, withholding on the entire amount of stated interest is permitted under the regulations. Although commentators have asked that the withholding agent be permitted to withhold on the amount that it knows is taxable, the final regulations do not modify the proposed regulations on this point because the IRS and Treasury consider that withholding on the entire amount is justified to the extent that, under existing rules, withholding on sales of obligations between interest payment dates is not required.

This comment is taken into account, however, in regulations that are proposed together with these final regulations to require withholding on sales of obligations between interest payment dates. These proposed regulations are intended to conform the withholding regime for sale of bonds between interest payment dates to that implemented for OID obligations under the final regulations. See project REG–114000–97, page 661.

2. Withholding on Distributions

The proposed regulations regarding withholding on corporate distributions are expanded and clarified in view of comments. Section 1.1441–3(c)(1) and (2)(i) are revised to clarify that the withholding procedures are elective. In other words, a distributing corporation or the custodian or nominee may choose to withhold on the entire amount distributed and, thus, to not take advantage of the election to limit withholding to the estimated earnings and profits amount. An election by the distributing corporation to determine withholding based on the estimated earnings and profits amount for distributions it makes directly to a foreign person does not mean that a custodian or nominee who receives payments of distributions for the account of foreign investors must do the same when it makes a payment of these distributions to the foreign investors. Instead, the custodian may choose to disregard the estimate of earnings and profits and to withhold on the entire distribution. The revisions reflect the fact that each withholding agent must be able to make this decision independently because of its own potential tax liability under section 1461 in the event of underwithholding. The final regulations clarify that the amounts of tax that the withholding agent pays to satisfy the tax liability under section 1461 if underwithholding has occurred is not subject to withholding even if it constitutes a constructive dividend. This rule applies irrespective of the fact that the satisfaction of the tax liability may be additional income to the shareholder unless the additional payment results from a contractual arrangement between the parties regarding the shareholder's satisfaction of its tax liability by the distributing corporation. With this rule, the final regulations eliminate, for this situation, the question as to whether a taxpayer realizes income when the withholding agent satisfies a tax liability under section 1461.

Further, proposed §1.1441–3(c)(2)(iii) (renumbered as §1.1441–3(c)(2)(ii)(C) in the final regulations) is revised so that an erroneous estimate by the distributing corporation is imputed to an intermediary not only in situations in which the IRS challenges the estimate but also in situations in which the distributing corporation unilaterally determines that its estimate is in error. Some commentators questioned whether a reference to interest in §1.1441–3(c)(3)(ii)(B) regarding consequences in the event of underwithholding had been omitted in error. Interest is not mentioned in the provision because, to the extent underwithholding is corrected by the due date of filing the annual return under §1.1461–1(b), no interest charge applies. On the other hand, if the withholding agent corrects the underwithholding as part of an amended return filed after the due date for filing the annual return, then an interest charge would apply, as reflected in §1.1441–3(c)(3)(ii)-(B)(*2*)(*ii*).

In response to another comment, §1.1441–3(c)(3)(ii) is added to allow custodians and nominees to rely on estimates made by mutual funds regarding their capital gain dividends and exempt interest dividends. Some commentators also asked that §1.1441–3(c)(3)(ii) be revised to provide that an adjustment to the amount of withholding is not a distribution for all purposes and not just for purposes of section 562(c). This comment is not accepted because there are circumstances in which the adjustment may constitute a distribution—such would be the case, if, for example, the adjustment cannot be made by adjusting the withholding on a subsequent distribution because the affected shareholder is no longer a shareholder or the adjustment occurs after the end of the taxable year.

Finally, §1.1441–3(c)(4) has been added to coordinate the general distribution provisions with the regulations under section 1445. Under §1.1445–5(b)(1), no withholding is required under section 1445 on a distribution from a U. S. real property holding corporation (USRPHC) if the distribution is subject to withholding under section 1441 or 1442. Given the change in the withholding procedures applicable to corporate distributions, the exemption from withholding under section 1445 may now lead to underwithholding on distributions from a USRPHC. In order to correct this situation, the final regulations give taxpayers a choice between two withholding regimes. A USRPHC may choose to withhold under sec-

tion 1441, provided it withholds on the entire amount of the distribution, regardless of estimated earnings or profits. However, the rate of withholding may be reduced under income tax treaty provisions, although not below the 10-percent rate applicable under section 1445 (unless the treaty provides otherwise for distributions from USRPHCs). For purposes of applying the treaty, the entire amount of the distribution is treated as a dividend. Alternatively, the USRPHC may withhold under a mixed regime. Under this regime, withholding applies under section 1441 on the portion of the distribution that represents estimated earnings and profits and under section 1445 on the remainder of the distribution. The mixed withholding regime is mandatory for distributions from publicly-traded real estate investment trusts (REITs). In other words, a REIT may not, with respect to its distributions, choose to apply the withholding regime of section 1441 to the entire distribution. Instead, the REIT must withhold under section 1441 on the portion of the distribution that is not designated as a capital gain dividend or a return of basis. Withholding under section 1445 is also required on the portion of the distribution that the REIT designates as a capital gain dividend in accordance with §1.1445–8.

3. Withholding on undetermined amounts

The final regulations also address the practical difficulties of withholding on an amount when, at the time of payment, there is not sufficient information to calculate which portion, if any, is taxable or to determine the source of the income. For these purposes, provisions have been added under §1.1441–3(d)(1) that require a withholding agent to withhold on the entire amount when such uncertainties exist. This requirement in part reflects the policy that withholding generally should apply to payments that leave the U.S. taxing jurisdiction. The requirement to withhold in the event of uncertainty is similar to the provisions under existing regulations under §1.1441–3(d)(1) (restated as §1.1441–3(d)(2) of the final regulations) requiring withholding of an amount sufficient to assure that the tax withheld is no less than 30-percent of the recognized gain. In order to minimize overwithholding, the final regulations provide an alternative to withholding on the entire amount when uncertainties exist. Instead, the withholding agent may make a reasonable estimate of the amount from U.S. sources or of the taxable amount and set aside a corresponding portion in escrow until the amount subject to withholding can be determined. Under this alternative, setting aside an amount is not an event of withholding for purposes of §1.1461–1(a) that would give rise to the requirement to pay the tax. Instead, the payment of the tax can be postponed until a determination can be made of the amount of withholding liability under this section. The provisions under §1.1441–1(d)(1) do not apply to uncertainties that are specifically addressed under other provisions of the regulations, such as lack of information regarding the identity or status of the beneficial owner or payee (see §1.1441–1(b)(3) for applicable presumptions in those cases and the grace period provisions set forth in §1.1441–1(b)(3)(iv)) or withholding on original issue discount amounts (see §1.1441–2(b)(3)).

E. *Comments and Changes to §1.1441–4*

1. Notional Principal Contracts

Commentators have questioned whether it is appropriate to treat income from notional principal contracts as FDAP income, particularly since it is unclear at the outset whether the arrangement will generate any income. The IRS and Treasury believe that the statute contemplates very few exceptions to the concept of FDAP, and the only clear exception is for gain from the disposition of property. Income from notional principal contracts is not gain from the disposition of property, nor is it the equivalent of gain. However, the final regulations minimize the burden associated with characterizing the income as FDAP because the liability for withholding under chapter 3 of the Code is eliminated for such income. See §1.1441–4(a)(3). Reporting under section 1461 or 6041, however, continues to be required under the final regulations. However, in response to comments, the reporting burden has been reduced and clarified (see §§1.1441–4(a)(3), 1.1461–1(c)(2)(i)(C) and (ii)(D), 1.6041–1(d)(5) and 1.6041–4(a)(4) of the final regulations).

Under the final regulations, notional principal contract payments are exempt from withholding. However, if paid to a foreign person, they are presumed effectively connected income and, as such, are required to be reported on a Form 1042–S. The effectively connected income presumption under §1.1441–4(a)(3) can be rebutted by providing to the withholding agent a valid withholding certificate representing that the payments are not effectively connected with the conduct of a U.S. trade or business. In such a case, no reporting is required on a Form 1042–S for these amounts. A financial institution (as defined in §1.165–12(c)(1)(iv)) may, instead of a withholding certificate, represent in a master agreement that governs the transactions in notional principal contracts between the parties (such as an International Swaps and Derivatives Association (ISDA) Agreement, including the Schedule thereto) or in the confirmation on the particular notional principal contract transaction, that the counterparty is a U.S. person or is a non-U.S. office of a foreign person. These representations are not required to be made under penalties of perjury.

In the final regulations, swap payments include payments on notional principal contracts described in §1.988–2(e), dealing with foreign currency swaps. Also, income on notional principal contracts does not, for purposes of these rules, include amounts characterized as embedded interest under §1.446–3(g)(4). Such amounts, if not effectively connected with the conduct of a U.S. trade or business and from U.S. sources, are subject to chapter 3 withholding and are reportable on a Form 1042 and 1042-S.

Under §1.6041–1(d)(5), a payment on a notional principal contract, including embedded interest, is a reportable payment, unless paid to an exempt recipient (i.e., a person described in §1.6049–4(c)(1)(ii)), paid outside the United States (unless the payor has actual knowledge that the payee is a U.S. person), treated as effectively connected with a U.S. trade or business under §1.1441–4(a)(3), or paid by a non-U.S. payor or a non-U.S. middleman. If none of these exceptions applies, and the payor does not hold a Form W–9, then a payment is presumed under §1.6049–5(d)(2)(i) to be made to a U.S. person that is not an exempt recipient, in which case backup withholding would be required under section 3406.

The final regulations under §§1.6041–1(d)(5) and 1.1461–1(c)(2)(i)(C) adopt the suggestion that nonperiodic payments are reportable only at the time that an actual payment is made. The final regulations require reporting of net income rather than gross amounts from notional principal contracts. Further, in response to comments, the final regulations in §§1.1441-4(a)(3) and 1.6041–1(d)(5) specify that the reporting requirements apply only prospectively, i.e., to payments made after December 31, 1998.

2. Form 8233 Procedures

The current regulations prescribe a procedure by which a withholding agent may grant a reduced rate under an income tax treaty on payments to nonresident aliens for services rendered in the U.S., generally in connection with a sporting, cultural, scientific, or artistic event. The procedure involves submitting a Form 8233 to the IRS for review and approval as instructed under §1.1441-4(b)(2). The regulations provide, in effect, that the withholding agent may not grant an exemption from withholding until after a 10-day period beginning with the date that the Form 8233, as reviewed and approved by the withholding agent, is mailed by the withholding agent to the IRS. The proposed regulations extend the 10-day period to 20 days.

Commentators objected to the 20-day period and asked for the retention of the 10-day period. In addition, they suggested that, instead of making the treaty exemption effective only after the submission of Form 8233, the exemption should be retroactive to the date of first payment covered by the certificate if the completed Form 8233 contains the nonresident alien's TIN, and if the withholding agent is not subsequently notified by the IRS within the 20-day period that the exemption is not valid. After further consideration, the comments are adopted. The 10-day waiting period is continued and the approval of the Form 8233 is made retroactive to the date of first payment covered by the certificate. However, the final regulations clarify that the IRS review process does not exonerate the withholding agent from liability for underwithholding. In its review, the IRS simply insures that the form contains all of the requested information, that the country of residence stated on the form is a country with which the U.S. has an income tax treaty, that the reduced rate that the withholding agent plans to apply is the proper rate under the applicable treaty, and that, based solely on information contained on the form, the reduced rate appears applicable. The IRS approval of the form makes no determination regarding whether the withholding agent's reliance on the form is reasonable, based on facts that the withholding agent knows or has reason to know at the time of the payment and that are not disclosed to the IRS as part of the review process. In addition, the final regulations allow the 90-day grace period to apply to payments covered by a Form 8233, in order to allow time for foreign persons who come to the United States for the first time and must complete a Form 8233 shortly after arrival to apply for and obtain an individual taxpayer identifying number. See §1.1441–1(b)(3)(iv).

The final regulations modify the proposed rule under §1.1441–1(b)(6) reducing the amount of certain compensation income by the personal exemption under section 151. The proposed regulations allowed a reduction for the full amount of the exemption. Commentators noted that allowing a reduction for the full amount of the allowable personal exemption may lead to inappropriate claims of multiple exemptions for nonresident aliens who come to the U.S. frequently for short-term events or assignments with different organizations. Commentators were concerned that they would have no ability to keep track of prior claims of the personal exemption. For this reason, the proration rule now currently in effect, is continued in the final regulations.

3. Reimbursed Expenses

Commentators asked that the regulations provide an exemption from withholding for reimbursed expenses paid to a nonresident alien individual in relation to performance of services in the U.S. as an independent contractor. A change to the regulations is not necessary, however. If the payments are exempt from tax under the Code, they are exempt from withholding under §1.1441–4(b)(1)(iv). If, on the other hand, those payments are not exempt under the Code, then it would be inappropriate to provide for an exemption from withholding under section 1441.

F. *Comments and Changes to §1.1441–5*

In response to comments, many partnership provisions have been consolidated in this section. A new paragraph (a) has been added to describe the steps necessary to determine the status of the payee for withholding purposes. The withholding procedures applicable to domestic partnerships are stated in paragraph (b). The withholding procedures applicable to foreign partnerships are stated in paragraph (c). Paragraph (d) describes applicable presumptions in the absence of documentation. Paragraph (e) is reserved for rules applicable to estates and trusts. Paragraph (f) contains the effective date provisions. Corresponding provisions have been added in §1.6049–5(d)(4), dealing with payments of reportable amounts under chapter 61 of the Code to address reporting of payments of amounts that are not subject to chapter 3 withholding.

Paragraph (c)(1) provides guidance for identifying the payee in the case of a payment to a foreign partnership. As a general rule, a payment to a foreign partnership is treated as a payment directly to the partners, whether or not documentation has been provided for the partners, with two exceptions: a payment to a "withholding foreign partnership" and a payment to a foreign partnership that has furnished a certificate upon which the withholding agent can rely to treat the payment as effectively connected with the conduct of a U.S. trade or business are treated as a payment to the foreign partnership and not to the partners.

Paragraph (c)(2) restates the rule proposed under §1.1441–1(e)(5), dealing with qualified intermediaries, for foreign partnerships that are withholding foreign partnerships. In order to avoid confusion, a withholding foreign partnership is no longer named a qualified intermediary.

Paragraph (c)(3) deals with foreign partnerships that are not withholding partnerships. Paragraph (c)(3)(iii) incorporates the withholding certificate provisions that were in proposed §1.1441–1(e)-(3)(iii). Those rules parallel the rules applicable to non-QIs under §1.1441–1(e)-(3)(iii) of the final regulations. In particular, the regulations require that a statement be attached to the withholding certificate if necessary to provide information sufficient for the withholding

agent to determine each partner's distributive share of income subject to withholding. The rules governing the statement are stated in paragraph (c)(3)(iv) and parallel similar rules in §1.1441–1(e)(3)(iv) of the final regulations applicable to non-QIs. At the request of commentators, paragraph (c)(3)(iii) clarifies that a foreign partnership receiving income that is effectively connected with the conduct of a U.S. trade or business is not required to furnish separate certificates for each of its partners. Instead, it may furnish one single withholding certificate, even though the partnership is not a withholding foreign partnership. See also paragraph (c)(1)(ii)(C). This procedure is reasonable because, in such a case, the partnership is subject to withholding procedures under section 1446.

Paragraph (d) describes the presumptions upon which a withholding agent can rely when making payments to a partnership for which certain documentation is lacking or unreliable. First, under paragraph (d)(2), a recipient that is presumed to be a partnership (based on presumptions set forth in §1.1441–1(b)(3)(ii)) is presumed to be a foreign partnership if certain indicia of foreign status are present. If, based on such a presumption, the withholding agent has determined that the payment is made to a foreign partnership (presumably acting for the account of its partners since intermediary status generally cannot be presumed in the absence of valid documentation), uncertainties may remain regarding the status of the partners, the allocation of a payment among them, or whether all the partners have been accounted for. Under the final regulations, a payment that cannot be reliably associated with a withholding certificate from a partner is presumed made to a foreign payee. As a result, the withholding agent is required to withhold 30 percent from the payment, without a reduction. Also, any part of a payment that it is not reliably allocated to a partner is presumed allocable to the partner with the highest withholding rate or the highest U.S. tax liability (as the withholding agent can best estimate) if the withholding rates are equal. Third, if the withholding agent does not have a reliable certification that all the partners are accounted for, and, as a result, the withholding agent cannot reliably determine the distributive share of any one or more partners, then none of the payment can be reliably associated with any one partner and the entire payment is presumed made to a foreign payee.

These procedures parallel those applicable to foreign intermediaries under §1.1441–1(b)(3)(v). They differ from the presumptions stated in the proposed regulations under §1.1441–1(f)(4)(ii) which provided that the amounts were paid to a U.S. payee that is not an exempt recipient. Thus, the final regulations, by presuming that the amounts are paid to a foreign payee, require that a 30-percent amount be withheld on amounts subject to withholding under chapter 3 of the Code rather than a 31-percent amount under the backup withholding provisions of section 3406. However, for amounts that are not subject to chapter 3 withholding, §1.16049–5(d)(4) retains the provisions in the proposed regulations that the payments are presumed made to a non-exempt recipient U.S. payee. In such a case, 31-percent backup withholding applies instead of 30-percent withholding.

The final regulations under §1.1441–5(d)(3)(iv) clarify that a foreign partnership that is a withholding foreign partnership determines who the payee is and the status of the payee, based on the provisions of §1.1441–1(b)(2) and §1.1441–5(c) and (d) in the same manner as if it were making payments directly to the partners other than in their capacity as partners. In the absence of documentation regarding the partners, the partners are presumed to be foreign persons rather than U.S. persons, including for amounts that are not subject to chapter 3 withholding. A presumption of U.S. status for amounts not subject to chapter 3 withholding would not be meaningful because a foreign partnership is not a payor for purposes of chapter 61 of the Code and backup withholding under section 3406 when making payments to its partners. Therefore, payments made by a foreign partnership to its partners are not reportable under chapter 61 and are not subject to backup withholding. Instead, a foreign partnership must file an annual return on Form 1065 and report each partner's distributive share on Forms K-1, which forms are filed with the IRS with a copy to each partner. Such filing requirements apply in all cases in which the foreign partnership derives U.S. income, irrespective of whether the tax liability has been satisfied by withholding at source or whether all the partners are foreign. See section 6031 and §§1.6031–1(c) and 1.6031(b)–1T. However, in order to reduce the burden on foreign partnerships that are not withholding foreign partnerships, the IRS and Treasury are planning to issue regulations under section 6031 that would eliminate the filing requirement under section 6031 for foreign partnerships that are not engaged in a U.S. trade or business, that furnish appropriate documentation for each of their partners, and whose partners' U.S. tax liability has been fully satisfied at source.

Commentators asked that foreign partnerships be allowed to certify under penalties of perjury that all the partners are foreign and to use the same sub-accounting procedures that qualified intermediaries may use. In particular, where a partner is entitled to reduced withholding under the regulations without providing a TIN, commentators argue that there should not be a requirement that the partnership's intermediary withholding certificate specify that partner's distributive share of the item of income paid to the partnership. Also, they argue that there should not be a requirement that a separate Form 1042–S be filed under the partner's name. Instead, the partnership's intermediary withholding certificate should indicate the aggregate distributive shares of all members entitled to a single rate, and reporting should be done on the aggregate amount under the partnership's account. These comments are similar to those received for non-QIs and are not adopted for the same reasons that they are rejected for non-QIs. It is important to retain the distinction between foreign partnerships that qualify as withholding agents (i.e., those that are withholding foreign partnerships or are subject to section 1446) and those that are not qualified to act as withholding agents. If a foreign partnership is not a withholding foreign partnership, it should not be permitted to certify the status of its partners on their behalf.

Commentators asked that a foreign entity holding a passive investment for its own account be allowed to use the withholding procedures applicable to foreign corporate entities, irrespective of its actual classification for tax purposes. It is argued that, in many cases, investments

are structured using organizations that, under the default classification rules of the check-the-box regulations would be classified as partnerships. In order to avoid more onerous withholding procedures, these entities would normally prefer a corporate classification. It is argued that the need to make an election for this purpose is an unnecessary step that should be eliminated. This comment is not accepted because the election procedure to insure corporate classification is simple and serves an important compliance role.

At the request of commentators, the final regulations in §1.1441–7(a) clarify that, if a nominee holds an interest in a domestic or foreign partnership on behalf of a partner and provides the partnership with the information required under §1.6031(c)–1T(a) with respect to the partner, the nominee is deemed to have satisfied its obligations as a withholding agent under chapter 3 of the Code and has no liability for underwithholding on the partner's distributive share of the amounts to which the furnished information pertains. This rule reflects the fact that a custodian holding a partnership interest for an investor often lacks the information needed to determine which withholding regime applies to income from the partnership. The necessary information to correctly withhold on partnership income is often only known to the partnership and is not easily accessible to the custodian. On the other hand, the partnership, which is also a withholding agent, or has withholding responsibilities, has the information necessary to determine how withholding should apply. It is also responsible for filing the partnership return and furnishing the Forms K–1 to the partners.

Some commentators requested that a withholding agent should be permitted to rely on a withholding certificate provided directly by a partner, without a withholding certificate from the partnership. The commentators argue that this reliance rule would permit partners to claim a reduced rate of withholding even though the partnership refuses to cooperate and to submit the proper documentation. This suggestion is not accepted because it would, in effect, read the partnership withholding certification rules out of the regulations. It may also become a source of confusion for withholding agents who would not always know how reliable the partner's information is. The IRS and Treasury believe that the partnership withholding certificate provides important information to the withholding agent, such as each partner's distributive share of the payment. In addition, in the absence of a partnership withholding certificate, the withholding agent would lack information required to be stated on the Form 1042-S (e.g., the partnership's EIN) and compliance may be weakened as a result.

G. *Comments and Changes to §1.1441–6*

1. Address Rule

Comments were received asking reconsideration of the proposal to eliminate the address rule for dividends. The IRS and Treasury believe, however, that there is no longer a justification for the address rule as in effect under current law. When the payment is made directly to a foreign beneficial owner, there is no justification for not requiring a Form W–8 from the owner in the same manner that is required for payments on debt obligations. In the case of payments of dividends to foreign intermediaries, the proposed and final regulations provide for new intermediary procedures that are more adapted to the monitoring of abusive claims of treaty benefits than is the address rule. For these reasons, the address rule is not reinstated.

2. Reliance on Withholding Certificate

In response to comments, §1.1441–6(b)(1) clarifies, by cross-reference to §1.1441–1(e)(4)(viii) dealing with reliance on withholding certificates, that a withholding agent may rely on information and certifications in a certificate without having to inquire into the truthfulness thereof, absent actual knowledge or reason to know otherwise. Therefore, absent actual knowledge or reason to know that such claims are false, a withholding agent may rely on claims on a Form W–8 of beneficial ownership and residence by a person claiming benefits under a tax treaty. Under these principles, a withholding agent may rely on representations from a foreign person regarding the application of foreign tax laws or certifications regarding the circumstances of the recipient or of the transaction. In particular, a withholding agent may rely on the recipient's representation made by furnishing a beneficial owner withholding certificate that it is a beneficial owner of the income. If the address on a withholding certificate comports with a claim of residence in a particular country, a withholding agent may also rely on such address as indicative of residence, even though the determination of residence for tax treaty purposes may be far more complex than establishing an address in the treaty country and is likely to involve the application of foreign tax laws, particularly in the case of a person other than an individual. However, if the withholding agent knows that the representations on a Form W–8 are inconsistent with foreign laws or with the recipient's or the transaction's circumstances, then the withholding agent must question the basis for the representations.

3. Requirement of a TIN

Commentators have suggested that the final regulations require a TIN only for related party transactions subject to treaty rate withholding. This would eliminate the need to provide a specific list of payments exempt from a TIN requirement. This suggestion is not adopted because the IRS and Treasury believe that the TIN requirement is useful in monitoring claims of reduced rates under tax treaties for all transactions. Because the procedures for obtaining a TIN are simple, the TIN requirement for non-market based transactions is not viewed as overly burdensome relative to the compliance benefits.

Section 1.1441–1(e)(4)(vii) enumerates the instances in which a TIN must be furnished on a withholding certificate. Under the proposed rules, a TIN is required to obtain the benefit of reduced withholding under an income tax treaty, unless the payment consists of dividends paid on publicly traded stocks. Commentators have requested that the exemption from having to furnish a TIN be extended to other securities, including pre-1984 bonds and other debt obligations, payments on any mutual fund investment (e.g., an open-end mutual fund), interests in publicly-traded grantor trusts generating royalty income, interest- and dividend-equivalent payments on the loan of exempted publicly traded stocks or securities, income from repurchase agreements involving exempted publicly traded stocks or securities, dividends on non-

publicly traded stocks, interest on syndicated or bank loans, income from publicly-traded grantor trusts, contingent interest, and amounts paid on private placements of stocks or securities.

In response to these comments, the final regulations are amended to expand the categories of income for which a TIN is not required to be furnished. Under the final regulations, the categories are dividends and interest on publicly traded securities, dividends on redeemable securities issued by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1), income related to loans of publicly traded securities, and dividends, interest, or royalties from units of beneficial interest in a publicly offered and registered unit investment trust. See §1.1441–6(b)(2)(ii). The covered securities extend to foreign securities as well as U.S. securities. Also, in response to comments that the regulations should provide a reliable source to determine whether or not a stock (or other security) is publicly traded, the regulations clarify that section 1092(d) and §1.1092(d)–1 apply to determine whether a stock or security is publicly traded for this purpose. An exception is not made for other securities because the IRS and Treasury believe that the TIN exemptions should be limited to income arising from securities that are publicly traded and should not extend to securities held and transacted as part of a private business relationship. Also, an exception is not made for sale-repurchase transactions (repos) because repos completed within a 6-month period give rise to income that is treated as short-term OID for tax purposes. Such income, if earned by a foreign person, is exempt from chapter 3 withholding. Because the type of repo transaction that would be equivalent to the type of TIN-exempted market transactions would generally be of substantially shorter duration, the IRS and Treasury believe that it is not appropriate to provide an exemption for more than 6-month repo transactions.

Comments suggested that requiring TINs on intermediary certificates is an undue compliance burden when reporting is not done to the intermediary's account, especially if the Form W–8 of any underlying beneficial owner is not required to bear a TIN. Commentators argue that any IRS compliance concerns can be met without the requirement for a TIN from a non-qualified intermediary since U.S. withholding agents would, in any event, supply the identification and address of the beneficial owners to the IRS on Form 1042–S. The final regulations eliminate the need for a TIN on a non-qualified intermediary certificate and on a certificate from a foreign partnership that is not a withholding foreign partnership. However, a TIN continues to be required in the case of a qualified intermediary certificate or in the case of a certificate from a foreign partnership.

Some commentators asked that the TIN requirement be made optional. They argue that this would provide a reasonable accommodation to foreign investors who only occasionally or rarely enter into financial transactions involving U.S. securities. This comment is not adopted; instead, the final regulations broaden the types of transactions exempt from the requirement to provide a TIN. This change should alleviate the concern expressed by these commentators. Also, commentators asked that the final regulations provide an exemption for intermediaries with a small number of foreign accounts (500 or less). This suggestion is also not adopted in light of the fact that the burden of manually processing account information for complying with these regulations should be outweighed by the substantial compliance benefits.

With regard to documentary evidence required to validate a TIN used to support a claim of treaty benefits, commentators asked that the documentary evidence remain valid indefinitely rather than expire after three years as provided in the proposed regulations. See §1.1441–6(c). This comment is not adopted. The withholding certificates, and the TIN showing on that certificate, are used to represent many facts, including the foreign status of the owner and his residence for tax treaty benefit purposes. These facts may change frequently, particularly for individuals, and it is important that beneficial owners recertify their status periodically to the IRS. This recertification is also important because withholding agents cannot monitor the continued validity of the original residence claim, since the TIN on the certificate does not indicate which country of residence has been represented to the IRS as part of the certification process.

The final regulations do not adopt a comment that some organizations claiming tax- exempt status under section 501(c) should be exempt from the requirement to obtain and furnish a TIN if the organization is a universally recognized charitable organization, such as a church or religious order. As previously stated, TINs are used by the IRS to electronically process and match tax information. Any exception to the TIN requirement precludes such electronic processing. In light of the ease with which such organizations can obtain an EIN, the IRS and Treasury believe that no change to the proposed regulations is justified. However, the regulations clarify that a TIN is required from a foreign exempt organization or foreign private foundation only to the extent it claims a reduced rate of withholding solely based upon its exempt status or if a TIN is otherwise required from non-tax exempt taxpayers in order to claim a reduced rate of withholding (e.g., under an income tax treaty). Also, a foreign private foundation is not required to furnish a TIN for income subject to the 4-percent tax under section 4948(a) if such income would otherwise be exempt from tax under the Code if paid to a foreign person that is not a private foundation.

4. Certification and Electronic Matching of TINs

The final regulations are revised to specify that a taxpayer must provide the IRS with a certificate of residence to enable it to certify a TIN if that procedure is available in the country of residence. Documentary evidence is permitted as an alternative means of establishing residence in a treaty country only if a certificate of residence is not reasonably available from the tax administration in the country of residence. This change reflects the view that a certificate of residence is more reliable evidence of tax residence in a treaty country than is documentary evidence. The obligation to furnish a certificate of residence if one is available does not apply to corporate bodies who may, instead, furnish incorporation documents establishing their status as a corporate body in the applicable treaty jurisdiction.

The final regulations retain the provision in the proposed regulations regarding the electronic confirmation by a withhold-

ing agent of a TIN under procedures to be prescribed by the IRS. The IRS has undertaken a TIN-matching prototype in the past. See 60 FR 66243 (December 21, 1995). More recently, the IRS and Treasury issued a regulation under §31.3406(j)–1 (1997–26 I.R.B. 4) and Rev. Proc. 97–31 (1997–26 I.R.B. 6) making a TIN-matching program available to Federal agency payors of reportable payments under section 3406. TIN-matching, however, will not apply for chapter 3 withholding purposes until specifically implemented by the IRS.

5. Treaty Benefits for Payments to Hybrids

The proposed regulations provide guidance on procedures for claiming reduced withholding rates under an income tax treaty. For this purpose, the proposed regulations define the term *beneficial owner* under foreign law principles. See proposed §§1.1441–1(c)(6)(i)(B) and 1.1441–6(b)(4). Commentators were divided on whether the proposed rule is a correct interpretation of the treaty. In particular, several commentators noted that the term *beneficial owner* is meant to be defined under the source country's domestic law. Also, commentators asked whether the proposed rules were solely for withholding purposes or were meant to define a foreign beneficial owner's eligibility for treaty benefits for purposes of section 894.

In part in response to these comments, temporary regulations have been issued under section 894 (62 FR 35673, published July 2, 1997) that are largely consistent with the principles contained in the proposed withholding regulations. Under these temporary regulations, a reduced withholding rate applies under an income tax treaty only to the extent that the income is treated as derived by a resident of the applicable treaty jurisdiction. Income is treated as being so derived only to the extent it is taxed in the hands of the resident as income of a resident of the applicable treaty jurisdiction. The final withholding regulations have been modified to reflect these temporary regulations.

The regulations under §1.1441–6(b)(4)(ii) finalize the rules regarding the type of withholding certificates that must be furnished in situations involving hybrid entities where the payment is made to the entity but the benefit is determined by the status of the interest holder. Generally, a partnership Form W–8 would have to be provided by the interest holder, which form must be presented by the entity on behalf of the interest holder. In order to reduce the burden in the case of reverse foreign hybrid entities (e.g., foreign mutual funds treated as corporations for U.S. tax purposes but as fiscally transparent entities for foreign countries' law purposes), the final regulations allow those entities to become qualified intermediary, so that, like foreign partnerships and entities acting as intermediaries for others, they may present a global Form W–8 to a U.S. withholding agent instead of furnishing individual forms for each of their shareholders who claim a benefit under an income tax treaty. See §1.1441–1(e)(5)(ii)(C).

The preamble to the temporary regulations under section 894 indicates that withholding agents should consider the effect of the regulations on their withholding obligations, including the need to obtain new withholding certificates to confirm claims of treaty benefits for payments made on or after the effective date of §1.894–1T(d). Until the final regulations under section 1441 are effective (i.e., until 1999), withholding agents may continue to rely on Forms 1001 regarding claims of reduced rates under income tax treaties. In addition, with respect to dividends, no Form 1001 is generally required due to the alternative "address" rule. However, withholding agents that are making payments in 1998 should require new Forms 1001 for payments that they believe are affected by the provisions of §1.894–1T(d) in order to insure that representations regarding entitlement to a reduced rate under an income tax treaty are given in light of the provisions of §1.894–1T(d). For this purpose, withholding agents may rely on Forms 1001 that are prepared and furnished in accordance with the procedures described in §1.1441–6(b)(4)(ii), even though these procedures are not effective until 1999. Thus, for example, if the withholding agent pays to a foreign reverse hybrid entity, it may rely on a Form 1001 furnished by the entity even though the name of the beneficial owner is that of the entity's interest holder. Implicit in the entity's presentation of a Form 1001 from its interest holder is a representation that the interest holder is a resident of an applicable treaty country and derives the income paid to the entity within the meaning of §1.894–1T(d)(1). A Form 1001 obtained in 1998 is valid until December 31, 1999 (except to the extent that circumstances change affecting its validity). Payments made after 1998 to persons for whom the withholding agent does not hold a certificate will require a new Form W–8.

In view of the temporary regulations under §1.894–1T(d), several commentators have asked for guidance on how to apply the "reason-to-know" standard to self-certifications of entitlement to treaty benefits in situations involving hybrid entities. The regulations do not include special guidance on this point, because the IRS and Treasury believe that the due diligence issues in this context are not different from those arising in other contexts. Therefore, withholding agents may rely on the general principles in §1.1441–1(e)(4)(viii) (that, absent actual knowledge or reason to know otherwise, a withholding agent may rely on information and certifications without having to inquire into the truthfulness thereof) and in §1.1441–6(b)(4)(ii) (that a withholding agent may rely on representations that the beneficial owner derives the income within the meaning of §1.894–T(d) and is a resident of the treaty country without inquiring into the truthfulness thereof or researching foreign law). For example, if a withholding agent knows that a person whose name is on a Form 1001 or a Form W–8 is an interest holder in an entity and that the treaty country where the person claims residence generally treats the entity as a non-fiscally transparent entity, the withholding agent would have reason to know that a claim of reduced rate by such person may not be reliable and should make further inquiries. Generally, any claim of treaty benefits by interest holders in a U.S. LLC should be scrutinized based on many published indications that foreign countries generally regard U.S. LLC's as corporate entities.

6. Certification of Entitlement to Benefits Under an Income Tax Treaty

The proposed regulations do not contain special procedures regarding the manner in which a foreign person can establish that it satisfies the conditions under applicable limitation on benefits

provisions of an income tax treaty. This matter is indirectly addressed in §1.1441–6(b)(1) for foreign persons claiming benefits under an income tax treaty that are required to file a disclosure statement under section 6114 if they are related to the withholding agent and the amounts received during the calendar year that exceed $500,000.

After further consideration, the IRS and Treasury have determined that certification procedures, as had been suggested in Notice 94–85 (1994–2 CB 511), issued under the U.S.-Dutch tax treaty, are not procedures that could realistically be extended to all tax treaties within a reasonable time frame, if at all. Instead, the IRS and Treasury believe that an approach relying on self-certification and proper disclosure to the IRS is more practical. Therefore, the final regulations provide in §1.1441–6(c)(5)(i) that those persons who are required to furnish an IRS-certified TIN must, as part of the TIN certification process, certify that they satisfy the conditions of an applicable limitation on benefits provision. For this purpose, the person must attach an affidavit to the request for certification, describing sufficient facts for the IRS to determine the basis upon which such conditions are satisfied. The IRS review of a foreign person's affidavit does not constitute an audit of the taxpayer on this issue. In view of these new procedures, Notice 94–85 is withdrawn.

The final regulations also provide under §1.1441–6(c)(5)(ii) that a taxpayer (other than an individual) applying for IRS certification of its TIN must certify to the IRS that any income for which it intends to claim benefits under an applicable income tax treaty is income that will properly be treated as derived by itself within the meaning of §1.894–1T(d)(1).

7. Reporting under section 6114

Under proposed §1.1441–6(b)(1), a taxpayer receiving income benefitting from a reduced rate under an income tax treaty is required to file an information return under section 6114 if it is related to the withholding agent and the amounts "paid" during the taxable year exceed $500,000. The final regulations modify the $500,0000 condition by providing that the requirement to file an information return applies only to amounts "received" during the calendar year that, in the aggregate, exceed $500,000. The revision clarifies that the test is not intended to be applied on a per-withholding agent basis. Rather, the $500,000 threshold is intended to measure the total amount received by the taxpayer, whether from one or several related withholding agent.

The final regulations under section 6114 are also revised to allow the IRS to eliminate duplicate reporting requirements for payments received by a foreign taxpayer that must be reported both on a Form 5472 under section 6038A and under section 6114. See §301.6114–1(c)(6). Such change is to be reflected in the applicable forms and instructions.

8. Joint Owners

One commentator suggested that since a joint owner can get a separate Form 1042–S, the final regulations under §1.1441–6 should let each joint owner claim its own treaty rate (if different) on its pro-rata share of the income. This suggestion is not adopted because of the difficulties, generally, for each joint owner to present reliable representation of its pro-rata share of the income being paid.

9. Claim of Treaty Benefits by U.S. Taxpayer

A commentator noted that the existing regulations under §1.1441–4(b)(2) fail to address the situation of a foreign national who is a resident alien of the United States under section 7701(b) and under a treaty tie-breaker rule, but who is entitled to treaty benefits under a treaty saving clause exception. The commentator indicated that procedures are needed to allow such persons to submit proper forms and documentation. According to the commentator, such persons entitled to treaty benefits often are not currently residents of a treaty country, do not have a permanent residence address in the foreign country of which they are claiming benefits, and are not able to obtain certification or documentation to satisfy the three-year rule under §1.1441–6(c)(4). Further, the commentator argued that the regulations should specify which form such persons can file to claim treaty benefits (under the proposed regulations neither Form W–8 nor W–9 would accommodate this claim). In response to this suggestion, paragraph (b)(5) is added to allow a U.S. taxpayer to claim benefits under an income tax treaty on a Form W–9 or such other form as the IRS may prescribe.

H. *Comments and Changes to §1.1441–7*

1. Withholding agent's due diligence standards

Section 1.1441–7(b)(1) is restated to clarify that a withholding agent is under a general due diligence standard to determine its withholding obligations based on its actual knowledge or reason to know, if based on such knowledge or reason to know, it appears that the obligation to withhold or report the payment is greater than would otherwise be the case. This due diligence standard applies generally, not just in the context of determining the extent to which a withholding agent can rely on a withholding certificate. Therefore, for example, if a withholding agent has reasons to believe that a foreign beneficial owner of interest income is related to the debtor, so that the portfolio interest exemption may not be available, the withholding agent should make an inquiry in order to ascertain whether the portfolio interest, in fact, applies. The fact that the Form W–8 is not required to certify lack of relationship does not mean that the withholding agent can ignore what it knows or otherwise suspects if such knowledge or reason to know affects the tax liability of the beneficial owner which withholding under chapter 3 of the Code is intended to satisfy.

2. Due Diligence Safe Harbors

Some commentators asked that the standard of care governing the withholding agent's liability should be actual knowledge rather than reason to know, especially in the context of high-volume commercial transactions where there is not necessarily a pre-existing client relationship. In response to this comment, the final regulations define *reason to know* so that certain circumstances described in paragraphs (b)(2)(ii) (A) through (F) are the only circumstances that require the withholding agent to exercise due diligence (other than actual knowledge). Further, examples are added regarding the documentation that a withholding agent may rely on in order to correct a defective Form W–8. This limitation only applies to payments made by a financial institu-

tion with which a customer may open an account that consists of portfolio interest, payments on publicly traded securities described in §1.1441–6(b)(2)(ii), deposit interest with banks or other financial institutions as described in sections 871(i)(2)(a) and 881(d), or original issue discount (or interest) on obligations with a maturity of 183 days or less from the date of original issue.

The final regulations eliminate the need to inquire further when the customer directs the financial institution to make a payment to another U.S. financial institution. While such direction may indicate that the account holder is, in fact, residing in the U.S., the burden of this due diligence requirement outweighs the compliance benefits.

However, the final regulations impose a duty to inquire when a payment is directed to a P.O. box or an in-care-of address where the withholding agent has a permanent address on file for the payee that is neither a P.O. box or an in-care-of address. Contrary to the comments, the IRS and Treasury believe that how a payment is directed may indicate that the beneficial owner wishes not to disclose his or her place of residence. As stated above, the beneficial owner may be treated as a foreign person despite a P.O. box address; however, such treatment would require that the withholding agent obtain evidence of foreign status in addition to the Form W–8.

The final regulations add a due diligence item. A withholding agent may not rely on a claim of partnership status on a Form W–8 if the name of the person on the form indicates that the entity may be the type of entity that is on the per se list of foreign corporations included in §301.7701–2(b)(8)(i), unless the form explains that the entity is a grandfathered partnership.

2. Authorized Foreign Agents

The proposed regulations would modify the current rules governing foreign agents of U.S. withholding agents by allowing a foreign agent to file Forms 1042 and 1042–S returns on behalf of the U.S. withholding agent. Some commentators have pointed out that the inability to tier authorized foreign agents limits the usefulness of the procedure. However, after further consideration, the IRS and Treasury have decided to leave the proposed rules unchanged. The authorized foreign agent procedure relies on the IRS' ability to audit the agent. Any compliance failure of the agent is imputed to the U.S. withholding agent. If the U.S. withholding agent acts through several layers of agents, the IRS would have to audit all of the agents in the chain of payment to determine the compliance of the U.S. withholding agent. Such audits are impractical. The procedure is retained, however, because it may still be useful in its proposed form in cases not involving tiers of intermediaries.

I. *Comments and Changes to §1.1441–8*

The final regulations are revised to take into account comments that the proposed documentation requirements for payments to foreign governments and international organizations are unnecessarily cumbersome. The documentation requirement is eliminated entirely for payments to international organizations and for interest on bankers' acceptances paid to central banks of issue. This exception is appropriate because the withholding exemption is not conditioned on any representation of the beneficial owner, other than its status as such (see §1.6049–4(c)-(1)(ii)(G) and (H) for an "eyeball" test for ascertaining the status of the payee as an international organization or a foreign central bank of issue). Payments to foreign governments and to the Bank for International Settlements must be documented, however, because a withholding exemption applies only if the government's or the Bank's income is not associated with a commercial activity. However, if a person represents that it is an integral part of a foreign government, the documentation remains valid permanently. If, on the other hand, the person claiming to be a foreign government represents that it is a controlled entity, then the certificate must be renewed every three years. A certificate furnished by the Bank for International Settlements is also valid permanently. In view of these simplified documentation requirements, the final regulations require that all payments to foreign governments, international organizations, and the Bank for International Settlements be reported on a Form 1042 and 1042-S, to the extent reportable if paid to a foreign person.

J. *Comments and Changes to §§1.1441–9 and 1.1443–1*

1. Foreign Tax-exempt Organization and Foreign Private Foundations

Several comments were received regarding withholding on the income of foreign tax-exempt organizations and applicable procedures for documenting the foreign organization's exempt status. The commentators questioned whether section 1443(a) should apply to items of passive income that would not be unrelated business income but for section 514 (relating to debt-financed property), and whether section 4948 should apply to impose a 4-percent tax on U.S. source portfolio interest and bank deposit interest so that a 4-percent withholding applies under section 1443(b) to payments of such income to foreign foundations.

Commentators argued that a foreign organization meeting the description of section 501(c)(3) should be permitted to claim tax-exempt status even if it has not first obtained an IRS determination. They argued that the IRS determination letter is required for domestic organizations because contributions to a domestic section 501(c)(3) organization are deductible. No such deduction is permitted for contributions to a foreign organization and, therefore, a foreign organization described in section 501(c)(3) should be treated like any other organization described under section 501(c). Also, commentators argued that the regulations should not require an opinion of counsel to be attached to the withholding certificate. The final regulations, however, do not accept most of these comments. As in the proposed regulations, foreign organizations that are required to obtain an IRS determination letter in order to qualify as a tax-exempt organization under section 501(c)(3) (i.e., those organizations that obtain a substantial portion of their support from U.S. sources) must obtain such a determination letter and attach it to the Form W–8. Other foreign organizations that may qualify for tax-exempt status under section 501(c)(3) without an IRS determination letter (i.e., organizations that receive substantially all of their support from sources outside the United States; see section 4948(b)) may establish their exempt status on the basis of an opinion of counsel. Also, they clarify that the opinion must be

from U.S. counsel, meaning an attorney admitted to, and in good standing with, the bar in one of the fifty States or the District of Columbia. In addition, the final regulations under §1.1441–9(b)(2) provide that tax-exempt organizations that claim that they are tax-exempt under section 501(c)(3) and not private foundations and do not have an IRS determination letter must attach an affidavit to their Form W–8 in addition to the opinion of counsel. Thus, the final regulations relieve those organizations from the obligation under the proposed regulations to provide an opinion of counsel regarding their non-private foundation status. The IRS and Treasury view the IRS certification procedure for section 501(c)(3) organizations as an important compliance measure. They do not believe that self-certification procedures should be substituted where the Code clearly requires an IRS determination letter.

The final regulations under §1.1441–9(a) also clarify that a foreign organization that does not rely on its tax-exempt qualification to claim reduced withholding on a payment need not comply with the special procedures in §1.1441–9. Instead, it may follow the same procedures that apply to taxable entities. In particular, the final regulations clarify that a foreign tax-exempt organization or foreign private foundation that claims a benefit under an income tax treaty must follow the procedures described under §1.1441–6 rather than rely on the procedures described under §§1.1441–9 or 1443–1.

The final regulations do not make a special exception for debt-financed income that, under section 512, is treated as unrelated business income. In addition, the final regulations do not eliminate the 4-percent tax imposed under section 4948(a) on any items of investment income of a private foreign foundation and required to be withheld under section 1443(b). The IRS and Treasury believe that they have no authority to eliminate a tax that is clearly imposed by statute. Therefore, it would be inappropriate to eliminate the requirement to withhold such tax. A foreign private foundation claiming a reduced rate of 4-percent is subject to the same documentation requirements as apply to tax-exempt foreign organizations, meaning that a Form W–8 must be furnished, to which the appropriate determination letter or opinion of U.S. counsel must be attached. The final regulations restate the existing regulations under section 1443 in an effort to eliminate unnecessary provisions. The elimination of several provisions does not indicate that the procedures do not apply (e.g., requirement to file Forms 1042 and 1042–S), but, simply that these provisions are not necessary.

K. *Comments and Changes to §§1.1461–1 and 1.1461–2*

1. Form 1042–S Reporting

In response to comments, the deadline for filing Forms 1042 and 1042–S has been moved from February 28 to March 15. Regarding joint accounts, the final regulations do not adopt the suggestion that only one Form 1042–S be required for a joint account even where the other joint owner requests another statement. Commentators argued that subdividing payments made to a single account and providing multiple Forms 1042–S would significantly increase administrative burden. However, joint owners should be able to obtain a proof of tax payment in case one of them wishes to apply for a refund of tax or needs to substantiate the payment of tax for any reason and it does not have access to the form issued to one of the joint owners. The fact that the obligation to issue more than one Form 1042–S is only on request by one of the joint owners should minimize the burden on withholding agents.

The proposed regulations require that a financial institution with actual knowledge of the payee's TIN report the TIN on Form 1042–S even though a TIN did not have to be provided in connection with the payment. In response to comments, the final regulations clarify in §1.1461–1(c)(3)(v) that, in the case of a financial institution dealing with customers through a system of accounts, actual knowledge exists only if such TIN was reported on a Form W–8 provided with respect to another payment made through the same account or through another account, the information with respect to which can be retrieved through a centralized account information system (including a universal account system) containing both accounts.

Commentators requested a clarification that Form 1042–S reporting is not required with respect to interest on deposits paid by any U.S. bank (including its foreign branches or subsidiaries), except in the limited situation where the interest is paid to a Canadian resident. This point is clarified under §1.1461–1(c)(2)(i), which limits reporting to amounts subject to withholding, as defined in §1.1441–2(a). However, §1.1461–1(c)(2)(i)(D) contains an exception for interest paid to Canadian residents. In addition, §1.1461–1(c)(2)(ii)(F) is added to clarify that interest or OID accrued on an obligation is not required to be reported on a Form 1042–S to the extent the interest or OID is not required to be withheld upon under §1.1441–2(b)(3) due to the lack of knowledge by the withholding agent. On the other hand, §1.1461–1(c)(2)(i)(E) clarifies that, as is the case under existing regulations, amounts representing interest on an obligation sold between interest payment dates is reportable on a Form 1042 and 1042–S, even though it is not subject to withholding.

2. Adjustments for Overwithholding or Underwithholding of Tax

Commentators asked that withholding agents be permitted to process refund claims for nonresident alien payees. Since refund claims will now require TINs, duplication of claims can be avoided. Commentators point to the fact that this procedure should be more efficient as it may require the IRS to process only a single refund claim from a withholding agent for all of its foreign clients rather than dealing with claims filed by each individual foreign client. This comment is accepted in the context of qualified intermediary arrangements. However, in other situations, a procedure allowing refunds on behalf of customers is impractical because of the risk that customers would independently file for refunds based on their form 1042–S.

Withholding agents also made a number of points regarding authority to rectify any underwithholding situation discovered after the due date for filing Form 1042 but before actual filing, streamlining current refund procedures by, for example, providing for a "quickie" refund form, and the reporting of adjustments to

withholding during the calendar year. Those points, however, should be addressed in the context of forms and administrative procedures, rather than in the regulations. The IRS will continue to work with the industry to find ways to improve and streamline the information and return filing procedures.

L. *Comments and Changes to Information Reporting Provisions Under Chapter 61 and Section 3406 of the Code*

1. Information Reporting—Exempt Recipient

Commentators asked that the proposed changes to the exempt recipient rules for corporations be eliminated. Under §1.6049–4(c)(1)(ii)(A) of the proposed regulations, the "eyeball" test for corporations with an account relationship with the payor would be required to be supplemented by an EIN or a corporate resolution. Commentators suggested that, instead, payors should be allowed to rely on the per se list provided in the check the box regulations under §301.7701–3.

In response to these comments, the final regulations eliminate the proposed corporate resolution requirement and, therefore, reinstate the "eyeball" test for corporate payees. Foreign corporations are able to establish their corporate payee status based on the per se list in §301.7701–2(b)(8)(i). In addition, a payee may establish corporate status with a copy of the Form 8832, if the entity has filed one with the IRS in order to elect corporate classification. See §1.6049–4(c)(1)(ii)(A)(*1*) and (*2*).

Section 1.6049–4(c)(1)(ii) of the 1988 proposed regulations delete nominees, custodians, and brokers from the list of exempt recipients. Some commentators objected to this change. The final regulations re-instate nominees, custodians, and brokers as exempt recipients. Additionally, swap dealers are included in the list of exempt recipients, and the description of financial institutions that are exempt recipients has been clarified to include clearing organizations.

Comments were received requesting that the list of international organizations be re-instated in the regulations. The final regulations do not contain such a list because frequent changes in the status of such organizations would make it too burdensome for the IRS to keep current. Instead, the IRS intends to issue guidance indicating that withholding agents and payors may rely on the list published by the Department of State.

Commentators asked that the list of exempt recipients under sections 6041 and 6045 be conformed to that under section 6049 and, in the case of section 6041, be extended to banks and financial institutions. The final regulations apply the same exempt recipient rules to interest under section 6049, dividends under section 6042, and notional principal contracts under section 6041. The exempt recipient rules under section 6045 remain unchanged, except that a foreign central bank of issue is added to the list for substitute payments under §1.6045–2(b)(2)(i)(G).

2. Information Reporting for Offshore Accounts—Documentary Evidence

The proposed regulations make a number of changes to the existing procedures applicable to deposits with foreign branches of U.S. banks. The proposed regulations modify the documentary evidence standard in §35a.9999–3, A–34, as part of an effort to subject all off-shore accounts to a uniform documentary evidence standard, whether the account is with a foreign branch of a U.S. bank, with a foreign branch of a domestic institution other than a bank, or with a foreign branch of a foreign financial institution. As a result, foreign branches of U.S. banks would become subject to more stringent documentary evidence requirements to the extent they would no longer be able to rely on an indication of foreign status from a customer. Instead, the proposed regulations require a foreign banking branch to obtain actual documentary evidence from the customer and keep a record of it. Some commentators questioned whether the proposed regulations eliminate the possibility of relying on a statement of foreign status incorporated in the account opening form. In addition, the proposed regulations impose a three-year renewal of the documentary evidence, a requirement that does not currently apply to foreign banking branches. Further, the proposed regulations eliminate the $600 threshold under the current regulations (by making foreign branch bank deposit interest subject to reporting under section 6041 rather than section 6049). They impose new backup withholding requirements for accounts actually known to the branch as being owned by a U.S. person. In addition, the provisions under §1.1441–1(f) create a presumption of U.S. status for undocumented accounts. Although a presumption of U.S. status is not sufficient for triggering an obligation to backup withhold (because the bank has no actual knowledge), it is sufficient to require the interest to be reported on a Form 1099.

After further consideration, and based on comments received, the final regulations are revised. Consistent with the regulations proposed in 1988 and in 1996, the requirement to document owners of accounts maintained at offshore branches of U.S. banks is imposed under section 6049 rather than section 6041. Therefore, the $600 limit will no longer apply to those accounts. On the other hand, the documentation requirements are substantially simplified. If the customer's address is in the country where the branch is located and it is not customary in that location that banks request documentary evidence from customers when opening an account, then the bank or other financial institution may rely on a declaration of foreign status, contained in an account opening form, that does not have to be signed under penalties of perjury. The declaration does not expire unless circumstances change that would indicate that the account holder has become a U.S. person or the payor is so notified. The payor must send a year-end reminder to the account holder to notify the payor of change of status, if applicable.

These alternative documentary evidence procedures are extended to all offshore accounts for payments that are not subject to withholding under chapter 3 of the Code and are not U.S. source bank deposit interest. These amounts include foreign source income and gross proceeds.

The alternative documentary evidence rules apply to accounts opened on or after the effective date of the regulations (i.e., on or after January 1, 1999). However, existing accounts as of that date are required to comply with the due diligence requirements, including inserting a negative confirmation statement in the annual year-end statement provided to the customer.

In response to comments, the final regulations under §1.6049–5(b)(10) are revised to incorporate a waiver from the certification requirement of regulations §1.163–5(c)(2)(i)(D)(3) for debt instruments with a maturity of 183 days or less from the date of issue. In addition, §1.6049–4(d)(3) is modified to clarify that the same conversion rules are applicable to all foreign currency-denominated obligations for purposes of section 6049.

3. Reporting Obligations of Non-U.S. Payors or Middlemen

Under the regulations under section 6045, dealing with broker proceeds, non-U.S. payors are exempt from reporting if the payment is made outside the United States. See §1.6045–1(a)(1). In contrast, non-U.S. payors and middlemen making payments of U.S. source interest or dividends are required to report these payments on a Form 1099, unless they receive documentation supporting the payee's foreign status (or the payee is an exempt recipient). Commentators requested that non-U.S. payors of U.S. interest and dividends be similarly exempt from information reporting if the payments are made outside the United States. This change is not appropriate, at least for amounts that are subject to withholding under chapter 3 of the Code. To the extent the U.S. interest or dividends are subject to U.S. 30-percent withholding, and documentation is received for reducing the withholding rate, the foreign payee exemption would apply under sections 6042 and 6049 and the payment would not be reportable. Under the final regulations, however, a payor making a payment of U.S. source dividends or interest (whether inside or outside the U.S.) to a payee who has provided no documentation is not exempt from Form 1099 information reporting, even if another payor "upstream" has withheld an amount under chapter 3 of the Code. However, a payor is exempt from backup withholding on the payment if an "upstream" withholding agent has withheld a full 30-percent amount from the payment. The payor, however, is not relieved from making a return on Form 1099 under section 6042 or 6049 if it has actual knowledge that the payee is a U.S. person who is not an exempt recipient. See §31.3406(g)–1(e). These rules also apply to U.S. source royalties reportable under section 6050N.

Further, the regulations under section 3406 are amended to authorize the IRS to establish procedures by which an amount backup withheld under section 3406 from a payee that subsequently establish that it is a foreign person exempt from information reporting and backup withholding can be credited toward amounts required to be withheld under chapter 3 of the Code. Such "cross-crediting" procedures are not available at present and would require the IRS to modify its systems.

4. Information Reporting for Capital Gain Dividends

Under the proposed regulations, capital gain dividends as defined under section 852(b)(3)(C) would no longer be reportable on Form 1099–DIV. Commentators objected that, absent such reporting, shareholders could not easily ascertain the amount of capital gain dividends paid for the calendar year for purposes of calculating their income tax liability. Accordingly, the final regulations eliminate the proposed exclusion of capital gain dividends under §1.6042–3(b)(3).

Effect on Other Documents

The following publications are obsolete as of October 14, 1997:

Rev. Rul. 55–106, 1955–1 CB 102.
Rev. Rul. 57–391, 1957–2 CB 606.
Rev. Rul. 60–288, 1960–2 CB 265.
Rev. Rul. 65–86, 1965–1 CB 538.
Rev. Rul 68–173, 1968–1 CB 626.
Rev. Rul. 68–237, 1968–1 CB 391.
Rev. Rul. 68–333, 1968–1 CB 390.
Rev. Rul. 69–41, 1969–1 CB 214.
Rev. Rul. 69–244, 1969–1 CB 215.
Rev. Rul. 70–175, 1970–1 CB 184.
Rev. Rul. 70–250, 1970–1 CB 182.
Rev. Rul. 70–251, 1970–1 CB 183.
Rev. Rul. 70–616, 1970–2 CB 174.
Rev. Rul. 72–87, 1972–1 CB 274.
Rev. Rul. 80–222, 1980–2 CB 211.
Rev. Rul. 83–175, 1983–2 CB 109.
Rev. Rul. 84–158, 1984–2 CB 262.
Rev. Rul. 85–61, 1985–1 CB 355.
Rev. Rul. 89–17, 1989–1 CB 268.
Rev. Rul. 89–33, 1989–1 CB 269.
Rev. Rul. 89–91, 1989–2 CB 129.
Rev. Proc. 65–2, 1965–1 CB 715.
Rev. Proc. 67–24, 1967–1 CB 625.
Notice 94–85, 1994–2 CB 511.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

This Treasury decision finalizes notices of proposed rulemaking published February 29, 1988 (53 FR 5991), December 21, 1995 (60 FR 66243), and April 15, 1996 (61 FR 17614), respectively. It has been determined that a final regulatory flexibility analysis is required under 5 U.S.C. §604 for the collections of information contained in this Treasury decision with respect to the notice of proposed rulemaking published on April 15, 1996. An initial regulatory flexibility analysis was not required because the notice of proposed rulemaking was issued prior to the effective date (June 27, 1996) of the amendments to the Regulatory Flexibility Act (5 U.S.C. chapter 6) made by the Small Business Regulatory Enforcement Fairness Act (SBREFA) (Public Law 104–121). It also has been determined that a regulatory flexibility analysis is not required for the notice of proposed rulemaking published on (1) December 21, 1995 because the notice does not impose any collection of information on a small entity, and was published prior to the March 29, 1996 enactment date of SBREFA, and (2) on February 29, 1988 because the notice was published prior to the enactment of SBREFA.

Final Regulatory Flexibility Act Analysis

The major objective of the final regulations is to prescribe new procedures to eliminate unnecessary burdens created by the lack of standardization and coordination of the current withholding and information reporting procedures with respect to amounts paid to foreign persons. To this effect, the regulations facilitate compliance and reduce taxpayer burden by simplifying the documentation requirements, unifying the certification procedures and clarifying reliance standards in an effort to streamline the processing of U.S. source payments to foreign persons.

The economic impact of collection of information contained in these regulations

on any small entity would result primarily from the entity being required either (1) to provide a Form W–8 as the beneficial owner or payee of U.S. source income, or (2) to receive a Form W–8 as the withholding agent or payor (and eventually, file a Form 1042 and Forms 1042–S). In both situations, these regulations generally impose minimal additional reporting or recordkeeping requirements beyond those already imposed under current law. In fact, the regulations significantly reduce the withholding and reporting burdens associated with Form W–8 by, for example, consolidating the current withholding certificates (Forms 1001, 1078, 4224, 8709 and W–8) into a Form W–8 format, permitting certain foreign intermediaries to certify on behalf of their customers, permitting the electronic transmission of the form (subject to IRS prescribed procedures), clarifying the standards for an acceptable substitute form, permitting a 90-day grace period for actual receipt of the form, and providing cure procedures for a late-received form.

For a small entity in the role of the beneficial owner, the new collection of information contained in these regulations is the extension of the Form W–8 requirement to claims for a treaty-based reduction in the withholding rate with respect to dividend income; thereby, subjecting dividends to the same documentation requirements as other income types. This change imposes no recordkeeping requirements beyond those necessary (and currently required for all other income types) to ensure proper entitlement to treaty benefits, and is illustrative of IRS efforts to eliminate unnecessary procedural differences in order to reduce the burden on withholding agents. Although there is no estimate of the number of beneficial owners or payees of U.S. source income payments, the number of cross border payments have steadily increased over the years (over 80 billion dollars paid in 1995). The IRS and Treasury believe that most of these payments are made to individuals, large financial institutions and large corporations.

For a small entity in the role of the withholding agent, the most significant change of the regulations that impacts the collection of information is the establishment of the wholly-elective qualified intermediary regime which will impose, but only pursuant to an agreement with the IRS, additional reporting and recordkeeping requirements in exchange for the benefit of furnishing a single Form W–8 for multiple beneficiary owners or payees. The IRS and Treasury believe that this alternative will be adopted primarily by large foreign financial institutions that maintain numerous accounts for large numbers of customers, and it is unlikely that a substantial number of small entities would find it necessary or useful to agree to act as a qualified intermediary. Of the approximately 25,000 tax returns (Form 1042) filed by withholding agents per year, the IRS estimates that 95-percent of such returns are filed by large financial institutions.

A summary of the significant issues raised by the public comments in response to the proposed regulations and IRS' views on such issues, and changes made as a result of the comments is set forth above in the section of the preamble to the regulations entitled "Explanation of Provisions and Revisions."

The IRS and Treasury Department are not aware of any federal rules that duplicate, overlap, or conflict with the regulations.

These regulations will affect small entities such as small banks, small businesses paying interest and dividends, small private foundations, and small tax-exempt organizations (including colleges and charities). The IRS and Treasury believe that most of these small entities will have a direct relationship with the foreign person and therefore, will not act as, or have transactions through, an intermediary (i.e., nominee, custodian, or agent). The professional competence necessary to comply with these regulations is no greater than that already necessary to handle the day-to-day business operations of a small entity because much of the recordkeeping and reporting requirements under the regulations can be easily (if not already done under the existing regulations) incorporated into the existing or customary recordkeeping and reporting obligations of the small entity (e.g., an account opening form of a bank, the registration form of a college, etc.).

None of the significant alternatives considered in drafting these regulations would have significantly altered the economic impact of these regulations on small entities. A detailed description of the measures taken to minimize the economic impact of the collections of information on small entities, consistent with the stated objectives of applicable statutes is set forth above in the section of the preamble to the regulations entitled "Explanation of Provisions and Revisions." In considering alternatives, the IRS and Treasury have concluded that a withholding system (based on reduction of withholding at source) rather than a refund system avoids the administrative burdens (including costs and delays) that can occur when applying for a refund of overwithheld amounts. Ensuring compliance under a withholding system, however, requires documentation substantiating claims of foreign status and of exemptions from, or reduced rates of, withholding, and submission of proper information to the IRS.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, 26 CFR parts 1, 31, 35a, 301, 502, 503, 509, 513, 514, 516, 517, 520, 521, and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for Section 1.1441–4T, revising the entries for Sections 1.1441–3, 1.1441–4, 1.1441–5, 1.1441–7, 1.6049–4 and 1.6049–5 adding entries in numerical order to read as follows:

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

Section 1.1441–2 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1441–3 also issued under 26 U.S.C. 1441(c)(4), 26 U.S.C. 3401(a)(6) and 26 U.S.C. 7701(l).

Section 1.1441–4 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1441–5 also issued under 26 U.S.C. 1441(c)(4), 26 U.S.C. 3401(a)(6) and 26 U.S.C. 7701(b)(11).

Section 1.1441–6 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1441–7 also issued under 26 U.S.C. 1441(c)(4), 26 U.S.C. 3401(a)(6) and 26 U.S.C. 7701(l).

Section 1.1443–1 also issued under 26 U.S.C. 1443(a). * * *

Section 1.1461–1 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1461–2 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6).

Section 1.1462–1 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6). * * *

Section 1.6042–3 also issued under 26 U.S.C. 6045. * * *

Section 1.6049–4 also issued under 26 U.S.C. 6049(a), (b), and (d).

Section 1.6049–5 also issued under 26 U.S.C. 6049(a), (b), and (d). * * *

§1.163-5 [Amended]

Par. 2. In §1.163–5, paragraph (c)(2)(i)(B)(5) is amended by removing the language "subdivision (iii) of A–5 of §35a.9999–4T" in the last sentence and adding "§1.6049–5(c)(1)" in its place.

Par. 3. Section 1.165–12 is amended by:

1. Adding a sentence at the end of paragraph (a).

2. Removing the language "(c)(1)(v)" and adding "(c)(1)(iv)" in its place in paragraph (c)(1)(i).

3. Removing paragraph (c)(1)(iii) and redesignating paragraphs (c)(1)(iv) and (c)(1)(v) as paragraphs (c)(1)(iii) and (iv).

4. Revising paragraphs (c)(1)(ii) and newly redesignated paragraph (c)(1) (iii).

5. Removing the language "(c)(1)(ii) and (iv)" and adding "(c)(1)(ii) and (iii)" in its place in paragraphs (c)(2)(iv) and (c)(3)(iv).

The addition and revisions read as follows:

§1.165–12 Denial of deduction for losses on registration-required obligations not in registered form.

(a) * * * For purposes of this section, the term *United States* means the United States and its possessions within the meaning of §1.163–5(c)(2)(iv).

* * * * *

(c) * * *

(1) * * *

(ii) The holder must offer to sell, sell and deliver the obligation in bearer form only outside of the United States except that a holder that is a registered broker-dealer as described in paragraph (c)(1)(i) of this section may offer to sell and sell the obligation in bearer form inside the United States to a financial institution as defined in paragraph (c)(1)(iv) of this section for its own account or for the account of another financial institution or of an exempt organization as defined in section 501(c)(3).

(iii) The holder may deliver an obligation in bearer form that is offered or sold inside the United States only if the holder delivers it to a financial institution that is purchasing for its own account, or for the account of another financial institution or of an exempt organization, and the financial institution or organization that purchases the obligation for its own account or for whose account the obligation is purchased represents that it will comply with the requirements of section 165(j)(3)(A), (B), or (C). Absent actual knowledge that the representation is false, the holder may rely on a written statement provided by the financial institution or exempt organization, including a statement that is delivered in electronic form. The holder may deliver a registration-required obligation in bearer form that is offered and sold outside the United States to a person other than a financial institution only if the holder has evidence in its records that such person is not a U.S. citizen or resident and does not have actual knowledge that such evidence is false. Such evidence may include a written statement by that person, including a statement that is delivered electronically. For purposes of this paragraph (c), the term *deliver* includes a transfer of an obligation evidenced by a book entry including a book entry notation by a clearing organization evidencing transfer of the obligation from one member of the organization to another member. For purposes of this paragraph (c), the term *deliver* does not include a transfer of an obligation to the issuer or its agent for cancellation or extinguishment. The record-retention provisions in §1.1441–1(e)(4)(iii) shall apply to any statement that a holder receives pursuant to this paragraph (c)(1)(iii).

* * * * *

Par. 4. Section 1.871–6 is revised to read as follows:

§1.871–6 Duty of withholding agent to determine status of alien payees.

For the obligation of a withholding agent to withhold the tax imposed by this section, see chapter 3 of the Internal Revenue Code and the regulations thereunder.

§1.871–7 [Amended]

Par. 5. In §1.871–7, paragraph (b), the third sentence is amended by removing the words "see paragraph (a) of §1.1441–2" and adding "see §1.1441–2(b)" in its place.

Par. 6. Section 1.871–14 is added to read as follows:

§1.871–14 Rules relating to repeal of tax on interest of nonresident alien individuals and foreign corporations received from certain portfolio debt investments.

(a) *General rule.* No tax shall be imposed under section 871(a)(1)(A), 871(a)(1)(C), 881(a)(1) or 881(a)(3) on any portfolio interest as defined in sections 871(h)(2) and 881(c)(2) received by a foreign person. But see section 871(b) or 882(a) if such interest is effectively connected with the conduct of a trade or business within the United States.

(b) *Rules concerning obligations in bearer form*—(1) *In general.* Interest (including original issue discount) with respect to an obligation in bearer form is portfolio interest within the meaning of section 871(h)(2)(A) or 881(c)(2)(A) only if it is paid with respect to an obligation issued after July 18, 1984, that is described in section 163(f)(2)(B) and the regulations under that section and an exception under section 871(h) or 881(c) does not apply. Any obligation that is not in registered form as defined in paragraph (c)(1)(i) of this section is an obligation in bearer form.

(2) *Coordination with withholding and reporting rules.* For an exemption from withholding under section 1441 with respect to obligations described in this paragraph (b), see §1.1441–1(b)(4)(i). For rules relating to an exemption from Form 1099 reporting and backup withholding

under section 3406, see section 6049 and §1.6049–5(b)(8) for the payment of interest and §1.6045–1(g)(1)(ii) for the redemption, retirement, or sale of an obligation in bearer form.

(c) *Rules concerning obligations in registered form*—(1) *In general*—(i) *Obligation in registered form.* For purposes of this section, an obligation is in registered form only as provided in this paragraph (c)(1)(i). The conditions for an obligation to be considered in registered form are identical to the conditions described in §5f.103–1 of this chapter. Therefore, an obligation that would be an obligation in registered form except for the fact that it can be converted at any time in the future into an obligation that is not in registered form shall not be an obligation in registered form. An obligation that is not in registered form by reason of the preceding sentence may nevertheless be in registered form, but only after the possibility of conversion is terminated. An obligation that is not in registered form and can be converted into an obligation that would meet the requirements of this paragraph (c)(1)(i) for being in registered form shall be considered in registered form only after the conversion is effected. For purposes of this section, an obligation is convertible if the obligation can be transferred by any means not described in §5f.103–1(c) of this chapter. An obligation is treated as an obligation in registered form if—

(A) The obligation is registered as to both principal and any stated interest with the issuer (or its agent) and transfer of the obligation may be effected only by surrender of the old instrument, and either the reissuance by the issuer of the old instrument to the new holder or the issuance by the issuer of a new instrument to the new holder;

(B) The right to the principal of, and stated interest on, the obligation may be transferred only through a book entry system maintained by the issuer (or its agent) described in this paragraph (c)(1)(i)(B). An obligation shall be considered transferable through a book entry system if the ownership of an interest in the obligation, is required to be reflected in a book entry, whether or not physical securities are issued. A book entry is a record of ownership that identifies the owner of an in interest in the obligation; or

(C) It is registered as to both principal and any stated interest with the issuer (or its agent) and may be transferred by way of either of the methods described in paragraph (c)(1)(i)(A) or (B) of this section.

(ii) *Requirements for portfolio interest qualification in the case of an obligation in registered form.* Interest (including original issue discount) received on an obligation that is in registered form qualifies as portfolio interest only if—

(A) The interest is paid on an obligation issued after July 18, 1984;

(B) The interest would be subject to tax under section 871(a)(1)(A), 871(a)(1)-(C), 881(a)(1) or 881(a)(3) but for section 871(h) or 881(c);

(C) A United States (U.S.) person otherwise required to deduct and withhold tax under chapter 3 of the Internal Revenue Code (Code) receives a statement that meets the requirements of section 871(h)(5) that the beneficial owner of the obligation is not a U.S. person; and

(D) An exception under section 871(h) or 881(c) does not apply.

(2) *Required statement.* For purposes of paragraph (c)(1)(ii)(C) of this section, a U.S. person will be considered to have received a statement that meets the requirements of section 871(h)(5) if either it complies with one of the procedures described in this paragraph (c)(2) and does not have actual knowledge or reason to know that the beneficial owner is a U.S. person or it complies with the procedures described in paragraph (d) or (e) of this section.

(i) The U.S. person (or its authorized foreign agent described in §1.1441-7(c)(2)) can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii). See §1.1441–1(b)(2)(vii) for rules regarding reliable association with documentation.

(ii) The U.S. person (or its authorized foreign agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–5(c)(2)(iv) from a person claiming to be withholding foreign partnership and the foreign partnership can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii).

(iii) The U.S. person (or its authorized foreign agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–1(c)(3)(ii) from a person representing to be a qualified intermediary that has assumed primary withholding responsibility in accordance with §1.1441–1(e)(5)(iv) and the qualified intermediary can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with its agreement with the Internal Revenue Service (IRS).

(iv) The U.S. person (or its authorized foreign agent described in §1.1441–7(c)(2)) can reliably associate the payment with a withholding certificate described in §1.1441–1(e)(3)(v) from a person claiming to be a U.S. branch of a foreign bank or of a foreign insurance company that is described in §1.1441–1(b)(2)(iv)(A) or a U.S. branch designated in accordance with §1.1441–1(b)-(2)(iv)(E) and the U.S. branch can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii).

(v) The U.S. person receives a statement from a securities clearing organization, a bank, or another financial institution that holds customers' securities in the ordinary course of its trade or business. In such case the statement must be signed under penalties of perjury by an authorized representative of the financial institution and must state that the institution has received from the beneficial owner a withholding certificate described in §1.1441–1(e)(2)(i) (a Form W–8 or an acceptable substitute form as defined §1.1441–1(e)(4)(vi)) or that it has received from another financial institution a similar statement that it, or another financial institution acting on behalf of the beneficial owner, has received the Form W–8 from the beneficial owner. In the case of multiple financial institutions between the beneficial owner and the U.S. person, this statement must be given by each financial institution to the one above it in the chain. No particular form is required for the statement provided by the financial institutions. However, the statement must provide the name and address

of the beneficial owner, and a copy of the Form W–8 provided by the beneficial owner must be attached. The statement is subject to the same rules described in §1.1441–1(e)(4) that apply to intermediary Forms W–8 described in §1.1441–1(e)(3)(iii). If the information on the Form W–8 changes, the beneficial owner must so notify the financial institution acting on its behalf within 30 days of such changes, and the financial institution must promptly so inform the U.S. person. This notice also must be given if the financial institution has actual knowledge that the information has changed but has not been so informed by the beneficial owner. In the case of multiple financial institutions between the beneficial owner and the U.S. person, this notice must be given by each financial institution to the institution above it in the chain.

(vi) The U.S. person complies with procedures that the U.S. competent authority may agree to with the competent authority of a country with which the United States has an income tax treaty in effect.

(3) *Time for providing certificate or documentary evidence*—(i) *General rule.* Interest on a registered obligation shall qualify as portfolio interest if the withholding certificate or documentary evidence that must be provided is furnished before expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect to such interest. See, however, §1.1441–1(b)(7) for consequences to a withholding agent that makes a payment without withholding even though it cannot reliably associate the payment with the documentation prior to the payment. If a withholding agent withholds an amount under chapter 3 of the Code because it cannot reliably associate the payment with the documentation for the beneficial owner on the date of payment, the beneficial owner may nevertheless claim the benefit of an exemption from tax under this section by claiming a refund or credit for the amount withheld based upon the procedures described in §§1.1464–1 and 301.6402–3(e) of this chapter. For this purpose, the taxpayer must attach a withholding certificate described in §1.1441–1(e)(2)(i) to the income tax filed for claiming a refund of tax. In the alternative, adjustments to any amount of overwithheld tax may be made under the procedures described in §1.1461–2(a) (for example, if the beneficial owner furnishes documentation to the withholding agent before the due date for filing the return required under §1.1461–1(b) with respect to that payment).

(ii) *Example.* The following example illustrates the rules of this paragraph (c)(3) and their coordination with §1.1441–1(b)(7):

Example. A is a withholding agent who, on October 12, 1999, pays interest on a registered obligation to B, a foreign corporation. B is a calendar year taxpayer, engaged in the conduct of a trade or business in the United States, and is, therefore, required to file an annual income tax return on Form 1120F. The interest, however, is not effectively connected with B's U.S. trade or business. On the date of payment, B has not furnished, and A cannot associate the payment with documentation for B. However, A does not withhold under section 1442, even though, under §1.1441–1(b)(3)(iii)(A), A should presume that B is a foreign person, because A's communications with B are mailed to an address in a foreign country. Assuming that B files a return for its taxable year ending December 31, 1999, and that its statute of limitations period with regard to that year expires on June 15, 2003, the interest paid on October 12, 1999, may qualify as portfolio interest only if B provides appropriate documentation to A on or before June 15, 2003. If B does not provide the documentation on or before June 15, 2003, and does not pay the tax, A is liable for the tax under section 1463, even if B provides the documentation to A after June 15, 2003. Therefore, the provisions in §1.1441–1(b)(7), regarding late-received documentation would not help A avoid liability for tax under section 1463 even if the documentation is furnished within the statute of limitations period of A. This is because, in a case involving interest, the documentation received within the limitations period of the beneficial owner serves as a condition for the interest to qualify as portfolio interest. When documentation is received after the expiration of the beneficial owner's limitations period, the interest can no longer qualify as portfolio interest. On the other hand, A could rely on documentation that it receives after the expiration of B's limitations period to establish B's right to a reduced rate of withholding under an applicable income tax treaty (since, in such a case, a claim of treaty benefits is not conditioned upon providing documentation prior to the expiration of the beneficial owner's limitations period).

(4) *Coordination with withholding and reporting rules.* For an exemption from withholding under section 1441 with respect to obligations described in this paragraph (c), see §1.1441–1(b)(4)(i). For rules applicable to withholding certificates, see §1.1441–1(e)(4). For rules regarding documentary evidence, see §1.6049–5(c)(1). For application of presumptions when the U.S. person cannot reliably associate the payment with documentation, see §1.1441–1(b)(3). For standards of knowledge applicable to withholding agents, see §1.1441–7(b). For rules relating to an exemption from Form 1099 reporting and backup withholding under section 3406, see section 6049 and §1.6049–5(b)(8) for the payment of interest and §1.6045–1(g)(1)(i) for the redemption, retirement, or sale of an obligation in registered form. For rules relating to reporting on Forms 1042 and 1042-S, see §1.1461–1(b) and (c).

(d) *Application of repeal of 30-percent withholding to pass-through certificates*—(1) *In general.* Interest received on a pass-through certificate qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1), or (e) of this section without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. This paragraph (d)(1) applies only to payments made to the holder of the pass-through certificate from the trustee of the pass-through trust and does not apply to payments made to the trustee of the pass-through trust. For example, a mortgage pass-through certificate in bearer form must meet the requirements set forth in paragraph (b)(1) of this section, but the obligations held by the fund or trust to which the mortgage pass-through certificate relates need not meet the requirements set forth in paragraph (b)(1), (c)(1)(ii), or (e) of this section. However, for purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a pass-through certificate will be considered as issued after July 18, 1984, only to the extent that the obligations held by the fund or trust to which the pass-through certificate relates are issued after July 18, 1984.

(2) *Interest in REMICs.* Interest received on a regular or residual interest in a REMIC qualifies as portfolio interest under section 871(h)(2) or 881(c)(2) if the interest satisfies the conditions described in paragraph (b)(1), (c)(1)(ii), or (e) of this section. For purposes of paragraph (b)(1), (c)(1)(ii), or (e) of this section, interest on a regular interest in a REMIC is not considered interest on any mortgage obligations held by the REMIC. The foregoing rule, however, applies only to payments made to the holder of the regular interest from the REMIC and does not

apply to payments made to the REMIC. For purposes of paragraph (b)(1), (c)(1)(ii), or (e) of this section, interest on a residual interest in a REMIC is considered to be interest on or with respect to the obligations held by the REMIC, and not on or with respect to the residual interest. For purposes of paragraphs (b)(1), (c)(1)(ii), and (e) of this section and section 127 of the Tax Reform Act of 1984, a residual interest in a REMIC will be considered as issued after July 18, 1984, only to the extent that the obligations held by the REMIC are issued after July 18, 1984, but a regular interest in a REMIC will be considered as issued after July 18, 1984, if the regular interest was issued after July 18, 1984, without regard to the date on which the mortgage obligations held by the REMIC were issued.

(3) *Date of issuance.* In general, a mortgage pass-through certificate will be considered to have been issued after July 18, 1984, if all of the mortgages held by the fund or trust were issued after July 18, 1984. If some of the mortgages held by the fund or trust were issued before July 19, 1984, then the portion of any interest payment which represents interest on those mortgages shall not be considered to be portfolio interest. The preceding sentence shall not apply, however, if all of the following conditions are satisfied:

(i) The mortgage pass-through certificate is issued after December 31, 1986;

(ii) Payment of the mortgage pass-through certificate is guaranteed by, and a guarantee commitment has been issued by, an entity that is independent from the issuer of the underlying obligation;

(iii) The guarantee commitment with respect to the mortgage pass-through certificate cannot have been issued more than 14 months prior to the date on which the mortgage pass-through certificate is issued; and

(iv) The fund or trust to which the mortgage pass-through certificate relates cannot contain mortgage obligations on which the first scheduled monthly payment of principal and interest was made more than twelve months before the date on which the guarantee commitment was made.

(e) *Foreign-targeted registered obligations*—(1) *General rule.* The statement described in paragraph (c)(1)(ii)(C) of this section is not required with respect to interest paid on a registered obligation that is targeted to foreign markets in accordance with the provisions of paragraph (e)(2) of this section if the interest is paid by a U.S. person, a withholding foreign partnership, or a U.S. branch described in §1.1441–1(b)(2)(iv)(A) or (E) to a registered owner at an address outside the United States, provided that the registered owner is a financial institution described in section 871(h)(5)(B). In that case, the U.S. person otherwise required to deduct and withhold tax may treat the interest as portfolio interest if it does not have actual knowledge that the beneficial owner is a United States person and if it receives the certificate described in paragraph (e)(3)(i) of this section from a financial institution or member of a clearing organization, which member is the beneficial owner of the obligation, or the documentary evidence or statement described in paragraph (e)(3)(ii) of this section from the beneficial owner, in accordance with the procedures described in paragraph (e)(4) of this section.

(2) *Definition of a foreign-targeted registered obligation.* An obligation is considered to be targeted to foreign markets for purposes of paragraph (e)(1) of this section if it is sold (or resold in connection with its original issuance) only to foreign persons (or to foreign branches of United States financial institutions described in section 871(h)(5)(B)) in accordance with procedures similar to those prescribed in §1.163–5(c)(2)(i)(A), (B), or (D). However, the provisions of that section that require an obligation to be offered for sale or resale in connection with its original issuance only outside the United States do not apply with respect to registered obligations offered for sale through a public auction. Similarly, the provisions of that section that require delivery to be made outside the United States do not apply to registered obligations offered for sale through a public auction if the obligations are considered to be in registered form by virtue of the fact that they may be transferred only through a book entry system. The obligation, if evidenced by a physical document other than a confirmation receipt, must contain on its face a legend indicating that it has been sold (or resold in connection with its original issuance) in accordance with those procedures.

(3) *Documentation.* A certificate described in paragraph (e)(3)(i) of this section is required if the United States person otherwise required to deduct and withhold tax (the withholding agent) pays interest to a financial institution described in section 871(h)(5)(B) or to a member of a clearing organization, which member is the beneficial owner of the obligation. The documentation described in paragraph (e)(3)(ii) of this section is required if a withholding agent pays interest to a beneficial owner that is neither a financial institution described in section 871(h)(5)(B) nor a member of a clearing organization.

(i) *Interest paid to a financial institution or a member of a clearing organization*—(A) *Requirement of a certificate*—(*1*) If the withholding agent pays interest to a financial institution described in section 871(h)(5)(B) or to a member of a clearing organization, which member is the beneficial owner of the obligation, the withholding agent must receive a certificate which states that, beginning at the time the last preceding certificate under this paragraph (e)(3)(i) was provided and while the financial institution or clearing organization member has held the obligation, with respect to each foreign-targeted registered obligation which has been held by the person providing the certificate at any time since the provision of such last preceding certificate, either—

(*i*) The beneficial owner of the obligation has not been a United States person on each interest payment date; or

(*ii*) If the person providing the certificate is a financial institution which is holding or has held an obligation on behalf of the beneficial owner, the beneficial owner of the obligation has been a United States person on one or more interest payment dates (identifying such date or dates), and the person making the certification has forwarded or will forward the appropriate United States beneficial ownership notification to the withholding agent in accordance with the provisions of paragraph (e)(4) of this section.

(*2*) The person providing the certificate need not state the foregoing where no previous certificate has been required to be provided by the payee to the withholding agent under this paragraph (e)(3)(i).

(B) *Additional representations.* Whether or not a previous certificate has

been required to be provided with respect to the obligation, each certificate furnished pursuant to the provisions in this paragraph (e)(3)(i) must further state that, for each foreign-targeted registered obligation held and every other such obligation to be acquired and held by the person providing the certificate during the period beginning on the date of the certificate and ending on the date the next certificate is required to be provided, the beneficial owner of the obligation will not be a United States person on each interest payment date while the financial institution or clearing organization member holds the obligation and that, if the person providing the certificate is a financial institution which is holding or will be holding the obligation on behalf of a beneficial owner, such person will provide a United States beneficial ownership notification to the withholding agent (and a clearing organization that is not a withholding agent where a member organization is required by this paragraph (e)(3) to furnish the clearing organization with a statement) in accordance with paragraph (e)(4) of this section in the event such certificate (or statement in the case of a statement provided by a member organization to a clearing organization that is not a withholding agent) is or becomes untrue with respect to any obligation. A clearing organization is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation.

(C) *Obligation must be identified.* The certificate described in paragraph (e)(3)(ii)(A) of this section must identify the obligation or obligations with respect to which it is given, except where the certification is given with respect to an obligation that has not been acquired at the time the certification is made. An obligation is identified if it or the larger issuance of which it is a part is described on a list (e.g., $5 million principal amount of 12% debentures of ABC Savings and Loan Association due February 25, 1995, $3 million principal amount of 10% U.S. Treasury notes due May 28, 1990) of all registered obligations targeted to foreign markets held by or on behalf of the person providing the certificate and the list is attached to, and incorporated by reference into, the certificate. The certificate must identify and provide the address of the person furnishing the certificate.

(D) *Payment to a depository of a clearing organization.* If the withholding agent pays interest to a depository of a clearing organization, then the clearing organization must provide the certificate described in this paragraph (e)(3)(i) to the withholding agent. Any certificate that is provided by a clearing organization must state that the clearing organization has received a statement from each member which complies with the provisions of this paragraph (e)(3)(i) and of paragraph (e)(4) of this section (as if the clearing organization were the withholding agent and regardless of whether the member is a financial institution described in section 871(h)(5)(B)).

(E) *Statement in lieu of Form W–8.* Subject to the requirements set out in paragraph (e)(4) of this section, a certificate or statement in the form described in this paragraph (e)(3)(i), in conjunction with the next annual certificate or statement, will serve as the certificate that may be provided in lieu of a Form W–8 with respect to interest on all foreign-targeted registered obligations held by the person making the certification or statement and which is paid to such person within the period beginning on the date of the certificate and ending on the date the next certificate is required to be provided.

(F) *Electronic transmission.* The certificate described in this paragraph (e)(3)(i) may be provided electronically under the terms and conditions of §1.163–5(c)(2)(i)(D)(*3*)(*ii*).

(ii) *Payment to a person other than a financial institution or member of a clearing organization.* If the withholding agent pays interest to the beneficial owner of an obligation that is neither a financial institution described in section 871(h)(5)(B) nor a member of a clearing organization, then such owner must provide the withholding agent a statement described in paragraph (c)(1)(ii)(C) of this section.

(4) *Applicable procedures regarding documentation*—(i) *Procedures applicable to certificates required under paragraph (e)(3)(i) of this section*—(A) *Time for providing certificate.* Where no previous certificate for foreign-targeted registered obligations has been provided to the withholding agent by the person providing the certificate under paragraph (e)(3)(i) of this section, such certificate must be provided within the period beginning 90 days prior to the first interest payment date on which the person holds a foreign-targeted registered obligation. The withholding agent may, in its discretion, withhold under section 1441(a), 1442(a), or 1443 if the certificate is not received by the date 30 days prior to the interest payment. Thereafter the certificate must be filed within the period beginning on January 15 and ending January 31 of each year. If a certificate provided pursuant to the first sentence of this paragraph (e)(4)(i)(A) is provided during the period beginning on January 15 and ending on January 31 of any year, then no other certificate need be provided during such period in such year.

(B) *Change of status notification on Form W–9.* If, on any interest payment date after the obligation was acquired by the person making the certification, the beneficial owner of the obligation is a U.S. person, then the person to whom the withholding agent pays interest must furnish the withholding agent with a U.S. beneficial ownership notification within 30 days after such interest payment date. A U.S. beneficial ownership notification must include a statement that the beneficial owner of the obligation has been a U.S. person on an interest payment date (identifying such date), that such owner has provided to the person providing the notification a Form W–9 (or a substitute form that is substantially similar to Form W–9 and completed under penalties of perjury), and that the person providing the notification has been and will be complying with the information reporting requirements of section 6049, if applicable.

(C) *Alternative notification statement.* Where the person providing the notification described in paragraph (e)(4)(i)(B) of this section is neither a controlled foreign corporation within the meaning of section 957(a), nor a foreign corporation 50-percent or more of the gross income of which from all sources for the three-year period ending with the close of the taxable year preceding the date of the statement was effectively connected with the conduct of trade or business in the United States, such person must attach to the notification a copy of the Form W–9 (or substitute

form that is substantially similar to Form W–9 and completed under penalties of perjury) provided by the beneficial owner. When a person that provides the U.S. beneficial ownership notification does not attach to it a copy of such Form W–9 (or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury), such person must state that it is either a controlled foreign corporation within the meaning of section 957(a), or a foreign corporation 50-percent or more of the gross income of which from all sources for the three-year period ending with the close of its taxable year preceding the date of the statement was effectively connected with the conduct of a trade or business in the United States. A withholding agent that receives a Form W–9 (or a substitute form that is substantially similar to Form W–9 and completed under penalties of perjury) must send a copy of such form to the IRS, at such address as the IRS shall indicate, within 30 days after receiving it and must attach a statement that the Form W–9 or substitute form was provided pursuant to this paragraph (e)(4) with respect to a U.S. person that has owned a foreign-targeted registered obligation on one or more interest payment dates.

(D) *Failure to provide notification.* If either a Form W–9 (or a substitute form that is substantially similar to a Form W–9 and completed under penalties of perjury) or the statement described in paragraph (e)(4)(i)(C) of this section is not attached to the U.S. beneficial ownership notification provided pursuant to paragraph (e)(4)(i)(B) of this section, the withholding agent is required to withhold under section 1441, 1442, or 1443 on a payment of interest made after the withholding agent has received the notification unless such form or statement (or a statement that the beneficial owner of the obligation is no longer a U.S. person) is received before the interest payment date from the person who provided the notification (or transferee). If, during the period beginning on the next January 15 and ending on the next January 31, such person certifies as set out in paragraph (e)(3)(i) of this section (subject to paragraph (e)(3)(i)(A)(*2*) of this section) then the withholding agent is not required to withhold during the year following such certification (unless such person again provides a U.S. beneficial ownership notification without attaching a Form W–9 or substitute form that is substantially similar to Form W–9 and completed under penalties of perjury or the statement described in paragraph (e)(4)(i)(C) of this section).

(E) *Procedures for clearing organizations.* Within the period beginning 10 days before the end of the calendar quarter and ending on the last day of each calendar quarter, any clearing organization (including a clearing organization that is a withholding agent) relying on annual certificates or statements from its member organizations, as set forth in paragraph (e)(3)(i) of this section, must send each member organization having submitted such certificate or statement a reminder that the member organization must give the clearing organization a U.S. beneficial ownership notification in the circumstances described in paragraph (e)(4)-(i)(B) of this section.

(F) *Retention of certificates.* The certificate described in paragraph (e)(3)(i) of this section must be retained in the records of the withholding agent for four years from the end of the calendar year in which it was received. The statement described in paragraph (e)(3)(i) of this section that is received by a clearing organization from a member organization must be retained in the records of the clearing organization for four years from the end of the calendar year in which it was received.

(G) *No reporting requirement.* The withholding agent who receives the certificate described in paragraph (e)(3)(i) of this section is not required to file Form 1042S to report payments under §1.1461–1(b) or (c) of interest that are made with respect to foreign-targeted registered obligations held by the person providing the certificate and are made within the period beginning with the certificate date and ending on the last date for filing the next certificate.

(ii) *Procedures regarding certificates required under paragraph (e)(3)(ii) of this section*—(A) *Time for providing certificate.* The statement described in paragraph (e)(3)(ii) of this section must be provided to the withholding agent within the period beginning 90 days prior to and ending on the first interest payment date on which the withholding agent pays interest to the beneficial owner. The withholding agent may, in its discretion, withhold under section 1441(a), 1442(a), or 1443 if the statement is not received by the date 30 days prior to the interest payment. The beneficial owner must confirm to the withholding agent the continuing validity of the documentary evidence within the period beginning 90 days prior to the first day of the third calendar year following the provision of such evidence and during the same period every three years thereafter while the owner still owns the obligation. The withholding agent who receives the statement described in paragraph (e)(3)(ii) of this section is not required to report payments of interest under §1.1461–1(b) or (c) if the payments are made with respect to foreign-targeted registered obligations held by the person who provides the statement and are made within the period beginning with the date on which the statement is provided and ending on the last date for confirming the validity of the statement. The statement received for purposes of paragraph (e)(3)(ii) of this section is subject to the applicable procedures set forth in §1.1441–1(e)(4).

(B) *Change of status notification on Form W–9.* If on any interest payment date after the obligation was acquired by the person providing the statement described in paragraph (e)(3)(ii) of this section, the beneficial owner of the obligation is a U.S. person, then the beneficial owner must so inform the withholding agent within 30 days after such interest payment date and must provide a Form W–9 (or substitute form that is substantially similar completed under penalties of perjury) to the withholding agent. However, the beneficial owner is not required to provide another Form W–9 (or substitute form that is substantially similar and completed under penalties of perjury) if such person has already provided it to the withholding agent within the same calendar year.

(iii) *Disqualification of documentation.* In accordance with the provisions of section 871(h)(4), the Secretary may make a determination in appropriate cases that a certificate or statement by any person, or class of persons, does not satisfy the requirements of that section. Should that determination be made, all payments of interest that otherwise qualify as portfolio interest to that person would become subject to 30-percent withholding under section 1441(a), 1442(a), or 1443.

(iv) *Special effective date.* Notwithstanding the foregoing requirements of this section—

(A) Any certificate that is required to be filed with the withholding agent during the period beginning on January 15 and ending on January 31, 1986, is not required to state that the beneficial owner of an obligation, prior to the date of the certificate, either was not a United States person or was a United States person if the obligation was acquired by the person providing the certificate on or before September 19, 1985; and

(B) All of the requirements of this paragraph (e), as in effect prior to the effective date of these amendments, shall remain effective with respect to each interest payment prior to the filing of the certificate described in paragraph (e)(4)(iv)(A) of this section, except that the provisions of paragraph (e)(3) of this section relating to which persons are required to receive certificates or statements and paragraph (e)(3)(ii) or (4)(ii) of this section shall become effective with respect to each interest payment after September 20, 1985.

(5) *Information reporting.* See §1.6049–5(b)(7) for special information reporting rules applicable to interest on foreign-targeted registered obligations. See §1.6045–1(g)(1)(ii) for information reporting rules applicable to the redemption, retirement, or sale of foreign-targeted registered obligations.

(f) *Securities lending transactions.* For applicable rules regarding substitute interest payments received pursuant to a securities lending transaction or a sale-repurchase transaction, see §§1.871–7(b)(2) and 1.881–2(b)(2).

(g) *Definitions.* For purposes of this section, the terms *U.S. person* and *foreign person* have the meaning set forth in §1.1441–1(c)(2), the term *beneficial owner* has the meaning set forth in §1.1441–1(c)(6), the term *withholding agent* has the meaning set forth in §1.1441-7(a); the term *payee* has the meaning set forth in §1.1441–1(b)(2); and the term *payment* has the meaning set forth in §1.1441–2(e).

(h) *Effective date*—(1) *In general.* This section shall apply to payments of interest made after December 31, 1998.

(2) *Transition rule.* For purposes of this section, a withholding agent that on December 31, 1998, holds a Form W–8 that is valid under the regulations in effect prior to January 1, 1999 (see 26 CFR parts 1 and 35a revised April 1, 1997), may treat it as a valid withholding certificate until its validity expires under these regulations or, if earlier, until December 31, 1999. Further, the validity of a Form W–8 that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (h)(2), however, does not apply to extend the validity period of a Form W–8 that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a withholding agent or payor may choose to not take advantage of the transition rule in this paragraph (h)(2) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

Par. 6. Section 1.1441-0 is added to read as follows:

§1.1441–0 Outline of regulation provisions for section 1441.

This section lists captions contained in §§1.1441–1 through 1.1441-9.

§1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

(a) Purpose and scope.
(b) General rules of withholding.
(1) Requirement to withhold on payments to foreign persons.
(2) Determination of payee and payee's status.
(i) In general.
(ii) Payments to a U.S. agent of a foreign person.
(iii) Payments to wholly-owned entities.
(A) Foreign-owned domestic entity.
(B) Foreign entity.
(iv) Payments to a U.S. branch of certain foreign banks or foreign insurance companies
(A) U.S. branch treated as a U.S. person in certain cases.
(B) Consequences to the withholding agent.
(C) Consequences to the U.S. branch.
(D) Definition of payment to a U.S. branch.
(E) Payments to other U.S. branches.
(v) Payments to a foreign intermediary.
(A) Payments treated as made to persons for whom the intermediary collects the payment.
(B) Payments treated as made to foreign intermediary.
(vi) Other payees.
(vii) Rules for reliably associating a payment with documentation.
(3) Presumptions regarding payee's status in the absence of documentation.
(i) General rules.
(ii) Presumptions of status as individual, corporation, partnership, etc.
(iii) Presumption of U.S. or foreign status.
(A) Payments to exempt recipients.
(B) Scholarships and grants.
(C) Pensions, annuities, etc.
(D) Certain payments to offshore accounts.
(iv) Grace period in the case of indicia of a foreign payee.
(v) Special rules applicable to payments to foreign intermediaries.
(A) Reliance on claim of status as foreign intermediary.
(B) Beneficial owner documentation is lacking or unreliable.
(C) Information regarding allocation of payment is lacking or unreliable.
(D) Certification that the foreign intermediary has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.
(vi) U.S. branches and foreign flow-through entities.
(vii) Joint payees.
(viii) Rebuttal of presumptions.
(ix) Effect of reliance on presumptions and of actual knowledge or reason to know otherwise.
(A) General rule.
(B) Actual knowledge or reason to know that amount of withholding is greater than is required under the presumptions or that reporting of the payment is required.
(x) Examples.
(4) List of exemptions from, or reduced rates of, withholding under chapter 3 of the Code.

(5) Establishing foreign status under applicable provisions of chapter 61 of the Code.
(6) Rules of withholding for payments by a foreign intermediary or certain U.S. branches.
(7) Liability for failure to obtain documentation timely or to act in accordance with applicable presumptions.
(i) General rule.
(ii) Proof that tax liability has been satisfied.
(iii) Liability for interest and penalties.
(iv) Special effective date.
(v) Examples.
(8) Adjustments, refunds, or credits of overwithheld amounts.
(9) Payments to joint owners.
(c) Definitions.
(1) Withholding.
(2) Foreign and U.S. person.
(3) Individual.
(i) Alien individual.
(ii) Nonresident alien individual.
(4) Certain foreign corporations.
(5) Financial institution and foreign financial institution.
(6) Beneficial owner.
(i) General rule.
(ii) Special rules for flow-through entities and arrangements.
(A) General rule.
(B) Trusts and estates.
(C) Definition of a flow-through entity or arrangement.
(7) Withholding agent.
(8) Person
(9) Source of income.
(10) Chapter 3 of the Code.
(11) Reduced rate.
(d) Beneficial owner's or payee's claim of U.S. status.
(1) In general.
(2) Payments for which a Form W–9 is otherwise required.
(3) Payments for which a Form W–9 is not otherwise required.
(4) Other payments.
(e) Beneficial owner's claim of foreign status.
(1) Withholding agent's reliance.
(i) In general.
(ii) Payments that a withholding agent may treat as made to a foreign person that is a beneficial owner.
(A) General rule.
(B) Additional requirements.
(2) Beneficial owner withholding certificate.
(i) In general.
(ii) Requirements for validity of certificate.
(3) Intermediary, flow-through, or U.S. branch withholding certificate.
(i) In general.
(ii) Intermediary withholding certificate from a qualified intermediary.
(iii) Intermediary withholding certificate from an intermediary that is not a qualified intermediary.
(iv) Information to the withholding agent regarding assets owned by beneficial owners, etc.
(A) General rule.
(B) Updating the information.
(C) Examples.
(v) Withholding certificate from certain U.S. branches.
(vi) Reportable amounts.
(4) Applicable rules.
(i) Who may sign the certificate.
(ii) Period of validity.
(A) Three-year period.
(B) Indefinite validity period.
(C) Withholding certificate for effectively connected income.
(D) Change in circumstances.
(iii) Retention of withholding certificate.
(iv) Electronic transmission of information.
(v) Electronic confirmation of taxpayer identifying number on withholding certificate.
(vi) Acceptable substitute form.
(vii) Requirement of taxpayer identifying number.
(viii) Reliance rules.
(A) Classification.
(B) Status of payee as an intermediary or as a person acting for its own account.
(ix) Certificates to be furnished for each account unless exception applies.
(A) Coordinated account information system in effect.
(B) Family of mutual funds.
(C) Special rule for brokers.
(5) Qualified intermediaries.
(i) General rule.
(ii) Definition of qualified intermediary.
(iii) Withholding agreement.
(A) In general.
(B) Terms of the withholding agreement.
(iv) Assignment of primary withholding responsibility.
(v) Information to withholding agent regarding applicable withholding rates.
(A) General rule.
(B) Categories of assets.
(C) Updating the information.
(f) Effective date.
(1) In general.
(2) Transition rules.
(i) Special rules for existing documentation.
(ii) Lack of documentation for past years.

§1.1441–2 Amounts subject to withholding.

(a) In general.
(b) Fixed or determinable annual or periodical income.
(1) In general.
(i) Definition.
(ii) Manner of payment.
(iii) Determinability of amount.
(2) Exceptions.
(3) Original issue discount.
(i) General rule.
(ii) Amounts actually known to the withholding agent.
(iii) Amounts for which certain documentation is not furnished.
(iv) Exceptions to withholding.
(4) Securities lending transactions and equivalent transactions.
(c) Other income subject to withholding.
(d) Exceptions to withholding where no money or property is paid or lack of knowledge.
(1) General rule.
(2) Cancellation of debt.
(3) Satisfaction of liability following underwithholding by withholding agent.
(e) Payment.
(1) General rule.
(2) Income allocated under section 482.
(3) Blocked income.
(4) Special rules for dividends.
(5) Certain interest accrued by a foreign corporation.
(6) Payments other than in U.S. dollars.
(f) Effective date.

(i) Documentation regarding the status of a partner is lacking or unreliable.
(ii) Information regarding the allocation of payment is lacking or unreliable.
(iii) Certification that the foreign partnership has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.
(iv) Determination by a withholding foreign partnership of the status of its partners.
(4) Examples.
(e) Trusts and estates. [Reserved]
(f) Failure to receive withholding certificate timely or to act in accordance with applicable presumptions.
(g) Effective date.
(1) General rule.
(2) Transition rules.

§1.1441–6 Claim of reduced withholding under an income tax treaty.

(a) In general.
(b) Reliance on claim of reduced withholding under an income tax treaty.
(1) In general.
(2) Exemption from requirement to furnish a taxpayer identifying number and special documentary evidence rules for certain income.
(i) General rule.
(ii) Income to which special rules apply.
(3) Competent authority agreements.
(4) Eligibility for reduced withholding under an income tax treaty in the case of a payment to a person other than an individual.
(i) General rule.
(ii) Withholding certificates.
C. In general.
D. Certification by qualified intermediary.
(iii) Multiple claims of treaty benefits.
(iv) Examples.
(5) Claim of benefits under an income tax treaty by a U.S. person.
(c) Proof of tax residence in a treaty country and certification of entitlement to treaty benefits.
(1) In general.
(2) Certification of taxpayer identifying number.
(i) In general.
(ii) IRS-certified TIN.
(iii) Special rules for qualified intermediaries.
(3) Certificate of residence.
(4) Documentary evidence establishing residence in the treaty country.
(i) Individuals.
(ii) Persons other than individuals.
(5) Certifications regarding entitlement to treaty benefits.
(i) Certification regarding conditions under a Limitation on Benefits Article.
(ii) Certification regarding whether the taxpayer is deriving the income.
(d) Joint owners.
(e) Related party dividends under U.S.-Denmark income tax treaty.
(f) Failure to receive withholding certificate timely.
(g) Effective date.
(1) General rule.
(2) Transition rules.

§1.1441–7 General provisions relating to withholding agents.

(a) Withholding agent defined.
(b) Standards of knowledge.
(1) In general.
(2) Reason to know.
(i) In general.
(ii) Limits on reason to know in certain cases.
(3) Coordinated account information systems.
(c) Authorized agent.
(1) In general.
(2) Authorized foreign agent.
(3) Notification.
(4) Liability of U.S. withholding agent.
(5) Filing of returns.
(d) United States obligations.
(e) Assumed obligations.
(f) Conduit financing arrangements.
(g) Effective date.

§1.1441-8 Exemption from withholding for payments to foreign governments, international organizations, foreign central banks of issue, and the Bank for International Settlements.

(a) Foreign governments.
(b) Reliance on claim of exemption by foreign government.
(c) Income of a foreign central bank of issue or the Bank for International Settlements.
(1) Certain interest income.
(2) Bankers' acceptances.
(d) Exemption for payments to international organizations.
(e) Failure to receive withholding certificate timely and other applicable procedures.
(f) Effective date.
(1) In general.
(2) Transition rules.

§1.1441–9 Exemption from withholding on exempt income of a foreign tax-exempt organization, including foreign private foundations.

(a) Exemption from withholding for exempt income.
(b) Reliance on foreign organization's claim of exemption from withholding.
(1) General rule.
(2) Withholding certificate.
(3) Presumptions in the absence of documentation.
(4) Reason to know.
(c) Failure to receive withholding certificate timely and other applicable procedures.
(d) Effective date.
(1) In general.
(2) Transition rules.

Par. 7. Sections 1.1441–1 and 1.1441-2 are revised to read as follows:

§1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

(a) *Purpose and scope.* This section, §§1.1441–2 through 1.1441–9, and 1.1443–1 provide rules for withholding under sections 1441, 1442, and 1443 when a payment is made to a foreign person. This section provides definitions of terms used in chapter 3 of the Internal Revenue Code (Code) and regulations thereunder. It prescribes procedures to determine whether an amount must be withheld under chapter 3 of the Code and documentation that a withholding agent may rely upon to determine the status of a payee or a beneficial owner as a U.S. person or as a foreign person and other relevant characteristics of the payee that may affect a withholding agent's obligation to withhold under chapter 3 of the Code and the regulations thereunder. Special procedures regarding payments to foreign per-

sons that act as intermediaries are also provided. Section 1.1441–2 defines the income subject to withholding under section 1441, 1442, and 1443 and the regulations under these sections. Section 1.1441–3 provides rules regarding the amount subject to withholding. Section 1.1441–4 provides exemptions from withholding for, among other things, certain income effectively connected with the conduct of a trade or business in the United States, including certain compensation for the personal services of an individual. Section 1.1441–5 provides rules for withholding on payments made to flow-through entities and other similar arrangements. Section 1.1441–6 provides rules for claiming a reduced rate of withholding under an income tax treaty. Section 1.1441–7 defines the term *withholding agent* and provides due diligence rules governing a withholding agent's obligation to withhold. Section 1.1441–8 provides rules for relying on claims of exemption from withholding for payments to a foreign government, an international organization, a foreign central bank of issue, or the Bank for International Settlements. Sections 1.1441–9 and 1.1443–1 provide rules for relying on claims of exemption from withholding for payments to foreign tax exempt organizations and foreign private foundations.

(b) *General rules of withholding*—(1) *Requirement to withhold on payments to foreign persons.* A withholding agent must withhold 30-percent of any payment of an amount subject to withholding made to a payee that is a foreign person unless it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner that is U.S. person or as made to a beneficial owner that is a foreign person entitled to a reduced rate of withholding. However, a withholding agent making a payment to a foreign person need not withhold where the foreign person assumes responsibility for withholding on the payment under chapter 3 of the Code and the regulations thereunder as a qualified intermediary (see paragraph (e)(5) of this section), as a U.S. branch of a foreign person (see paragraph (b)(2)(iv) of this section), as a withholding foreign partnership (see §1.1441–5(c)(2)(i)), or as an authorized foreign agent (see §1.1441–7(c)(1)). This section (dealing with general rules of withholding and claims of foreign or U.S. status by a payee or a beneficial owner), and §§1.1441–4, 1.1441–5, 1.1441–6, 1.1441–8, 1.1441–9, and 1.1443–1 provide rules for determining whether documentation is required as a condition for reducing the rate of withholding on a payment to a foreign beneficial owner or to a U.S. payee and if so, the nature of the documentation upon which a withholding agent may rely in order to reduce such rate. Paragraph (b)(2) of this section prescribes the rules for determining who the payee is, the extent to which a payment is treated as made to a foreign payee, and reliable association of a payment with documentation. Paragraph (b)(3) of this section describes the applicable presumptions for determining the payee's status as U.S. or foreign and the payee's other characteristics (i.e., as an owner or intermediary, as an individual, partnership, corporation, etc.). Paragraph (b)(4) of this section lists the types of payments for which the 30-percent withholding rate may be reduced. Because the treatment of a payee as a U.S. or a foreign person also has consequences for purposes of making an information return under the provisions of chapter 61 of the Code and for withholding under other provisions of the Code, such as sections 3402, 3405 or 3406, paragraph (b)(5) of this section lists applicable provisions outside chapter 3 of the Code that require certain payees to establish their foreign status (e.g., in order to be exempt from information reporting). Paragraph (b)(6) of this section describes the withholding obligations of a foreign person making a payment that it has received in its capacity as an intermediary. Paragraph (b)(7) of this section describes the liability of a withholding agent that fails to withhold at the required 30-percent rate in the absence of documentation. Paragraph (b)(8) of this section deals with adjustments and refunds in the case of overwithholding. Paragraph (b)(9) of this section deals with determining the status of the payee when the payment is jointly owned. See paragraph (c)(6) of this section for a definition of beneficial owner. See §1.1441–7(a) for a definition of withholding agent. See §1.1441–2(a) for the determination of an amount subject to withholding. See §1.1441–2(e) for the definition of a payment and when it is considered made. Except as otherwise provided, the provisions of this section apply only for purposes of determining a withholding agent's obligation to withhold under chapter 3 of the Code and the regulations thereunder.

(2) *Determination of payee and payee's status*—(i) *In general.* Except as otherwise provided in this paragraph (b)(2), a payee is the person to whom a payment is made, regardless of whether such person is the beneficial owner of the amount (as defined in paragraph (c)(6) of this section). A foreign payee is a payee who is a foreign person. A U.S. payee is a payee who is a U.S. person. Generally, the determination by a withholding agent of the U.S. or foreign status of a payee and of its other relevant characteristics (e.g., as a beneficial owner or intermediary, or as an individual, corporation, or flow-through entity) is made on the basis of a withholding certificate that is a Form W–8 or a Form 8233 (indicating foreign status of the payee or beneficial owner) or a Form W–9 (indicating U.S. status of the payee). The provisions of this paragraph (b)(2), paragraph (b)(3) of this section, and §1.1441–5(c), (d), and (e) dealing with determinations of payee and applicable presumptions in the absence of documentation, apply only to payments of amounts subject to withholding under chapter 3 of the Code (within the meaning of §1.1441–2(a)). Similar payee and presumption provisions are set forth under §1.6049–5(d) for payments of amounts that are not subject to withholding under chapter 3 of the Code (or the regulations thereunder) but that may be reportable under provisions of chapter 61 of the Code (and the regulations thereunder). See paragraph (d) of this section for documentation upon which the withholding agent may rely in order to treat the payee or beneficial owner as a U.S. person. See paragraph (e) of this section for documentation upon which the withholding agent may rely in order to treat the payee or beneficial owner as a foreign person. For applicable presumptions of status in the absence of documentation, see paragraph (b)(3) of this section and §1.1441–5(d). For definitions of a foreign person and U.S. person, see paragraph (c)(2) of this section.

(ii) *Payments to a U.S. agent of a foreign person.* A withholding agent making

a payment to a U.S. person (other than to a U.S. branch that is treated as a U.S. person pursuant to paragraph (b)(2)(iv) of this section) and who has actual knowledge that the U.S. person receives the payment as an agent of a foreign person must treat the payment as made to the foreign person. However, the withholding agent may treat the payment as made to the U.S. person if the U.S. person is a financial institution and the withholding agent has no reason to believe that the financial institution will not comply with its obligation to withhold. See paragraph (c)(5) of this section for the definition of a financial institution.

(iii) *Payments to wholly-owned entities*—(A) *Foreign-owned domestic entity.* A payment to a wholly-owned domestic entity that is disregarded for federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall be treated as a payment to the owner of the entity, subject to the provisions of paragraph (b)(2)(iv) of this section. For purposes of this paragraph (b)(2)(iii)(A), a domestic entity means a person that would be treated as a U.S. person if it had an election in effect under §301.7701–3(c)(1)(i) of this chapter to be treated as a corporation. For example, a limited liability company, A, organized under the laws of the State of Delaware, opens an account at a U.S. bank. Upon opening of the account, the bank requests A to furnish a Form W–9 as required under section 6049(a) and the regulations under that section. A does not have an election in effect under §301.7701–3(c)(1)(i) of this chapter and, therefore, is not treated as an organization taxable as a corporation, including for purposes of the exempt recipient provisions in §1.6049–4(c)(1). If A has a single owner and the owner is a foreign person (as defined in paragraph (c)(2) of this section), then A may not furnish a Form W–9 because it may not represent that it is a U.S. person for purposes of the provisions of chapters 3 and 61 of the Code, and section 3406. Therefore, A must furnish a Form W–8 with the name, address, and taxpayer identifying number (TIN) (if required) of the foreign person who is the single owner in the same manner as if the account were opened directly by the foreign single owner. See §§1.894–1T(d) and 1.1441–6(b)(4) for special rules where the entity's owner is claiming a reduced rate of withholding under an income tax treaty.

(B) *Foreign entity.* A payment to a wholly-owned foreign entity that is disregarded under §301.7701–2(c)(2) of this chapter as an entity separate from its owner shall be treated as a payment to the single owner of the entity, subject to the provisions of paragraph (b)(2)(iv) of this section if the foreign entity has a U.S. branch in the United States. For purposes of this paragraph (b)(2)(iii)(B), a foreign entity means a person that would be treated as a foreign person if it had an election in effect under §301.7701–3(c)(1)(i) of this chapter to be treated as a corporation. See §§1.894–1T(d) and 1.1441–6(b)(4) for special rules where the foreign entity or its owner is claiming a reduced rate of withholding under an income tax treaty. Thus, for example, if the foreign entity's single owner is a U.S. person, the payment shall be treated as a payment to a U.S. person. Therefore, based on the savings clause in U.S. income tax treaties, such an entity may not claim benefits under an income tax treaty even if the entity is organized in a country with which the United States has an income tax treaty in effect and treats the entity as a non-fiscally transparent entity. See §1.894–1T(d)(6), *Example 10.* Unless it has actual knowledge or reason to know that the foreign entity to whom the payment is made is disregarded under §301.7701–2(c)(2) of this chapter, a withholding agent may treat a foreign entity as an entity separate from its owner unless it can reliably associate the payment with a withholding certificate from the entity's owner.

(iv) *Payments to a U.S. branch of certain foreign banks or foreign insurance companies*—(A) *U.S. branch treated as a U.S. person in certain cases.* A payment to the U.S. branch of a foreign person is a payment to the foreign person. However, a U.S. branch described in this paragraph (b)(2)(iv)(A) and a withholding agent (including another U.S. branch described in this paragraph (b)(2)(iv)(A)) may agree to treat the branch as a U.S. person for purposes of withholding on specified payments to the U.S. branch. Such agreement must be evidenced by a U.S. branch withholding certificate described in paragraph (e)(3)(v) of this section furnished by the U.S. branch to the withholding agent. A U.S. branch described in this paragraph (b)(2)(iv)(A) is any U.S. branch of a foreign bank subject to regulatory supervision by the Federal Reserve Board or a U.S. branch of a foreign insurance company required to file an annual statement on a form approved by the National Association of Insurance Commissioner with the Insurance Department of a State, a Territory, or the District of Columbia. The Internal Revenue Service (IRS) may approve a list of U.S. branches that may qualify for treatment as a U.S. person under this paragraph (b)(2)(iv)(A) (see §601.601(d)(2) of this chapter).

(B) *Consequences to the withholding agent.* Any person that is otherwise a withholding agent regarding a payment to a U.S. branch described in paragraph (b)(2)(iv)(A) of this section shall treat the payment in one of the following ways—

(*1*) As a payment to a U.S. person, in which case the withholding agent is not responsible for withholding on such payment to the extent it can reliably associate the payment with a withholding certificate described in paragraph (e)(3)(v) of this section that has been furnished by the U.S. branch under its agreement with the withholding agent to be treated as U.S. person;

(*2*) As a payment directly to the persons whose names are on withholding certificates or other appropriate documentation forwarded by the U.S. branch to the withholding agent when no agreement is in effect to treat the U.S. branch as a U.S. person for such payment, to the extent the withholding agent can reliably associate the payment with such certificates or documentation; or

(*3*) As a payment to a foreign person of income that is effectively connected with the conduct by that foreign person of a trade or business in the United States if the withholding agent cannot reliably associate the payment with a certificate from the U.S. branch or any other certificate or other appropriate documentation from another person.

(C) *Consequences to the U.S. branch.* A U.S. branch that is treated as a U.S. person under paragraph (b)(2)(iv)(A) of this section shall be treated as a person for purposes of section 1441(a) and all other provisions of chapter 3 of the Code and

the regulations thereunder for any payment that it receives as such. Thus, the U.S. branch shall be responsible for withholding on the payment in accordance with the provisions under chapter 3 of the Code and the regulations thereunder and other applicable withholding provisions of the Code. For this purpose, it shall obtain and retain documentation from payees or beneficial owners of the payments that it receives as a U.S. person in the same manner as if it were a separate entity. For example, if a U.S. branch receives a payment on behalf of its home office and the home office is a qualified intermediary, the U.S. branch must obtain a withholding certificate described in paragraph (e)(3)(ii) of this section from its home office. In addition, a U.S. branch that has not provided documentation to the withholding agent for a payment that is, in fact, not effectively connected income is a withholding agent with respect to that payment. See paragraph (b)(6) of this section.

(D) *Definition of payment to a U.S. branch.* A payment is treated as a payment to a U.S. branch of a foreign bank or foreign insurance company if the payment is credited to an account maintained in the United States in the name of a U.S. branch of the foreign person, or the payment is made to an address in the United States where the U.S. branch is located and the name of the U.S. branch appears on documents (in written or electronic form) associated with the payment (e.g., the check mailed or a letter addressed to the branch).

(E) *Payments to other U.S. branches.* Similar withholding procedures may apply to payments to U.S. branches that are not described in paragraph (b)(2)(iv)(A) of this section to the extent permitted by the district director or the Assistant Commissioner (International). Any such branch must establish that its situation is analogous to that of a U.S. branch described in paragraph (b)(2)-(iv)(A) of this section regarding its registration with, and regulation by, a U.S. governmental institution, the type and amounts of assets it is required to, or actually maintain in the United States, and the personnel who carry out the activities of the branch in the United States. In the alternative, the branch must establish that the withholding and reporting requirements under chapter 3 of the Code and the regulations thereunder impose an undue administrative burden and that the collection of the tax imposed by section 871(a) or 881(a) on the foreign person (or its members in the case of a foreign partnership) will not be jeopardized by the exemption from withholding. Generally, an undue administrative burden will be found to exist in a case where the person entitled to the income, such as a foreign insurance company, receives from the withholding agent income on securities issued by a single corporation, some of which is, and some of which is not, effectively connected with conduct of a trade or business within the United States and the criteria for determining the effective connection are unduly difficult to apply because of the circumstances under which such securities are held. No exemption from withholding shall be granted under this paragraph (b)(2)(iv)(E) unless the person entitled to the income complies with such other requirements as may be imposed by the district director or the Assistant Commissioner (International) and unless the district director or the Assistant Commissioner (International) is satisfied that the collection of the tax on the income involved will not be jeopardized by the exemption from withholding. The IRS may prescribe such procedures as are necessary to make these determinations (see §601.601(d)(2) of this chapter).

(v) *Payments to a foreign intermediary*—(A) *Payments treated as made to persons for whom the intermediary collects the payment.* Except as otherwise provided in paragraph (b)(2)(v)(B) of this section, a payment to a person that the withholding agent may treat as a foreign intermediary in accordance with the provisions of paragraph (b)(3)(v)(A) of this section is treated as a payment made directly to the person or persons for whom the intermediary collects the payment. Thus, for example, a payment that the withholding agent can reliably associate with a withholding certificate from a qualified intermediary (defined in paragraph (e)(5)(ii) of this section) and that is allocable to the category of assets described in paragraph (e)(5)(v)(B)(*3*) of this section (i.e., assets allocable to persons for whom the foreign qualified intermediary does not hold documentation as specified under its agreement with the IRS) is treated as a payment to the persons holding assets in that category. See paragraph (b)(3)(v)(B) of this section for applicable presumptions in such a case. For similar rules for payments to flow-through entities, see §1.1441–5(c)(1)(i) and (e).

(B) *Payments treated as made to foreign intermediary.* A payment to a person that the withholding agent can reliably associate with a withholding certificate described in paragraph (e)(3)(ii) of this section from a qualified intermediary that has elected to assume primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section is treated as a payment to the qualified intermediary, except to the extent of the portion of the payment that the withholding agent can reliably associate with Forms W–9. See paragraphs (b)(1) and (e)(5)(iv) of this section for consequences to the withholding agent.

(vi) *Other payees.* A payment to a person described in §1.6049–4(c)(1)(ii) that the withholding agent would treat as a payment to a foreign person without obtaining documentation for purposes of information reporting under section 6049 (if the payment were interest) is treated as a payment to a foreign payee for purposes of chapter 3 of the Code and the regulations thereunder (or to a foreign beneficial owner to the extent provided in paragraph (e)(1)(ii)(A)(*6*) or (*7*) of this section). Further, payments that the withholding agent can reliably associate with documentary evidence described in §1.6049–5(c)(4) relating to the payee is treated as a payment to a foreign payee. A payment that the withholding agent may treat as a payment to an authorized foreign agent (as defined in §1.1441–7(c)(2)) is treated as a payment to the agent and not to the persons for whom the agent collects the payment. See §1.1441–5(b)(1) and (c)(1) for payee determinations for payments to partnerships. See §1.1441–5(e) for payee determinations for payments to foreign trusts or foreign estates.

(vii) *Rules for reliably associating a payment with documentation.* Generally, a withholding agent can reliably associate a payment with documentation if, for that payment, it holds valid documentation to which the payment relates, it can reliably determine how much of the payment re-

lates to the valid documentation (e.g., based on information furnished in accordance with paragraph (e)(3)(iv) or (5)(v) of this section in the case of a payment to a foreign intermediary or in accordance with §1.1441–5(c)(3)(iv) in the case of a payment to a foreign partnership), and it has no actual knowledge or reason to know that any of the information or certifications stated in the documentation are incorrect. The documentation referred to in this paragraph (b)(2)(vii) is documentation described in paragraph (d) or (e) of this section upon which a withholding agent may rely in order to treat the payment as a payment made to a payee or beneficial owner that is a U.S. or a foreign person, and to ascertain the characteristics of the payee or beneficial owner, as may be relevant to withholding or reporting under chapter 3 of the Code and the regulations thereunder (e.g., beneficial owner or intermediary, corporation or partnership). For purposes of this paragraph (b)(2)(vii), documentation also includes a withholding certificate described in paragraph (e)(3)(ii) of this section from a person representing to be a qualified intermediary that has assumed primary withholding responsibility, a withholding certificate described in paragraph (e)(3)(v) of this section from a person representing to be a U.S. branch described in paragraph (b)(2)(iv)(A) of this section, a withholding certificate described in §1.1441–5(c)(2)(iv) from a person representing to be a withholding foreign partnership, and the agreement that the withholding agent has in effect with an authorized foreign agent in accordance with §1.1441–7(c)(2)(i). A withholding agent that is not required to obtain documentation with respect to a payment is considered to lack documentation for purposes of this paragraph (b)(2)(vii). For example, a withholding agent paying U.S. source interest to a person that is an exempt recipient, as defined in §1.6049–4(c)(1)(ii), is not required to obtain documentation from that person in order to determine whether an amount paid to that person is reportable under an applicable information reporting provision under chapter 61 of the Code. Therefore, the withholding agent may rely on the provisions of paragraph (b)(3)(iii)(A) of this section to determine whether the person is presumed to be a U.S. person (in which case, no withholding is required under this section), or whether the person is presumed to be a foreign person (in which case 30-percent withholding is required under this section). See paragraph (b)(3)(v)(A) of this section for special reliance rules in the case of a payment to a foreign intermediary and §1.1441–5(d)(3) for special reliance rules in the case of a payment to a foreign partnership.

(3) *Presumptions regarding payee's status in the absence of documentation*— (i) *General rules.* A withholding agent that cannot reliably associate a payment with documentation may rely on the presumptions of this paragraph (b)(3) in order to determine the status of the payee as a U.S. or a foreign person and the payee's other relevant characteristics (e.g., as an owner or intermediary, as an individual, trust, partnership, or corporation). The determination of withholding and reporting requirements applicable to payments to a person presumed to be a foreign person is governed only by the provisions of chapter 3 of the Code and the regulations thereunder. For the determination of withholding and reporting requirements applicable to payments to a person presumed to be a U.S. person, see chapter 61 of the Code, sections 3402, 3405, or 3406, and the regulations under these provisions. A presumption that a payee is a foreign payee is not a presumption that the payee is a foreign beneficial owner. Therefore, the provisions of this paragraph (b)(3) have no effect for purposes of reducing the withholding rate if associating the payment with documentation of foreign beneficial ownership is required as a condition for such rate reduction. See paragraph (b)(3)(ix) of this section for consequences to a withholding agent that fails to withhold in accordance with the presumptions set forth in this paragraph (b)(3) or if the withholding agent has actual knowledge or reason to know of facts that are contrary to the presumptions set forth in this paragraph (b)(3). See paragraph (b)(2)(vii) of this section for rules regarding the extent which a withholding agent can reliably associate a payment with documentation.

(ii) *Presumptions of status as individual, corporation, partnership, etc.* A withholding agent that cannot reliably associate a payment with documentation must presume that the payee is an individual, a trust, or an estate, if the payee appears to be such person (i.e., based on the payee's name or other indications). In the absence of reliable indications that the payee is an individual, estate, or trust, the withholding agent must presume that the payee is a corporation or one of the persons enumerated under §1.6049–4(c)(1)-(ii)(B) through (Q) if it can be so treated under §1.6049–4(c)(1)(ii)(A)(*1*) or any one of the paragraphs under §1.6049–4-(c)(1)(ii)(B) through (Q) without the need to furnish documentation. If the withholding agent cannot treat a payee as a person described in §1.6049–4(c)(1)(ii)-(A)(*1*) through (Q), then the payee shall be presumed to be a partnership. The fact that a payee is presumed to have a certain status under the provisions of this paragraph (b)(3)(ii) does not mean that it is excused from furnishing documentation, if documentation is otherwise required in order to obtain a reduced rate of withholding under this section. For example, if, for purposes of this paragraph (b)(3)(ii), a payee is presumed to be a tax-exempt organization based on §1.6049–4(c)(1)(ii)(B), the withholding agent cannot rely on this presumption to reduce the rate of withholding on payments to such person (if such person is also presumed to be a foreign person under paragraph (b)(3)(iii)(A) of this section) because a reduction in the rate of withholding for payments to a foreign tax-exempt organization generally requires that a valid Form W–8 described in §1.1441–9(b)(2) be furnished to the withholding agent.

(iii) *Presumption of U.S. or foreign status.* A payment that the withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person, except as otherwise provided in this paragraph (b)(3)(iii), in paragraphs (b)(3)(iv) and (v) of this section, or in §1.1441–5(d) or (e).

(A) *Payments to exempt recipients.* If a withholding agent cannot reliably associate a payment with documentation from the payee and the payee is an exempt recipient (as determined under the provisions of §1.6049–4(c)(1)(ii) in the case of interest, or under similar provisions under chapter 61 of the Code applicable to the

type of payment involved, but not including a payee that the withholding agent may treat as a foreign intermediary in accordance with paragraph (b)(3)(v) of this section), the payee is presumed to be a foreign person and not a U.S. person—

(*1*) If the withholding agent has actual knowledge of the payee's employer identification number and that number begins with the two digits "98";

(*2*) If the withholding agent's communications with the payee are mailed to an address in a foreign country;

(*3*) If the name of the payee indicates that the entity is the type of entity that is on the per se list of foreign corporations contained in §301.7701–2(b)(8)(i) of this chapter; or

(*4*) If the payment is made outside the United States (as defined in §1.6049–5(e)).

(B) *Scholarships and grants.* A payment representing taxable scholarship or fellowship grant income that does not represent compensation for services (but is not excluded from tax under section 117) and that a withholding agent that cannot reliably associate with documentation is presumed to be made to a foreign person if the withholding agent has a record that the payee has a U.S. visa that is not an immigrant visa. See section 871(c) and §1.1441–4(c) for applicable tax rate and withholding rules.

(C) *Pensions, annuities, etc.* A payment from a trust described in section 401(a), 403(a), or a payment with respect to any annuity, custodial account, or retirement income account described in section 403(b) that a withholding agent cannot reliably associate with documentation is presumed to be made to a U.S. person only if the withholding agent has a record of a Social Security number for the payee and relies on a mailing address described in the following sentence. A mailing address is an address used for purposes of information reporting or otherwise communicating with the payee that is an address in the United States or in a foreign country with which the United States has an income tax treaty in effect that provides that the payee, if an individual resident in that country, would be entitled to an exemption from U.S. tax on amounts described in this paragraph (b)(3)(iii)(C). Any payment described in this paragraph (b)(3)(iii)(C) that is not presumed made to a U.S. person is presumed to be made to a foreign person. A withholding agent making a payment to a person presumed to be a foreign person may not reduce the 30-percent amount of withholding required on such payment unless it receives a withholding certificate described in paragraph (e)(2)(i) of this section furnished by the beneficial owner. For basis of reduction in the 30-percent rate, see §1.1441–4(e) or §1.1441–6(b).

(D) *Certain payments to offshore accounts.* A payment that would be subject to withholding under section 1441, 1442, or 1443 if made to a foreign person and is exempt from backup withholding under section 3406 by reason of §31.3406(g)–1(e) of this chapter (relating to exemption from backup withholding under section 3406 for certain payments to offshore accounts) is presumed to be made to a foreign payee.

(iv) *Grace period in the case of indicia of a foreign payee.* A withholding agent may choose, in its discretion, to apply the provisions of §1.6049–5(d)(2)(ii) regarding a 90-day grace period for purposes of this paragraph (b)(3) (by substituting the term *withholding agent* for the term *payor*) to amounts described in §1.1441–6(b)(2)(ii) and to amounts covered by a Form 8233 described in §1.1441–4(b)(2)(ii). Thus, for these amounts, a withholding agent may, in its discretion, choose to treat an account holder as a foreign person and withhold under chapter 3 of the Code (and the regulations thereunder) while awaiting documentation. For purposes of determining the rate of withholding under this section, the withholding agent must withhold at the unreduced 30-percent rate at the time that the amounts are credited to the account. However, a withholding agent who can reliably associate the payment with a withholding certificate that is otherwise valid within the meaning of the applicable provisions except for the fact that it is transmitted by facsimile may rely on that facsimile form for purposes of withholding at the claimed reduced rate. For reporting of amounts credited both before and after the grace period, see §1.1461–1(c)(7). The following adjustments shall be made at the expiration of the grace period:

(A) If, at the end of the grace period, the documentation is not furnished in the manner required under this section and the account holder is presumed to be a U.S. person who is not an exempt recipient, then backup withholding applies to amounts credited to the account after the expiration of the grace period only. Amounts credited to the account during the grace period shall be treated as owned by a foreign payee and adjustments must be made to correct any underwithholding on such amounts in the manner described in §1.1461–2.

(B) If, at the end of the grace period, the documentation is not furnished in the manner required under this section and the account holder is presumed to be a foreign person, or if documentation is furnished that does not support the claimed rate reduction, then adjustments must be made to correct the underwithholding on amounts credited to the account during the grace period, based on adjustment procedures described in §1.1461–2.

(v) *Special rules applicable to payments to foreign intermediaries*—(A) *Reliance on claim of status as foreign intermediary.* A withholding agent that can reliably associate a payment with a withholding certificate described in paragraph (e)(3)(ii) or (iii) of this section may treat the payment as made to a foreign intermediary, as represented in the certificate. For this purpose, a U.S. person's foreign branch that is a qualified intermediary defined in paragraph (e)(5)(ii) of this section shall be treated as a foreign intermediary. For purposes of this section, a payment that the withholding agent can reliably associate with a withholding certificate described in paragraph (e)(3)(ii) or (iii) of this section that would be valid except for the fact that some or all of the withholding certificates or other appropriate documentation required to be attached are lacking or are unreliable or that information for allocating the payment among the various persons for whom the intermediary is acting is lacking or is unreliable shall nevertheless be treated as a payment to a foreign intermediary and the rules of this paragraph (b)(3)(v) shall apply accordingly. A payee that the withholding agent may not reliably treat as a foreign intermediary under this paragraph (b)(3)(v)(A) is presumed to be an owner whose status as an individual, trust, estate, etc., must be determined in accordance with paragraph (b)(3)(ii) of this

section, to the extent relevant. In addition, such payee is presumed to be a U.S. or a foreign payee based upon the presumptions described in paragraph (b)(3)(iii) of this section. The provisions of paragraphs (b)(3)(v)(B), (C), and (D) of this section are not relevant to a withholding agent that can reliably associate a payment with a withholding certificate from a person representing to be a qualified intermediary that has assumed primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section.

(B) *Beneficial owner documentation is lacking or unreliable.* Any portion of a payment that the withholding agent may treat as made to a foreign intermediary in accordance with paragraph (b)(3)(v)(A) of this section but cannot reliably associate with a beneficial owner due to the lack of a withholding certificate or other appropriate documentation for that beneficial owner is presumed to be made to a foreign payee for whom the foreign intermediary collects the payment (see paragraph (b)(2)(v) of this section). For purposes of this paragraph (b)(2)(v)(B), any payment that a foreign qualified intermediary represents to be allocable to the category of assets described in paragraph (e)(5)(v)(B)(*3*) of this section (i.e., assets allocable to persons for whom the qualified intermediary does not hold documentation as specified under its agreement with the IRS) is treated as a payment that the withholding agent cannot reliably associate with beneficial owners. As a result, any payment allocable to such category of assets is presumed to be made to an unidentified foreign payee. Under paragraph (b)(1) of this section, a payment to a foreign payee is subject to withholding at a 30-percent rate.

(C) *Information regarding allocation of payment is lacking or unreliable.* If a withholding agent can reliably associate a payment with a group of beneficial owners or payees but lacks reliable information to determine how much of the payment is allocable to one or more of the beneficial owners or payees in the group (because, for example, the statement described in paragraph (e)(3)(iv) of this section has not been furnished), the payment, to the extent it cannot reliably be allocated, is presumed to be allocable entirely to the beneficial owner or payee in the group with the highest applicable withholding rate or, if the rates are equal, to the beneficial owner or payee in the group with the highest U.S. tax liability, as the withholding agent shall estimate, based on its knowledge and available information. If a withholding certificate attached to an intermediary certificate is another intermediary certificate or a certificate from a foreign partnership described in §1.1441–5(c)(3)(iii), the rules of this paragraph (b)(3)(v)(C) apply by treating the share of the payment allocable to the other intermediary or to the foreign partnership as if the payment were made directly to the other intermediary or to the foreign partnership.

(D) *Certification that the foreign intermediary has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.* If the certification required under paragraph (e)(3)(iii)(D) of this section (that the attached withholding certificates and other appropriate documentation represent all of the persons to whom the intermediary withholding certificate relates) is lacking or is unreliable and, as a result, the withholding agent cannot reliably determine how much of the payment is allocable to each of the persons or group of persons for which the withholding agent holds a withholding certificate or other appropriate documentation, then none of the payment can reliably be associated with any one person and the entire payment is presumed to be made to an unidentified foreign payee for whom the intermediary collects the payment and from which a 30-percent amount must be withheld in accordance with paragraph (b)(1) of this section.

(vi) *U.S. branches and foreign flow-through entities.* The rules of paragraphs (b)(3)(v)(B), (C), and (D) of this section shall apply to payments to a U.S. branch described in paragraph (b)(2)(iv)(A) of this section that has agreed to assume withholding responsibility in the same manner that they apply to payments to a foreign intermediary. See §1.1441–5(d) for similar rules in the case of payments to foreign partnerships. See §1.1441–5(e) for similar rules in the case of payments to foreign trusts or foreign estates.

(vii) *Joint payees.* A payment made to joint payees for whom the withholding agent cannot reliably associate documentation for all joint payees or can reliably associate the payment with a Form W–9 furnished in accordance with the procedures described in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter from one of the joint payees is presumed to be made to U.S. persons. For purposes of applying this paragraph (b)(3), the grace period rules in paragraph (b)(3)(iv) of this section shall apply only if each payee qualifies for the conditions described in paragraph (b)(3)(iv) of this section. However, as provided in paragraph (b)(3)(iii)(D) of this section, a payment of an amount that would be subject to withholding under section 1441, 1442, or 1443 if paid to a foreign person and is exempt from the application of the provisions of section 3406 by reason of §31.3406(g)–1(e) of this chapter (relating to exemption from backup withholding under section 3406 of the Code for certain payments made with respect to offshore accounts), is presumed to be made to foreign persons.

(viii) *Rebuttal of presumptions.* A payee or beneficial owner may rebut the presumptions described in this paragraph (b)(3) by providing reliable documentation to the withholding agent or, if applicable, to the IRS.

(ix) *Effect of reliance on presumptions and of actual knowledge or reason to know otherwise*—(A) *General rule.* Except as otherwise provided in paragraph (b)(3)(ix)(B) of this section, a withholding agent that withholds on a payment under section 3402, 3405 or 3406 in accordance with the presumptions set forth in this paragraph (b)(3) shall not be liable for withholding under this section even it is later established that the beneficial owner of the payment is, in fact, a foreign person. Similarly, a withholding agent that withholds on a payment under this section in accordance with the presumptions set forth in this paragraph (b)(3) shall not be liable for withholding under section 3402 or 3405 or for backup withholding under section 3406 even if it is later established that the payee or beneficial owner is, in fact, a U.S. person. A withholding agent that, instead of relying on the presumptions described in this paragraph (b)(3), relies on its own actual knowledge to withhold a lesser amount, not withhold, or not report a payment, even though reporting of the payment or withholding a

greater amount would be required if the withholding agent relied on the presumptions described in this paragraph (b)(3) shall be liable for tax, interest, and penalties to the extent provided under section 1461 and the regulations under that section. See paragraph (b)(7) of this section for provisions regarding such liability if the withholding agent fails to withhold in accordance with the presumptions described in this paragraph (b)(3)

(B) *Actual knowledge or reason to know that amount of withholding is greater than is required under the presumptions or that reporting of the payment is required.* Notwithstanding the provisions of paragraph (b)(3)(ix)(A) of this section, a withholding agent may not rely on the presumptions described in this paragraph (b)(3) to the extent it has actual knowledge or reason to know that the status or characteristics of the payee or of the beneficial owner are other than what is presumed under this paragraph (b)(3) and, if based on such knowledge or reason to know, it should withhold (under this section or another withholding provision of the Code) an amount greater than would be the case if it relied on the presumptions described in this paragraph (b)(3) or it should report (under this section or under another provision of the Code) an amount that would not otherwise be reportable if it relied on the presumptions described in this paragraph (b)(3). In such a case, the withholding agent must rely on its actual knowledge or reason to know rather than on the presumptions set forth in this paragraph (b)(3). Failure to do so and, as a result, failure to withhold the higher amount or to report the payment, shall result in liability for tax, interest, and penalties to the extent provided under sections 1461 and 1463 and the regulations under those sections.

(x) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. A withholding agent, W, makes a payment of U.S. source dividends to person X, Inc. at an address outside the United States. W cannot reliably associate the payment to X with documentation. Under §§1.6042–3(b)(1)(vii) and 1.6049–4(c)(1)(ii)(A)(1), W may treat X as a corporation. Thus, under the presumptions described in paragraph (b)(3)(iii) of this section, W must presume that X is a foreign person (because the payment is made outside the United States). However, W knows that X is a U.S. person who is an exempt recipient. W may not rely on its actual knowledge to not withhold under this section. If W's knowledge is, in fact, incorrect, W would be liable for tax, interest, and, if applicable, penalties, under section 1461. W would be permitted to reduce or eliminate its liability for the tax by establishing, in accordance with paragraph (b)(7) of this section, that the tax is not due or has been satisfied. If W's actual knowledge is, in fact, correct, W may nevertheless be liable for tax, interest, or penalties under section 1461 for the amount that W should have withheld based upon the presumptions. W would be permitted to reduce or eliminate its liability for the tax by establishing, in accordance with paragraph (b)(7) of this section, that its actual knowledge was, in fact, correct and that no tax or a lesser amount of tax was due.

Example 2. A withholding agent, W, makes a payment of U.S. source dividends to Y who does not qualify as an exempt recipient under §§1.6042–3(b)(1)(vii) and 1.6049–4(c)(1)(ii). W cannot reliably associate the payment to Y with documentation. Under the presumptions described in paragraph (b)(3)(iii) of this section, W must presume that Y is a U.S. person who is not an exempt recipient for purposes of section 6042. However, W knows that Y is a foreign person. W may not rely on its actual knowledge to withhold under this section rather than backup withhold under section 3406. If W's knowledge is, in fact, incorrect, W would be liable for tax, interest, and, if applicable, penalties, under section 3403. If W's actual knowledge is, in fact, correct, W may nevertheless be liable for tax, interest, or penalties under section 3403 for the amount that W should have withheld based upon the presumptions. Paragraph (b)(7) of this section does not apply to provide relief from liability under section 3403.

Example 3. A withholding agent, W, makes a payment of U.S. source dividends to X, Inc. W cannot reliably associate the payment to X, Inc. with documentation. X, Inc. presents none of the indicia of foreign status described in paragraph (b)(3)(iii)(A) of this section, but W has actual knowledge that X, Inc. is a foreign corporation. W may treat X, Inc. as an exempt recipient under §1.6042–3(b)(1)(vii). Because there are no indicia of foreign status, W would, absent actual knowledge or reason to know otherwise, be permitted to treat X, Inc. as a domestic corporation in accordance with the presumptions of paragraph (b)(3)(iii) of this section. However, under paragraph (b)(3)(ix)(B) of this section, W may not rely on the presumption of U.S. status since reliance on its actual knowledge requires that it withhold an amount greater than would be the case under the presumptions.

Example 4. A withholding agent, W, is a plan administrator who makes pension payments to person X with a mailing address in a foreign country with which the United States has an income tax treaty in effect. Under that treaty, the type of pension income paid to X is taxable solely in the country of residence. The plan administrator has a record of X's U.S. social security number. W has no actual knowledge or reason to know that X is a foreign person. W may rely on the presumption of paragraph (b)(3)(iii)(C) of this section in order to treat X as a U.S. person. Therefore, any withholding and reporting requirements for the payment are governed by the provisions of section 3405 and the regulations under that section.

(4) *List of exemptions from, or reduced rates of, withholding under chapter 3 of the Code.* A withholding agent that has determined that the payee is a foreign person for purposes of paragraph (b)(1) of this section must determine whether the payee is entitled to a reduced rate of withholding under section 1441, 1442, or 1443. This paragraph (b)(4) identifies items for which a reduction in the rate of withholding may apply and whether the rate reduction is conditioned upon documentation being furnished to the withholding agent. Documentation required under this paragraph (b)(4) is documentation that a withholding agent must be able to associate with a payment upon which it can rely to treat the payment as made to a foreign person that is the beneficial owner of the payment in accordance with paragraph (e)(1)(ii) of this section. This paragraph (b)(4) also cross-references other sections of the Code and applicable regulations in which some of these exceptions, exemptions, or reductions are further explained. See, for example, paragraph (b)(4)(viii) of this section, dealing with effectively connected income, that cross-references §1.1441–4(a); see paragraph (b)(4)(xv) of this section, dealing with exemptions from, or reductions of, withholding under an income tax treaty, that cross-references §1.1441–6. This paragraph (b)(4) is not an exclusive list of items to which a reduction of the rate of withholding may apply and, thus, does not preclude an exemption from, or reduction in, the rate of withholding that may otherwise be allowed under the regulations under the provisions of chapter 3 of the Code for a particular item of income identified in this paragraph (b)(4).

(i) Portfolio interest described in section 871(h) or 881(c) and substitute interest payments described in §1.871–7(b)(2)(i) or 1.881-2(b)(2) are exempt from withholding under section 1441(a). See §1.871–14 for regulations regarding portfolio interest and section 1441(c)(9) for exemption from withholding. Documentation establishing foreign status is required for interest on an obligation in registered form to qualify as portfolio interest. See section 871(h)(2)(B)(ii) and §1.871–14(c)(1)(ii)(C). For special documentation rules regarding foreign-targeted registered obligations described in §1.871–14(e)(2), see §1.871–14(e)(3) and (4) and, in particular, §1.871–14(e)(4)(i)(A) and (ii)(A) regarding the time when the withholding agent must receive the documentation. The documentation furnished for purposes of qualifying interest as portfolio interest

serves as the basis for the withholding exemption for purposes of this section and for purposes of establishing foreign status for purposes of section 6049. See §1.6049–5(b)(8). Documentation establishing foreign status is not required for qualifying interest on an obligation in bearer form described in §1.871–14(b)(1) as portfolio interest. However, in certain cases, documentation for portfolio interest on a bearer obligation may have to be furnished in order to establish foreign status for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See §1.6049–5(b)(7).

(ii) Bank deposit interest and similar types of deposit interest (including original issue discount) described in section 871(i)(2)(A) or 881(d) that are from sources within the United States are exempt from withholding under section 1441(a). See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See §1.6049–5(d)(3)(iii) for exceptions to the foreign payee and exempt recipient rules regarding this type of income. See also §1.6049–5(b)(11) for applicable documentation exemptions for certain bank deposit interest paid on obligations in bearer form.

(iii) Bank deposit interest (including original issue discount) described in section 861(a)(1)(B) is exempt from withholding under sections 1441(a) as income that is not from U.S. sources. Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. Reporting requirements for payments of such interest are governed by section 6049 and the regulations under that section. See §1.6049–5(b)(12) and alternative documentation rules under §1.6049–5(c)(4).

(iv) Interest or original issue discount from sources within the United States on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3) is exempt from withholding under sections 1441(a). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 and backup withholding under section 3406. See §1.6049–5(b)(12) for applicable documentation for establishing foreign status and §1.6049–5(d)(3)(iii) for exceptions to the foreign payee and exempt recipient rules regarding this type of income. See also §1.6049–5(b)(10) for applicable documentation exemptions for certain obligations in bearer form.

(v) Income from sources without the United States is exempt from withholding under sections 1441(a). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6049 or other applicable provisions of chapter 61 of the Code and backup withholding under section 3406. See, for example, §1.6049–5(b)(6) and (12) and alternative documentation rules under §1.6049–5(c)(4). See also paragraph (b)(5) of this section for cross references to other applicable provisions of the regulations under chapter 61 of the Code.

(vi) Distributions from certain domestic corporations described in section 871(i)(2)(B) or 881(d) are exempt from withholding under section 1441(a). See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6042 and backup withholding under section 3406. See §1.6042–3(b)(1)(iii) through (vi).

(vii) Dividends paid by certain foreign corporations that are treated as income from sources within the United States by reason of section 861(a)(2)(B) are exempt from withholding under section 884(e)(3) to the extent that the distributions are paid out of earnings and profits in any taxable year that the corporation was subject to branch profits tax for that year. Documentation establishing foreign status is not required for purposes of this withholding exemption but may have to be furnished for purposes of the information reporting provisions of section 6042 and backup withholding under section 3406. See §1.6042-3(b)(1)(iii) through (vii).

(viii) Certain income that is effectively connected with the conduct of a U.S. trade or business is exempt from withholding under section 1441(a). See section 1441(c)(1). Documentation establishing foreign status and status of the income as effectively connected must be furnished for purposes of this withholding exemption to the extent required under the provisions of §1.1441–4(a). Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of applicable information reporting provisions under chapter 61 of the Code and for backup withholding under section 3406. See, for example, §1.6041–4(a)(1).

(ix) Certain income with respect to compensation for personal services of an individual that are performed in the United States is exempt from withholding under section 1441(a). See section 1441(c)(4) and §1.1441–4(b). However, such income may be subject to withholding as wages under section 3402. Documentation establishing foreign status must be furnished for purposes of any withholding exemption or reduction to the extent required under §1.1441–4(b) or 31.3401(a)(6)–1(e) and (f) of this chapter. Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of information reporting under section 6041. See §1.6041–4(a)(1).

(x) Amounts described in section 871(f) that are received as annuities from certain qualified plans are exempt from withholding under section 1441(a). See section 1441(c)(7). Documentation establishing foreign status must be furnished for purposes of the withholding exemption as required under §1.1441–4(d). Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of information reporting under section 6041. See §1.6041–4(a)(1).

(xi) Payments to a foreign government (including a foreign central bank of issue) that are excludable from gross income under section 892(a) are exempt from withholding under section 1442. See §1.1441–8(b). Documentation establishing status as a foreign government is required for purposes of this withholding exemption. Payments to a foreign government are exempt from information re-

porting under chapter 61 of the Code (see §1.6049–4(c)(1)(ii)(F)).

(xii) Payments of certain interest income to a foreign central bank of issue or the Bank for International Settlements that are exempt from tax under section 895 are exempt from withholding under section 1442. Documentation establishing eligibility for such exemption is required to the extent provided in §1.1441–8(c)(1). Payments to a foreign central bank of issue or to the Bank for International Settlements are exempt from information reporting under chapter 61 of the Code (see §1.6049–4(c)(1)(ii)(H) and (M)).

(xiii) Amounts derived by a foreign central bank of issue from bankers' acceptances described in section 871(i)(2)(C) or 881(d) are exempt from tax and, therefore, from withholding. See section 1441(c)(10). Documentation establishing foreign status is not required for purposes of this withholding exemption if the name of the payee and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is a foreign central bank of issue as defined in §1.861–2(b)(4). See §1.1441–8(c)(2) for withholding procedures. See also §§1.6049–4(c)(1)(ii)(H) and 1.6041–3(q)(8) for a similar exemption from information reporting.

(xiv) Payments to an international organization from investments in the United States of stocks, bonds, or other domestic securities or from interest on deposits in banks in the United States of funds belonging to such international organization are exempt from tax under section 892(b) and, thus, from withholding. Documentation establishing status as an international organization is not required if the name of the payee and other facts surrounding the payment reasonably indicate that the beneficial owner of the payment is an international organization within the meaning of section 7701(a)(18). See §1.1441–8(d). Payments to an international organization are exempt from information reporting under chapter 61 of the Code (see §1.6049–4(c)(1)(ii)(G)).

(xv) Amounts may be exempt from, or subject to a reduced rate of, withholding under an income tax treaty. Documentation establishing eligibility for benefits under an income tax treaty is required for this purpose as provided under §§1.1441–6. Documentation furnished for this purpose also serves as documentation establishing foreign status for purposes of applicable information reporting provisions under chapter 61 of the Code and for backup withholding under section 3406. See, for example, §1.6041–4(a)(1).

(xvi) Amounts of scholarships and grants paid to certain exchange or training program participants that do not represent compensation for services but are not excluded from tax under section 117 are subject to a reduced rate of withholding of 14-percent under section 1441(b). Documentation establishing foreign status is required for purposes of this reduction in rate as provided under §1.1441–4(c). This income is not subject to information reporting under chapter 61 of the Code nor to backup withholding under section 3406. The compensatory portion of a scholarship or grant is reportable as wage income. See §1.6041–3(o).

(xvii) Amounts paid to a foreign organization described in section 501(c) are exempt from withholding under section 1441 to the extent that the amounts are not income includible under section 512 in computing the organization's unrelated business taxable income and are not subject to the tax imposed by section 4948(a). Documentation establishing status as a tax-exempt organization is required for purposes of this exemption to the extent provided in §1.1441–9. Amounts includible under section 512 in computing the organization's unrelated business taxable income are subject to withholding to the extent provided in section 1443(a) and §1.1443–1(a). Gross investment income (as defined in section 4940(c)(2)) of a private foundation is subject to withholding at a 4-percent rate to the extent provided in section 1443(b) and §1.1443–1(b). Payments to a tax-exempt organization are exempt from information reporting under chapter 61 of the Code and the regulations thereunder (see §1.6049–4(c)(1)(ii)(B)(*1*)).

(xviii) Per diem amounts for subsistence paid by the U.S. government to a nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954 are exempt from withholding under section 1441(a). See section 1441(c)(6). Documentation of foreign status is required under §1.1441–4(e) for purposes of establishing eligibility for this exemption. See §1.6041-3(p).

(xix) Interest with respect to tax-free covenant bonds issued prior to 1934 is subject to special withholding procedures set forth in §1.1461–1 in effect prior to January 1, 1999 (see §1.1461–1 as contained in 26 CFR part 1, revised April 1, 1997).

(xx) Income from certain gambling winnings of a nonresident alien individual is exempt from tax under section 871(j) and from withholding under section 1441(a). See section 1441(c)(11). Documentation establishing foreign status is not required for purposes of this exemption but may have to be furnished for purposes of the information reporting provisions of section 6041 and backup withholding under section 3406. See §§1.6041–1 and 1.6041–4(a)(1).

(xxi) Any payments not otherwise mentioned in this paragraph (b)(4) shall be subject to withholding at the rate of 30-percent if it is an amount subject to withholding (as defined in §1.1441–2(a)) unless and to the extent the IRS may otherwise prescribe in published guidance (see §601.601(d)(2) of this chapter) or unless otherwise provided in regulations under chapter 3 of the Code.

(5) *Establishing foreign status under applicable provisions of chapter 61 of the Code.* This paragraph (b)(5) identifies relevant provisions of the regulations under chapter 61 of the Code that exempt payments from information reporting, and therefore, from backup withholding under section 3406, based on the payee's status as a foreign person. Many of these exemptions require that the payee's foreign status be established in order for the exemption to apply. The regulations under applicable provisions of chapter 61 of the Code generally provide that the documentation described in this section may be relied upon for purposes of determining foreign status.

(i) Payments to a foreign person that are governed by section 6041 (dealing with certain trade or business income) are exempt from information reporting under §1.6041–4(a).

(ii) Payments to a foreign person that are governed by section 6041A (dealing with remuneration for services and certain sales) are exempt from information reporting under §1.6041A–1(d)(3).

(iii) Payments to a foreign person that are governed by section 6042 (dealing with dividends) are exempt from information reporting under §1.6042–3(b)(1)(iii) through (vi).

(iv) Payments to a foreign person that are governed by section 6044 (dealing with patronage dividends) are exempt from information reporting under §1.6044–3(c)(1).

(v) Payments to a foreign person that are governed by section 6045 (dealing with broker proceeds) are exempt from information reporting under §1.6045–1(g).

(vi) Payments to a foreign person that are governed by section 6049 (dealing with interest) to a foreign person are exempt from information reporting under §1.6049–5(b)(6) through (15).

(vii) Payments to a foreign person that are governed by section 6050N (dealing with royalties) are exempt from information reporting under §1.6050N–1(c).

(viii) Payments to a foreign person that are governed by section 6050P (dealing with income from cancellation of debt) are exempt from information reporting under section 6050P or the regulations under that section except to the extent provided in Notice 96–61 (I.R.B. 1996–49); see also §601.601(b)(2) of this chapter.

(6) *Rules of withholding for payments by a foreign intermediary or certain U.S. branches.* A foreign intermediary described in paragraph (e)(3)(i) of this section or a U.S. branch described in paragraph (b)(2)(iv) of this section that receives an amount subject to withholding (as defined in §1.1441–2(a)) shall be deemed to have satisfied any obligation it has under chapter 3 of the Code and the regulations thereunder to withhold and report the amount when it, in turn, pays such amount to another person (whether or not the beneficial owner) to the extent that the payment is associated with a valid withholding certificate described in paragraph (e)(3)(ii), (iii), or (v) of this section that it has furnished to another withholding agent and the intermediary does not know and has no reason to know that the correct amount has not been withheld under chapter 3 of the Code and the regulations thereunder. See §1.1441–5(c)-(3)(v) for a similar rule for payments by certain foreign partnerships.

(7) *Liability for failure to obtain documentation timely or to act in accordance with applicable presumptions*—(i) *General rule.* A withholding agent that cannot reliably associate a payment with documentation on the date of payment and that does not withhold under this section, or withholds at less than the 30-percent rate prescribed under section 1441(a) and paragraph (b)(1) of this section, is liable under section 1461 for the tax required to be withheld under chapter 3 of the Code and the regulations thereunder, without the benefit of a reduced rate unless—

(A) The withholding agent has appropriately relied on the presumptions described in paragraph (b)(3) of this section (including the grace period described in paragraph (b)(3)(iv) of this section) in order to treat the payee as a U.S. person or, if applicable, on the presumptions described in §1.1441–4(a)(2)(i) or (3) to treat the payment as effectively connected income; or

(B) The withholding agent can demonstrate to the satisfaction of the district director or the Assistant Commissioner (International) that the proper amount of tax, if any, was in fact paid to the IRS; or

(C) No documentation is required under section 1441 or this section in order for a reduced rate of withholding to apply.

(ii) *Proof that tax liability has been satisfied.* Proof of payment of tax may be established for purposes of paragraph (b)(7)(i)(B) of this section on the basis of a Form 4669 (or such other form as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter)), establishing the amount of tax, if any, actually paid by or for the beneficial owner on the income. Proof that a reduced rate of withholding was, in fact, appropriate under the provisions of chapter 3 of the Code and the regulations thereunder may also be established after the date of payment by the withholding agent on the basis of a valid withholding certificate or other appropriate documentation furnished after that date. However, in the case of a withholding certificate or other appropriate documentation received after the date of payment (or after the grace period specified in paragraph (b)(3)(iv) of this section), the district director or the Assistant Commissioner (International) may require additional proof if it is determined that the delays in obtaining the withholding certificate affect its reliability.

(iii) *Liability for interest and penalties.* A withholding agent that has failed to withhold other than based on appropriate reliance on the presumptions described in paragraph (b)(3) of this section or in §1.1441–4(a)(2)(i) or (3) is not relieved from liability for interest under section 6601. Such liability exists even if there is no underlying tax liability due. The interest on the amount that should have been withheld shall be imposed as prescribed under section 6601 beginning on the last date for paying the tax due under section 1461 (which, under section 6601, is the due date for filing the withholding agent's return of tax). The interest shall stop accruing on the earlier of the date that the required withholding certificate or other documentation is provided to the withholding agent and to the extent of the amount of tax that is determined not to be due based on documentation provided, or the date, and to the extent, that the unpaid tax liability under section 871, 881 or under section 1461 is satisfied. Further, in the event that a tax liability is assessed against the beneficial owner under section 871, 881, or 882 and interest under section 6601(a) is assessed against, and collected from, the beneficial owner, the interest charge imposed on the withholding agent shall be abated to that extent so as to avoid the imposition of a double interest charge. However, the withholding agent is not relieved of any applicable penalties. See section 1464.

(iv) *Special effective date.* See paragraph (f)(2)(ii) of this section for the special effective date applicable to this paragraph (b)(7).

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

Example 1. On June 15, 1999, a withholding agent pays U.S. source interest on an obligation in registered form (issued after July 18, 1984) to a foreign corporation that it cannot reliably associate with a Form W–8 or other appropriate documentation upon which to rely to treat the beneficial owner as a foreign person. The withholding agent does not withhold from the payment. On September 30, 2001, the withholding agent receives from the foreign corporation a valid Form W–8 described in paragraph (e)(2)(ii) of this section. Thus, the interest qualifies as portfolio interest retroactively to June 15, 1999 (the date of payment). See §1.871–14(c)(3). The foreign corporation does not file a U.S. federal income tax return and does not pay the tax owed. The withholding agent is not liable

under section 1461 for the 30-percent tax on the interest income because the receipt of the Form W–8 exempts the interest from tax for purposes of sections 881(a) and 1461. The withholding agent, however, is liable for interest on the amount of withholding that should have been deducted from the payment on June 15, 1999 and deposited. Under paragraph (b)(7)(iii) of this section, the period during which interest may be assessed against the withholding agent runs from March 15, 2000 (the due date for the Form 1042 relating to the payment) until September 30, 2001 (i.e., the date that appropriate documentation is furnished to the withholding agent).

Example 2. On June 15, 1999, a withholding agent pays U.S. source dividends to a foreign corporation that it cannot reliably associate with a Form W–8 or other appropriate documentation upon which to rely to treat the beneficial owner as a foreign person. The withholding agent does not withhold from the payment. On September 30, 2001, the withholding agent receives from the foreign corporation a valid Form W–8 described in paragraph (e)(2)(ii) of this section claiming a reduced 15-percent rate of withholding under a U.S. income tax treaty. The dividend qualifies for the reduced treaty rate retroactively to June 15, 1999, (the date of payment). The foreign corporation does not file a U.S. federal income tax return and does not pay the tax owed. Under section 1461, the withholding agent is liable only for a 15-percent tax on the dividend income because the receipt of the Form W–8 allows the tax rate to be reduced for purposes of sections 881(a) and 1461 from 30-percent to 15-percent. The withholding agent, however, is liable for interest on the full 30-percent amount that should have been deducted and withheld from the payment on June 15, 1999, and deposited, over a period running from March 15, 2000, (the due date for the Form 1042 relating to the payment) until September 30, 2001, (the date that the appropriate documentation is furnished to the withholding agent supporting a reduction in rate under a tax treaty). Additional interest may be assessed relating to the outstanding 15-percent tax liability (i.e., the portion of the 30-percent total tax liability that is not reduced under the treaty). Such additional interest runs from March 15, 2000, until such date as that 15-percent tax liability is satisfied by the withholding agent or the taxpayer (subject to abatement in order to avoid a double interest charge).

(8) *Adjustments, refunds, or credits of overwithheld amounts.* If the amount withheld under section 1441, 1442, or 1443 is greater than the tax due by the withholding agent or the taxpayer, adjustments may be made in accordance with the procedures described in §1.1461–2(a). Alternatively, refunds or credits may be claimed in accordance with the procedures described in §1.1464–1, relating to refunds or credits claimed by the beneficial owner, or §1.6414–1, relating to refunds or credits claimed by the withholding agent. If an amount was withheld under section 3406 or is subsequently determined to have been paid to a foreign person, see paragraph (b)(3)(vii) of this section and §31.6413(a)–3(a)(1) of this chapter.

(9) *Payments to joint owners.* A payment to joint owners that requires documentation in order to reduce the rate of withholding under chapter 3 of the Code and the regulations thereunder does not qualify for such reduced rate unless the withholding agent can reliably associate the payment with documentation from each owner. Notwithstanding the preceding sentence, a payment to joint owners qualifies as a payment exempt from withholding under this section if any one of the owners provides a certificate of U.S. status on a Form W–9 in accordance with paragraph (d)(2) or (3) of this section or the withholding agent can associate the payment with a withholding certificate upon which it can rely to treat the payment as made to a U.S. beneficial owner under paragraph (d)(4) of this section. See §31.3406(h)–2(a)(3)(i)(B) of this chapter.

(c) *Definitions*—(1) *Withholding.* The term *withholding* means the deduction and withholding of tax at the applicable rate from the payment.

(2) *Foreign and U.S. person.* The term *foreign person* means a nonresident alien individual, a foreign corporation, a foreign partnership, a foreign trust, a foreign estate, and any other person that is not a U.S. person described in the next sentence. For purposes of the regulations under chapter 3 of the Code, the term *foreign person* also means, with respect to a payment by a withholding agent, a foreign branch of a U.S. person that furnishes an intermediary withholding certificate described in paragraph (e)(3)(ii) of this section. A U.S. person is a person described in section 7701(a)(30), the U.S. government (including an agency or instrumentality thereof), a State (including an agency or instrumentality thereof), or the District of Columbia (including an agency or instrumentality thereof).

(3) *Individual*—(i) *Alien individual.* The term *alien individual* means an individual who is not a citizen or a national of the United States. See §1.1–1(c).

(ii) *Nonresident alien individual.* The term *nonresident alien individual* means a person described in section 7701(b)-(1)(B), an alien individual who is a resident of a foreign country under the residence article of an income tax treaty and §301.7701(b)–7(a)(1) of this chapter, or an alien individual who is a resident of Puerto Rico, Guam, the Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, or American Samoa as determined under §301.7701(b)–1(d) of this chapter. An alien individual who has made an election under section 6013(g) or (h) to be treated as a resident of the United States is nevertheless treated as a nonresident alien individual for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

(4) *Certain foreign corporations.* For purposes of this section, a corporation created or organized in Guam, the Commonwealth of Northern Mariana Islands, the U.S. Virgin Islands, and American Samoa, is not treated as a foreign corporation if the requirements of sections 881(b)(1)(A), (B), and (C) are met for such corporation. Further, a payment made to a foreign government or an international organization shall be treated as a payment made to a foreign corporation for purposes of withholding under chapter 3 of the Code and the regulations thereunder.

(5) *Financial institution and foreign financial institution.* For purposes of the regulations under chapter 3 of the Code, the term *financial institution* means a person described in §1.165–12(c)(1)(iv) (not including a person providing pension or other similar benefits or a regulated investment company or other mutual fund, unless otherwise indicated) and the term *foreign financial institution* means a financial institution that is a foreign person, as defined in paragraph (c)(2) of this section.

(6) *Beneficial owner*—(i) *General rule.* In the case of a payment of income, the term beneficial owner means the person who is the owner of the income for tax purposes and who beneficially owns that income. A person shall be treated as the owner of the income to the extent that it is required under U.S. tax principles to include the amount paid in gross income under section 61 (determined without regard to an exclusion or exemption from gross income under the Code). Beneficial ownership of income is determined under the provisions of section 7701(l) and the regulations under that section and any other applicable general U.S. tax principles, including principles governing the determination of whether a transaction is a conduit transaction. Thus, a person receiving income in a capacity as a nominee, agent, custodian for another person is not the beneficial owner of the income.

In the case of a scholarship, the student receiving the scholarship is the beneficial owner of that scholarship. In the case of a payment of an amount that is not income, the beneficial owner determination shall be made under this paragraph (c)(6) as if the amount was income.

(ii) *Special rules for flow-through entities and arrangements*—(A) *General rule.* The beneficial owners of income paid to a partnership or other flow-through arrangements described in paragraph (c)(6)(ii)(C) of this section are those persons who, under U.S. tax principles, are the owners of the income for tax purposes in their separate or individual capacities and who beneficially own that income. For example, a partnership (first tier) that is a partner in another partnership (second tier) is not the beneficial owner of income paid to the second tier partnership since the first tier partnership is not the owner of the income under U.S. tax principles. Rather, the partners of the first tier partnership are the beneficial owners (to the extent they are not themselves partnerships and are not conduits within the meaning of section 7701(l) and the regulations under that section). See §1.1441–5(b) for applicable withholding procedures for payments to a domestic partnership. See also §1.1441–5(c)(3)(ii) for applicable withholding procedures for payments to a foreign partnership where one of the partners (at any level in the chain of tiers) is a domestic partnership. See §1.1441–6(b)(4) for rules governing the eligibility of a payment to an entity or other arrangement for a reduced rate of withholding under an income tax treaty.

(B) *Trusts and estates.* The provisions of paragraphs (c)(6)(i) and (ii)(A) of this section shall not apply to a trust or an estate, whether domestic or foreign. The beneficial owner of income paid to a trust or to an estate shall be determined under the provisions of §1.1441–3(f) and (g) in effect prior to January 1, 1999 (see §1.1441–3(f) and (g) as contained in 26 CFR part 1, revised April 1, 1997).

(C) *Definition of a flow-through entity or arrangement.* For purposes of this paragraph (c)(6)(ii), a flow-through entity means a partnership, estate, or trust. A flow-though arrangement is a contractual arrangement that does not involve an entity and is treated as a partnership for U.S. tax purposes or is a wholly-owned entity that is disregarded for federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner. The term *partnership* means any entity or arrangement (as defined in §301.7701–2(c)(1) of this chapter) whose tax regime is governed by subchapter K of chapter 1 of the Code.

(7) *Withholding agent.* For a definition of the term *withholding agent* and applicable rules, see §1.1441–7.

(8) *Person.* For purposes of the regulations under chapter 3 of the Code, the term *person* shall mean a person described in section 7701(a)(1) and the regulations under that section and a U.S. branch to the extent treated as a U.S. person under paragraph (b)(2)(iv) of this section. For purposes of the regulations under chapter 3 of the Code, the term person does not include a wholly-owned entity that is disregarded for federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner. See paragraph (b)(2)(iii) of this section for procedures applicable to payments to such entities.

(9) *Source of income.* The source of income is determined under the provisions of part I (section 861 and following) , subchapter N, chapter 1 of the Code and the regulations under those provisions.

(10) *Chapter 3 of the Code.* For purposes of the regulations under sections 1441, 1442, and 1443, any reference to chapter 3 of the Code shall not include references to sections 1445 and 1446, unless the context indicates otherwise.

(11) *Reduced rate.* For purposes of regulations under chapter 3 of the Code, and other withholding provisions of the Code, the term *reduced rate*, when used in regulations under chapter 3 of the Code, shall include an exemption from tax.

(d) *Beneficial owner's or payee's claim of U.S. status*—(1) *In general.* Under paragraph (b)(1) of this section, a withholding agent is not required to withhold under chapter 3 of the Code on payments to a U.S. payee, to a person presumed to be a U.S. payee in accordance with the provisions of paragraph (b)(3) of this section, or to a person that the withholding agent may treat as a U.S. beneficial owner of the payment. Absent actual knowledge or reason to know otherwise, a withholding agent may rely on the provisions of this paragraph (d) in order to determine whether to treat a payee or beneficial owner as a U.S. person.

(2) *Payments for which a Form W–9 is otherwise required.* A withholding agent may treat as a U.S. person a payee who is required to furnish a Form W–9 and who furnishes it in accordance with the procedures described in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter (including the requirement that the payee furnish its taxpayer identifying number (TIN)) if the withholding agent meets all the requirements described in §31.3406(h)–3(e) of this chapter regarding reliance by a payor on a Form W–9.

(3) *Payments for which a Form W–9 is not otherwise required.* In the case of a payee who is not required to furnish a Form W–9 under section 3406, the withholding agent may rely on a certificate of U.S. status described in this paragraph (d)(3). A certificate of U.S. status is a certificate described in §31.3406(h)–3(c)(2) of this chapter (relating to forms for exempt recipients) or a Form W–9 (or a substitute form or such other form as the IRS may prescribe) that is signed under penalties of perjury by the payee and contains the name, permanent residence address, and TIN of the payee. The procedures described in §31.3406(h)–2(a) of this chapter shall apply to payments to joint payees. A withholding agent that receives a Form W–9 in order to satisfy this paragraph (d)(3) must retain the form in accordance with the provisions of §31.3406(h)–3(g) of this chapter, if applicable, or of paragraph (e)(4)(iii) of this section (relating to the retention of withholding certificates) if §31.3406(h)–3(g) of this chapter does not apply. The rules of this paragraph (d)(3) are only intended to provide a method by which a withholding agent may determine that a payee is not a foreign person and do not otherwise impose a requirement that documentation be furnished by a person who is otherwise treated as an exempt recipient for purposes of the applicable information reporting provisions under chapter 61 of the Code (e.g., §1.6049–4(c)(1)(ii) for payments of interest).

(4) *Other payments.* This paragraph (d)(4) describes the documentation upon which a withholding agent may rely in order to treat a payment as made to a U.S. person that is a beneficial owner for purposes of paragraph (b)(1) of this section.

The withholding agent may treat the payment as made to a U.S. beneficial owner only if it can reliably associate the payment with documentation prior to the payment, if it complies with the electronic confirmation procedures described in paragraph (e)(4)(v) of this section, if required, and if it has not been notified by the IRS that any of the information on the withholding certificate or other documentation is incorrect or unreliable. In the case of a Form W–9 that is required to be furnished for a reportable payment that may be subject to backup withholding, the payor may be notified in accordance with section 3406(a)(1)(B) and the regulations under that section. See applicable procedures under that section and the regulations under that section for payors who have been notified with regard to such a Form W–9. Payors who have been notified in relation to other Forms W–9, including under section 6724(b) pursuant to section 6721, may rely on the withholding certificate or other documentation only to the extent provided under procedures as prescribed by the IRS (see §601.601(d)(2) of this chapter). A withholding agent may treat a payment as made to a U.S. beneficial owner—

(i) To the extent the withholding agent can reliably associate the payment with a Form W–9 described in paragraph (d)(2) or (3) of this section attached to a valid intermediary, flow-through, or U.S. branch withholding certificate described in paragraph (e)(3)(i) of this section;

(ii) To the extent the withholding agent can reliably associate a payment to a qualified intermediary with the category of assets described in paragraph (e)(5)-(v)(B)(2) of this section that the qualified intermediary has represented, in accordance with paragraphs (e)(3)(ii)(E) and (5)(v) of this section as being allocable to U.S. persons based on the Forms W–9 that they have furnished; or

(iii) To the extent the withholding agent can reliably associate the payment with a Form W–8 from a U.S. branch described in paragraph (e)(3)(v) of this section that evidences an agreement between the U.S. branch and the withholding agent to treat the U.S. branch as U.S. person.

(e) *Beneficial owner's claim of foreign status*—(1) *Withholding agent's reliance*—(i) *In general.* Absent actual knowledge or reason to know otherwise, a withholding agent may treat a payment as made to a foreign beneficial owner in accordance with the provisions of paragraph (e)(1)(ii) of this section. See paragraph (e)(4)(viii) of this section for applicable reliance rules. See paragraph (b)(4) of this section for a description of payments for which a claim of foreign status is relevant for purposes of claiming a reduced rate of withholding for purposes of section 1441, 1442, or 1443. See paragraph (b)(5) of this section for a list of payments for which a claim of foreign status is relevant for other purposes, such as claiming an exemption from information reporting under chapter 61 of the Code.

(ii) *Payments that a withholding agent may treat as made to a foreign person that is a beneficial owner*—(A) *General rule.* The withholding agent may treat a payment as made to a foreign person that is a beneficial owner if it complies with the requirements described in paragraph (e)(1)(ii)(B) of this section and, then, only to the extent—

(*1*) That the withholding agent can reliably associate the payment with a beneficial owner withholding certificate described in paragraph (e)(2) of this section furnished by the person whose name is on the certificate or attached to a valid foreign intermediary, flow-through entity, or U.S. branch withholding certificate described in paragraph (e)(3)(v) of this section;

(*2*) That the payment is made outside the United States (within the meaning of §1.6049–5(e)) with respect to an offshore account (within the meaning of §1.6049–5(c)(1)) and the withholding agent can reliably associate the payment with documentary evidence described in §§1.1441–6(c)(3) or (4), or 1.6049–5(c)-(1) relating to the beneficial owner;

(*3*) That the withholding agent can reliably associate the payment with the category of assets described in paragraph (e)(5)(v)(B)(*1*) of this section that the qualified intermediary has represented, in accordance with paragraphs (e)(3)(ii)(E) and (5)(v) of this section as being allocable to foreign persons for whom the qualified intermediary is holding valid documentation;

(*4*) That the withholding agent can reliably associate the payment with a withholding certificate described in §1.1441–5(c)(3)(iii) from a foreign partnership claiming that the payment is effectively connected income;

(*5*) That the withholding agent identifies the payee as a U.S. branch described in paragraph (b)(2)(iv) of this section, the payment to which it treats as effectively connected income in accordance with §1.1441–4(a)(2)(ii) or (3);

(*6*) That the withholding agent identifies the payee as an international organization (or any wholly-owned agency or instrumentality thereof) as defined in section 7701(a)(18) that has been designated as such by executive order (pursuant to 22 U.S.C. 288 through 288(f)); or

(*7*) That the withholding agent pays interest from bankers' acceptances and identifies the payee as a foreign central bank of issue (as defined in §1.861–2(b)(4)).

(B) *Additional requirements.* In order for a payment described in paragraph (e)(1)(ii)(A) of this section to be treated as made to a foreign beneficial owner, the withholding agent must hold the documentation (if required) prior to the payment, comply with the electronic confirmation procedures described in paragraph (e)(4)(v) of this section (if required), and must not have been notified by the IRS that any of the information on the withholding certificate or other documentation is incorrect or unreliable. If the withholding agent has been so notified, it may rely on the withholding certificate or other documentation only to the extent provided under procedures prescribed by the IRS (see §601.601(d)(2) of this chapter). See paragraph (b)(2)(vii) of this section for rules regarding reliable association of a payment with a withholding certificate or other appropriate documentation.

(2) *Beneficial owner withholding certificate*—(i) *In general.* A beneficial owner withholding certificate is a statement by which the beneficial owner of the payment represents that it is a foreign person and, if applicable, claims a reduced rate of withholding under section 1441. A separate withholding certificate must be submitted to each withholding agent. If the beneficial owner receives more than one type of payment from a single withholding agent, the beneficial owner may have to submit more than one withholding certificate to the single withholding agent for the different types of payments as may be required by the applicable forms and instructions, or as the withholding agent

may require (such as to facilitate the withholding agent's compliance with its obligations to determine withholding under this section or the reporting of the amounts under §1.1461–1(b) and (c)). For example, if a beneficial owner claims that some but not all of the income it receives is effectively connected with the conduct of a trade or business in the United States, it may be required to submit two separate withholding certificates, one for income that is not effectively connected and one for income that is so connected. See §1.1441–6(b)(4)(ii) for special rules for determining who must furnish a beneficial owner withholding certificate when a benefit is claimed under an income tax treaty. See paragraph (e)(4)(ix) of this section for reliance rules in the case of certificates held by another person or at a different branch location of the same person.

(ii) *Requirements for validity of certificate.* A beneficial owner withholding certificate is valid only if it is provided on a Form W–8, or a Form 8233 in the case of personal services income described in §1.1441–4(b) or certain scholarship or grant amounts described in §1.1441–4(c) (or a substitute form described in paragraph (e)(4)(vi) of this section, or such other form as the IRS may prescribe). A Form W–8 is valid only if its validity period has not expired, it is signed under penalties of perjury by the beneficial owner, and it contains all of the information required on the form. The required information is the beneficial owner's name, permanent residence address, and TIN (if required), the country under the laws of which the beneficial owner is created, incorporated, or governed (if a person other than an individual), the classification of the entity, and such other information as may be required by the regulations under section 1441 or by the form or accompanying instructions in addition to, or in lieu of, the information described in this paragraph (e)(2)(ii). A person's permanent residence address is an address in the country where the person claims to be a resident for purposes of that country's income tax. In the case of a certificate furnished in order to claim a reduced rate of withholding under an income tax treaty, the residence must be determined in the manner prescribed under the applicable treaty. See §1.1441–6(b)(4)(i). The address of a financial institution with which the beneficial owner maintains an account, a post office box, or an address used solely for mailing purposes is not a residence address for this purpose. If the beneficial owner is an individual who does not have a tax residence in any country, the permanent residence address is the place at which the beneficial owner normally resides. If the beneficial owner is not an individual and does not have a tax residence in any country, then the permanent residence address is the place at which the person maintains its principal office. See paragraph (e)(4)(vii) of this section for circumstances in which a TIN is required on a beneficial owner withholding certificate. See paragraph (f)(2)(i) of this section for continued validity of certificates during a transition period.

(3) *Intermediary, flow-through, or U.S. branch withholding certificate*—(i) *In general.* An intermediary withholding certificate is a Form W–8 by which a payee represents that it is a foreign person and that it is an intermediary with respect to a payment and not the beneficial owner. A flow-through withholding certificate is a Form W–8 furnished by a flow-through entity under §1.1441–5(c)-(2) or (3) for a partnership or under §1.1441–5(e) for a foreign estate or trust. See paragraph (c)(6)(ii)(C) of this section for a definition of a flow-through entity. A U.S. branch certificate is a Form W–8 by which the payee represents that it is a U.S. branch described in paragraph (b)(2)(iv)(A) or (E) of this section and that the payment is not effectively connected with the conduct of its trade or business in the United States. An intermediary withholding certificate is used by an intermediary either to make representations regarding the status of beneficial owners of the amount paid or to transmit appropriate documentation to the withholding agent. A flow-through certificate is used by a flow-through entity to establish its status as a foreign person or the status of its partners or beneficiaries, if required, and, if applicable, to claim a reduced rate of withholding. An intermediary means, with respect to a payment that it receives, a person that, for that payment, acts as a custodian, broker, nominee, or otherwise as an agent for another person, regardless of whether such other person is the beneficial owner of the amount paid, a flow-through entity, or another intermediary. See paragraph (e)(4)(viii) of this section for applicable reliance rules.

(ii) *Intermediary withholding certificate from a qualified intermediary.* An intermediary withholding certificate from a person representing to be a qualified intermediary (described in paragraph (e)(5)(ii) of this section) is valid only if it is furnished on a Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe), it is signed under penalties of perjury by an officer of the qualified intermediary with authority to sign for the intermediary, its validity has not expired, and it contains the following information, statement, and certifications:

(A) The name, permanent residence address (as described in paragraph (e)(2)(ii) of this section), and the employer identification number of the intermediary, and the country under the laws of which the intermediary is created, incorporated, or governed.

(B) A certification that the person whose name is on the Form W–8 is not acting for its own account and is acting as a qualified intermediary within the meaning of paragraph (e)(5)(ii) of this section.

(C) A certification that the intermediary has obtained the appropriate certificates (such as Forms W–8 or W–9) or other appropriate documentation in the manner required in its withholding agreement with the IRS for those account holders that are covered by the certificate and whose assets are identified as being allocable to the categories described in paragraph (e)(5)(v)(B)(*1*) or (*2*) (in accordance with paragraph (e)(5)(v) of this section or otherwise).

(D) A certification whether the qualified intermediary is assuming primary withholding responsibility for the amounts to which the certificate relates.

(E) A statement attached to the certificate that provides such information as may be required by the form and accompanying instructions, including sufficient information for the withholding agent to determine the amount required to be withheld from amounts paid to the intermediary and reported to the IRS. See paragraph (e)(5)(v) of this section for requirement of a statement and rules applicable thereto.

(F) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (e)(3)(ii).

(iii) *Intermediary withholding certificate from an intermediary that is not a qualified intermediary.* An intermediary withholding certificate from a person that does not represent to be a qualified intermediary within the meaning of paragraph (e)(5)(ii) of this section is valid only if it is furnished on a Form W–8 (or an acceptable substitute form, or such other form as the IRS may prescribe), it is signed under penalties of perjury by a person authorized to sign for the intermediary, it contains the information, statement, and certifications described in this paragraph (e)(3)(iii), its validity has not expired, and the withholding certificates and other appropriate documentation for all the persons to whom the certificate relates are attached to the certificate. Appropriate documentation consists of beneficial owner withholding certificates described in paragraph (e)(2)(i) of this section, intermediary withholding certificates described in paragraph (e)(3)(i) of this section, flow-through certificates described in §1.1441–5(c)(2)(iv), (3)(iii), and (e), documentary evidence described in §1.1441–6(b)(2)(i) or in §1.6049–5(c)(1) related to the beneficial owner (or documentary evidence described in §1.6049–5(c)(4) for purposes of information reporting under chapter 61 of the Code), and other documentation or certificate applicable under other provisions of the Code or regulations that certify or establish the status of the payee or beneficial owner as a U.S. or a foreign person. If the intermediary is acting on behalf of another intermediary that is not a qualified intermediary or on behalf of a partnership that is not a withholding foreign partnership described in §1.1441–5(c)(2)(i), then the intermediary must attach to its own withholding certificate the intermediary withholding certificate or the partnership withholding certificate to which all the withholding certificates and other appropriate documentation required to be attached under this paragraph (e)(3)(iii) or in §1.1441–5(c)(3)(iii) or (e) are also attached. Nothing in this paragraph (e)(3)(iii) shall require an intermediary to furnish original documentation. Copies of certificates or documentary evidence may be passed up to the U.S. withholding agent, in which case the intermediary must retain the original documentation for the same time period that the copy is required to be retained by the withholding agent under paragraph (e)(4)(iii) of this section and must provide it to the withholding agent upon request. For purposes of this paragraph (e)(3)(iii), a valid intermediary withholding certificate also includes a statement described in §1.871–14(c)(2)(v) furnished in order for interest to qualify as portfolio interest for purposes of sections 871(h) and 881(c) or in order for amounts described in §1.1441–6(b)(2)(ii) to qualify as amounts paid to a foreign person. The information and certification required on a Form W–8 described in this paragraph (e)(3)(iii) (or on an acceptable substitute form or such other form as the IRS may prescribe) are as follows:

(A) The name and permanent resident address (as described in paragraph (e)(2)(ii) of this section) of the intermediary, and the country under the laws of which the intermediary is created, incorporated, or governed.

(B) A certification that the person whose name is on the Form W–8 is not acting for its own account and is using the certificate as a form to transmit withholding certificates and other appropriate documentation for the payment to which the form relates.

(C) If furnishing an intermediary certificate to transmit withholding certificates or other appropriate documentation for more than one person, a statement attached to the Form W–8 that provides such information as may be required by the form and accompanying instructions, including sufficient information for the withholding agent to determine the amount required to be withheld from amounts paid to the intermediary. See paragraph (e)(3)(iv) of this section for rules applicable to such a statement.

(D) A certification either that the attached withholding certificates and other appropriate documentation represent all of the persons to whom the intermediary withholding certificate relates or that the amounts allocable to persons covered by the intermediary withholding certificate and for whom withholding certificates or other appropriate documentation are lacking or unreliable are separately identified.

(E) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certification described in this paragraph (e)(3)(iii).

(iv) *Information to the withholding agent regarding assets owned by beneficial owners, etc.*—(A) *General rule.* An intermediary that has not represented that it is acting as a qualified intermediary within the meaning of paragraph (e)(5)(ii) of this section must provide information sufficient for the withholding agent to determine the proportion of each payment of reportable amounts (as described in paragraph (e)(3)(vi) of this section) that is allocable to each person to whom the intermediary withholding certificate relates, including persons for whom the intermediary has not attached a withholding certificate or other appropriate documentation. The withholding agent may rely on such information in order to determine the amount of withholding on the payment and how to report this payment under chapter 3 or 61 of the Code and the regulations thereunder. The sum of all the proportions indicated by the intermediary, expressed as a percentage, must equal, but not exceed, one hundred percent of the payment. The information for persons for whom a withholding certificate or other appropriate documentation is lacking or unreliable may be provided in the aggregate and need not be provided separately for each such person. The foreign intermediary is not required to disclose the names of the persons for whom it collects the payment, unless it has actual knowledge that any such person is a U.S. person that is not an exempt recipient. In such a case, the intermediary must state separately the information for such U.S. person even though such person has not provided a Form W–9 to the intermediary in the manner described in paragraph (d)(2) of this section. The information may be furnished in any manner that the parties choose. For example, if the withholding agent maintains separate accounts for different types of income or withholding rates, the intermediary must provide sufficient information so that the withholding agent may allocate assets appropriately among the relevant accounts. If the withholding agent does not maintain separate

accounts, it may require the intermediary to attach a statement to the intermediary withholding certificate under paragraphs (e)(3)(iii)(C) and (D) of this section providing the information described in this paragraph (e)(3)(iv).

(B) *Updating the information.* The intermediary must update the information furnished to the withholding agent in accordance with paragraph (e)(3)(iv)(A) of this section as often as is necessary in order to enable the withholding agent to withhold at the appropriate rate on each payment and to report such income for purposes of chapter 3 or 61 of the Code and sections 3402, 3405 and 3406 (and the regulations under those provisions). Any update of the information as required under this paragraph (e)(3)(iv)(B) shall be treated as an integral part of the intermediary withholding certificate with which it is associated. See paragraph (e)(4)(ii)(D) of this section regarding how changes in the information described in this paragraph (e)(3)(iv) may affect the validity of withholding certificates. See paragraph (b)(3)(v)(C) of this section for consequences if the information is not updated as required.

(C) *Examples.* The rules of paragraph (e)(3)(iii) of this section and of this paragraph (e)(3)(iv) are illustrated by the following examples:

Example 1. A U.S. withholding agent, W, pays U.S. source dividends to foreign intermediary X who, in turn, pays to foreign intermediary Y, who collects on behalf of foreign beneficial owners, A and B. A and B have each furnished a beneficial owner Form W–8 to Y. Y must furnish to X an intermediary Form W–8 described in paragraph (e)(3)(iii) of this section, to which it must attach the original or copies of A's and B's Forms W–8. X, in turn, must furnish to W its own intermediary Form W–8 described in paragraph (e)(3)(iii) of this section, to which it must attach the original or copies of the intermediary Form W–8 received from Y and A's and B's Forms W–8.

Example 2. A foreign bank, X, acts as an intermediary for five different persons, A, B, C, D, and E, who each own securities from which they receive U.S. source dividends. The distributions are paid by a U.S. financial institution, W, as custodian of the securities for X. A's, B's, C's, D's, and E's respective claimed ownership interest in the securities is 20- percent each. X has furnished to W an intermediary Form W–8 described in paragraph (e)(3)(iii) of this section, to which it has attached a statement described in this paragraph (e)(3)(iv) stating each of A', B's, and C's interest in the securities with respect to which distributions are made periodically. The respective ownership interests of D and E are not stated separately because X has not received a valid withholding certificate or other appropriate documentation from D or E. Therefore, on the statement, D's and E's interest in the securities is stated in the aggregate (i.e., 40-percent attributable to undocumented owners). X has attached a Form W–8 for A and documentary evidence for B (who each claim a reduced rate of withholding under an income tax treaty), and a Form W–9 for C. In determining the amount to be withheld from the amount paid to X, W may rely on X's intermediary Form W–8, the allocation statement attached to the Form W–8, and the attached Form W–8, documentary evidence, and Form W–9 for each of A, B, and C. Based on paragraphs (b)(1), (b)(2)(v), (b)(2)(vii), (d)(4)(i), and (e)(1)(ii)(A)(1) of this section, W may withhold as follows on the payment to X: no withholding on 20-percent of the payment on the basis of C's Form W–9, withholding at the reduced treaty rate on 40-percent of the payment on the basis of A's Form W–8 and B's documentary evidence, and 30-percent on 40-percent of the payment to the undocumented owners group formed by D and E in accordance with the presumptions described in paragraph (b)(3)(v)(B) of this section (i.e., due to the lack of documentation for D and E). Under paragraph (e)(3)(iii) of this section, X is not required to identify D or E to W. For purposes of making a return under §1.1461–1(c), W would prepare a single Form 1042–S for the group of undocumented owners, D and E (if the names are undisclosed, the Form 1042–S should be made in the name of X and state that the return is made for unknown owners (see §1.1461–1(c)(4)(iv)). Because X has not furnished required documentation for D and E, X does not qualify under paragraph (b)(6) of this section for relief from an obligation to make a report on a Form 1042–S (to the extent D and E are presumed to be foreign persons under paragraph (b)(3)(iii) of this section) when X makes the payment to D and E (however, because a full 30-percent amount was withheld under this section, X does not have to withhold an additional amount under the facts of this example). In contrast, under paragraph (b)(6) of this section, X is not required to make a report on Form 1042–S for its payments to A or B. Under §1.6042–3(b)(1)(vi), X is not required to report C's share of the payment on Form 1099 (unless X has actual knowledge that W has not reported the portion of payment allocable to C in accordance with §1.6042–2).

Example 3. The facts are the same as in *Example 2*, except that D's name is D Insurance Company whom X knows is a U.S. person. Because of D's name, X may treat D as an exempt recipient on an eyeball test basis under §§1.6042–3(b)(1)(vii) and 1.6049–4(c)(1)(ii)(A)(1). However, even if those facts are disclosed to W, W must withhold 30-percent of the portion of the payment allocable to D because W is making a payment to a foreign person (X). Under paragraph (b)(1) of this section, W may reduce the rate of withholding only if it can associate the payment with documentation upon which it can rely to treat the beneficial owner as a U.S. person or as a foreign person entitled to a reduced rate of withholding. Because X has not furnished documentation for D, W does not have the proper documentation with which it can associate the payment allocable to D. Thus, insofar as W is concerned, the portion of the payment allocable to D is treated as a payment to an undocumented owner that W must presume to be a foreign person under paragraph (b)(3)(v)(B) of this section. Accordingly, under this paragraph (e)(3)(iv), W need not identify the information for D separately and can aggregate the portion of the payment allocable to D and E. W's reporting requirements for the portion of the payment allocable to D and E are the same as under *Example 2*. When X makes the payment to D, X does not benefit from the relief from reporting under §1.6042–3(b)(1)(vi). However, X is not required to report the payment to D on Form 1099 under section 6042 because, under §1.6042–3(b)(1)(vii), X can treat D as an exempt recipient.

(v) *Withholding certificate from certain U.S. branches.* A U.S. branch certificate is a representation by the U.S. branch whose name is on the certificate that the payment it receives is not effectively connected with the conduct of a trade or business in the United States and that it is using the certificate either to transmit the appropriate documentation for the persons for whom the branch receives the payment (i.e., as an intermediary) or as evidence of its agreement with the withholding agent to be treated as a U.S. person with respect to any payment associated with the certificate. A U.S. branch withholding certificate is valid only if it is furnished on a Form W–8 (or an acceptable substitute form, or such other form as the IRS may prescribe), it is signed under penalties of perjury by a person authorized to sign for the branch, its validity has not expired, and it contains the information, statement, and certifications described in this paragraph (e)(3)(v). If the certificate is furnished to transmit withholding certificates and other documentation, it must contain the information and certifications described in paragraphs (e)(3)(v)(A) through (C) of this section and in paragraphs (e)(3)(iii)(C) and (D) of this section. If the certificate is furnished pursuant to an agreement to treat the U.S. branch as a U.S. person, the information and certification required on the Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe) are limited to the following—

(A) The name of the person of which the branch is a part and the address of the branch in the United States;

(B) A certification that the payments associated with the certificate are not effectively connected with the conduct of its trade or business in the United States; and

(C) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certification described in this paragraph (e)(3)(v).

(vi) *Reportable amounts.* For purposes of this section, the term reportable amount means an amount subject to withholding within the meaning of §1.1441–2(a), bank deposit interest (including original issue discount) and similar types of deposit interest described in section 871(i)(2)(A) or 881(d) that are

from sources within the United States, and any amount of interest or original issue discount from sources within the United States on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3). For purposes of this paragraph (e)(3)(vi), however, reportable amounts do not include payments with respect to deposits with banks and other financial institutions that remain on deposit for a period of two weeks or less, to amounts of original issue discount arising from a sale and repurchase transaction that is completed within a period of two weeks or less, or to amounts described in §1.6049–5(b)(7), (10) or (11) (relating to certain obligations issued in bearer form). While short-term OID and bank deposit interest are not subject to withholding under chapter 3 of the Code, such amounts may be subject to information reporting under section 6049 if paid to a U.S. person who is not an exempt recipient described in §1.6049–4(c)(1)(ii) and to backup withholding under section 3406 in the absence of documentation. See §1.6049–5(d)(3)(iii) for applicable procedures when such amounts are paid to a foreign intermediary.

(4) *Applicable rules.* The provisions in this paragraph (e)(4) describe procedures applicable to withholding certificates on Form W–8 or Form 8233 (or a substitute form) or documentary evidence furnished to establish foreign status. These provisions do not apply to Forms W–9 (or their substitutes). For corresponding provisions regrading Form W–9 (or a substitute form), see section 3406 and the regulations under that section.

(i) *Who may sign the certificate.* A withholding certificate (or other acceptable substitute) may be signed by any person authorized to sign a declaration under penalties of perjury on behalf of the person whose name is on the certificate as provided in section 6061 and the regulations under that section (relating to who may sign generally for an individual, estate, or trust, which includes certain agents who may sign returns and other documents), section 6062 and the regulations under that section (relating to who may sign corporate returns), and section 6063 and the regulations under that section (relating to who may sign partnership returns).

(ii) *Period of validity*—(A) *Three-year period.* A withholding certificate described in paragraph (e)(2)(i) of this section, a certificate described in §1.871–14-(c)(2)(v) (furnished to qualify interest as portfolio interest for purposes of sections 871(h) and 881(c) or to qualify amounts paid on certain securities described in §1.1441–6(b)(2)(ii) as paid to a foreign person), or documentary evidence described in §1.1441–6(b)(2)(i) or in §1.6049–5(c)(1) shall remain valid until the earlier of the last day of the third calendar year following the year in which the certificate is signed or the documentary evidence is created or the day that a change of circumstances occurs that makes any information on the certificate or documentary evidence incorrect. For example, a certificate signed on September 30, 1999, remains valid through December 31, 2002, unless circumstances change that make the information on the form no longer correct.

(B) *Indefinite validity period.* Notwithstanding paragraph (e)(4)(ii)(A) of this section, the following certificates or parts of certificates shall remain valid until the status of the person whose name is on the certificate is changed in a way relevant to the certificate or circumstances change that make the information on the certificate no longer correct:

(*1*) A beneficial owner withholding certificate described in paragraph (e)(2)(ii) of this section that is furnished with a TIN if the income for which such certificate is furnished is required to be reported under §1.1461–1(c)(2)(i) or the TIN furnished on the certificate is reported to the IRS under the procedures described in §1.1461–1(d).

(*2*) A certificate described in paragraph (e)(3)(ii) of this section (dealing with a certificate from a person representing to be a qualified intermediary).

(*3*) A certificate described in paragraph (e)(3)(iii) of this section (dealing with a certificate from a person representing to be a non-qualified intermediary), but not including the withholding certificates or documentary evidence required to be attached to the certificate.

(*4*) A certificate described in paragraph (e)(3)(v) of this section (dealing with a certificate from a person representing to be a U.S. branch), but not the withholding certificates or documentary evidence required to be attached to the certificate.

(*5*) A certificate described in §1.1441–5(c)(2)(iv) (dealing with a certificate from a person representing to be a withholding foreign partnership).

(*6*) A certificate described in §1.1441–5(c)(3)(iii) (dealing with a certificate from a person representing to be a foreign partnership that is not a withholding foreign partnership), but not including the withholding certificates or documentary evidence required to be attached to the certificate.

(*7*) A certificate furnished by a person representing to be an integral part of a foreign government (within the meaning of §1.892–2T(a)(2)) in accordance with §1.1441–8(b), or by a person representing to be a foreign central bank of issue (within the meaning of §1.861–2(b)(4)) or the Bank for International Settlements in accordance with §1.1441–8(c)(1).

(C) *Withholding certificate for effectively connected income.* Notwithstanding paragraph (e)(4)(ii)(B)(*1*) of this section, the period of validity of a withholding certificate furnished to a withholding agent to claim a reduced rate of withholding for income that is effectively connected with the conduct of a trade or business within the United States shall be limited to the three-year period described in paragraph (e)(4)(ii)(A) of this section.

(D) *Change in circumstances.* If a change in circumstances makes any information on a certificate or other documentation incorrect, then the person whose name is on the certificate or other documentation must inform the withholding agent within 30 days of the change and furnish a new certificate or new documentation. A certificate or documentation becomes invalid from the date that the withholding agent holding the certificate or documentation knows or has reason to know that circumstances affecting the correctness of the certificate or documentation have changed. However, a withholding agent may choose to apply the provisions of paragraph (b)(3)(iv) of this section regarding the 90-day grace period as of that date while awaiting a new certificate or documentation or while seeking information regarding changes, or suspected changes, in the person's circumstances. If an intermediary (including a U.S. branch described in paragraph (b)(2)(iv)(A) of this section that passes

through certificates to a withholding agent) or a flow-through entity becomes aware that a certificate or other appropriate documentation it has furnished to the person from whom it collects the payment is no longer valid because of a change in the circumstances of the person who issued the certificate or furnished the other appropriate documentation, then the intermediary or flow-through entity must notify the person from whom it collects the payment of the change of circumstances. It must also obtain a new withholding certificate or new appropriate documentation to replace the existing certificate or documentation whose validity has expired due to the change in circumstances. If a beneficial owner withholding certificate is used to claim foreign status only (and not, also, residence in a particular foreign country for purposes of an income tax treaty), a change of address is a change in circumstances for purposes of this paragraph (e)(4)(ii)(D) only if it changes to an address in the United States. Further, a change of address within the same foreign country is not a change in circumstances for purposes of this paragraph (e)(4)(ii)(D). A change in the circumstances affecting the withholding information provided to the withholding agent in accordance with the provisions in paragraph (e)(3)(iv) or (5)(v) of this section or in §1.1441–5(c)(3)(iv) shall terminate the validity of the withholding certificate with respect to the information that is no longer reliable unless the information is updated. A withholding agent may rely on a certificate without having to inquire into possible changes of circumstances that may affect the validity of the statement, unless it knows or has reason to know that circumstances have changed. A withholding agent may require a new certificate at any time prior to a payment, even though the withholding agent has no actual knowledge or reason to know that any information stated on the certificate has changed.

(iii) *Retention of withholding certificate.* A withholding agent must retain each withholding certificate and other documentation for as long as it may be relevant to the determination of the withholding agent's tax liability under section 1461 and §1.1461–1.

(iv) *Electronic transmission of information.* Under procedures issued by the IRS (see §601.601(d)(2) of this chapter), a withholding agent may be permitted to receive in electronic form the information required to be included on a withholding certificate.

(v) *Electronic confirmation of taxpayer identifying number on withholding certificate.* The Commissioner may prescribe procedures in a revenue procedure (see §601.601(d)(2) of this chapter) or other appropriate guidance to require a withholding agent to confirm electronically with the IRS information concerning any TIN stated on a withholding certificate.

(vi) *Acceptable substitute form.* A withholding agent may substitute its own form instead of an official Form W–8 or 8233 (or such other official form as the IRS may prescribe). Such a substitute for an official form will be acceptable if it contains provisions that are substantially similar to those of the official form, it contains the same certifications relevant to the transactions as are contained on the official form and these certifications are clearly set forth, and the substitute form includes a signature-under-penalties-of-perjury statement identical to the one stated on the official form. The substitute form is acceptable even if it does not contain all of the provisions contained on the official form, so long as it contains those provisions that are relevant to the transaction for which it is furnished. For example, a withholding agent that pays no income for which treaty benefits are claimed may develop a substitute form that is identical to the official form, except that it does not include information regarding claim of benefits under an income tax treaty. A withholding agent who uses a substitute form must furnish instructions relevant to the substitute form only to the extent and in the manner specified in the instructions to the official form. A withholding agent may refuse to accept a certificate from a payee or beneficial owner (including the official Form W–8 or 8233) if the certificate is not provided the acceptable substitute form provided by the withholding agent. However, a withholding agent may refuse to accept a certificate provided by a payee or beneficial owner only if the withholding agent furnishes the payee or beneficial owner with an acceptable substitute form immediately upon receipt of an unacceptable form or within 5 business days of receipt of an unacceptable form from the payee or beneficial owner. In that case, the substitute form is acceptable only if it contains a notice that the withholding agent has refused to accept the form submitted by the payee or beneficial owner and that the payee or beneficial owner must submit the acceptable form provided by the withholding agent in order for the payee or beneficial owner to be treated as having furnished the required withholding certificate.

(vii) *Requirement of taxpayer identifying number.* A TIN must be stated on a withholding certificate when required by this paragraph (e)(4)(vii). A TIN is required to be stated on a beneficial owner certificate if the beneficial owner is claiming the benefit of a reduced rate under an income tax treaty (other than for amounts described in §1.1441–6(b)(2)(ii)), an exemption from withholding because income is effectively connected with a U.S. trade or business, an exemption under section 871(f) for certain annuities received under qualified plans, or an exemption solely based on a foreign organization's claim of tax exempt status under section 501(c) or private foundation status. Thus, a TIN is not required from a foreign private foundation that is subject to the 4-percent tax under section 4948(a) on income if that income is otherwise exempt under the Code. In addition, a TIN is required to be stated on the withholding certificate from a person representing to be a qualified intermediary described in paragraph (e)(5)(ii) of this section, on the withholding certificate from a person representing to be a withholding foreign partnership described in §1.1441–5(c)(2)(i)), on the withholding certificate from a person representing to be a foreign trust or foreign estate, or from a fiduciary thereof, and on the withholding certificate from a person representing to be a U.S. branch described in paragraph (e)(3)(v) of this section. A TIN is an IRS individual taxpayer identification number, an employer identification number, or a social security number as described in section 6109 and §301.6109–1 of this chapter, or any other identifier that the Commissioner may designate.

(viii) *Reliance rules.* A withholding agent may rely on the information and cer-

tifications stated on withholding certificates or other documentation without having to inquire into the truthfulness of this information or certification, unless it has actual knowledge or reason to know that the same is untrue. In the case of amounts described in §1.1441–6(b)(2)(ii), a withholding agent described in §1.1441–7(b)(2)(ii) has reason to know that the information or certifications on a certificate are untrue only to the extent provided in §1.1441–7(b)(2)(ii). See §1.1441–6(b)(4)(ii) for reliance on representations regarding eligibility for a reduced rate under an income tax treaty. Paragraphs (e)(4)(viii)(A) and (B) of this section provide examples of such reliance.

(A) *Classification.* A withholding agent may rely on the claim of entity classification indicated on the withholding certificate that it receives from or for the beneficial owner, unless it has actual knowledge or reason to know that the classification claimed is incorrect. A withholding agent may not rely on a person's claim of classification other than as a corporation if the name of the corporation indicates that the person is a per se corporation described in §301.7701–2(b)(8)(i) of this chapter unless the certificate contains a statement that the person is a grandfathered per se corporation described in §301.7701–2(b)(8) of this chapter and that its grandfathered status has not been terminated. In the absence of reliable representation or information regarding the classification of the payee or beneficial owner, see §1.1441–1(b)(3)(ii) for applicable presumptions.

(B) *Status of payee as an intermediary or as a person acting for its own account.* A withholding agent may rely on the type of certificate furnished as indicative of the payee's status as an intermediary or as an owner, unless the withholding agent has actual knowledge or reason to know otherwise. For example, a withholding agent that receives a beneficial owner withholding certificate from a foreign financial institution may treat the institution as the beneficial owner, unless it has information in its records that would indicate otherwise or the certificate contains information that is not consistent with beneficial owner status (e.g., sub-account numbers or names). If the financial institution also acts as an intermediary, the withholding agent may request that the institution furnish two certificates, i.e., a beneficial owner certificate described in paragraph (e)(2)(i) of this section for the amounts that it receives as a beneficial owner, and an intermediary withholding certificate described in paragraph (e)(3)(i) of this section for the amounts that it receives as an intermediary. In the absence of reliable representation or information regarding the status of the payee as an owner or as an intermediary, see paragraph (b)(3)(v)(A) for applicable presumptions.

(ix) *Certificates to be furnished for each account unless exception applies.* Unless otherwise provided in this paragraph (e)(4)(ix), a withholding agent that is a financial institution with which a customer may open an account shall obtain withholding certificates or other appropriate documentation on an account-by-account basis.

(A) *Coordinated account information system in effect.* A withholding agent may rely on the withholding certificate or other appropriate documentation furnished by a customer for a pre-existing account under any one or more of the circumstances described in this paragraph (e)(4)(ix)(A).

(*1*) A withholding agent may rely on documentation furnished by a customer for another account if all such accounts are held at the same branch location.

(*2*) A withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related to the withholding agent if the withholding agent and the related person are part of a universal account system that uses a customer identifier that can be used to retrieve systematically all other accounts of the customer. See §31.3406(c)–1(c)(3)(ii) and (iii)(C) of this chapter for an identical procedure for purposes of backup withholding. For purposes of this paragraph (e)(4)(ix)(A), a withholding agent is related to another person if it is related within the meaning of section 267(b) or 707(b).

(*3*) A withholding agent may rely on documentation furnished by a customer for an account held at another branch location of the same withholding agent or at a branch location of a person related to the withholding agent if the withholding agent and the related person are part of an information system other than a universal account system and the information system is described in this paragraph (e)(4)(ix)(A)(*3*). The system must allow the withholding agent to easily access data regarding the nature of the documentation, the information contained in the documentation, and its validity status, and must allow the withholding agent to easily transmit data into the system regarding any facts of which it becomes aware that may affect the reliability of the documentation. The withholding agent must be able to establish how and when it has accessed the data regarding the documentation and, if applicable, how and when it has transmitted data regarding any facts of which it became aware that may affect the reliability of the documentation. In addition, the withholding agent or the related party must be able to establish that any data it has transmitted to the information system has been processed and appropriate due diligence has been exercised regarding the validity of the documentation.

(B) *Family of mutual funds.* An interest in a mutual fund that has a common investment advisor or common principal underwriter with other mutual funds (within the same family of funds) may, in the discretion of the mutual fund, be represented by one single withholding certificate where shares are acquired or owned in any of the funds. See §31.3406(h)–3(a)(2) of this chapter for an identical procedures for purposes of backup withholding.

(C) *Special rule for brokers.* A withholding agent may rely on the certification of a broker acting as the agent of a beneficial owner that the broker holds a valid beneficial owner withholding certificate described in paragraph (e)(2)(i) of this section or other documentation for that beneficial owner. The certification must contain the date of expiration of the certificate or documentation and be in writing or in electronic form. For purposes of this paragraph (e)(4)(ix)(C), the term broker shall have the same meaning as in §31.3406(h)–3(d) of this chapter.

(5) *Qualified intermediaries*—(i) *General rule.* A qualified intermediary, as defined in paragraph (e)(5)(ii) of this section, may furnish an intermediary withholding certificate to a withholding agent. Such a certificate certifies on be-

half of other persons (such as beneficial owners, intermediaries, flow-through entities described in §1.1441–5, or U.S. payees) for the purpose of claiming and verifying reduced rates of withholding under section 1441 or 1442 and for the purpose of reporting and withholding under other provisions of the Code, such as the provisions under chapter 61 of the Code and section 3406 (and the regulations under those provisions). Furnishing such a certificate is in lieu of transmitting to a withholding agent withholding certificates or other appropriate documentation for the persons for whom the qualified intermediary receives the payment or for its shareholders (in the case of claims of benefits under an income tax treaty by a reverse hybrid entity). Although the qualified intermediary is required to obtain withholding certificates or other appropriate documentation from beneficial owners, payees, or shareholders pursuant to its agreement with the IRS, it is not required to attach such documentation to the intermediary withholding certificate. However, the qualified intermediary must disclose the names of those U.S. persons for whom the qualified intermediary receives reportable payments (within the meaning of paragraph (e)(3)(vi) of this section) and who are not exempt recipients (as defined in §1.6049–4(c)(1)(ii) or an applicable provision under section 6041, 6042, 6045, or 6050N), irrespective of local secrecy laws. A person may claim qualified intermediary status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may prescribe.

(ii) *Definition of qualified intermediary.* With respect to a payment to a foreign person, the term *qualified intermediary* means a person that is a party to a withholding agreement with the IRS and such person is—

(A) A foreign financial institution or a foreign clearing organization (as defined in §1.163–5(c)(2)(i)(D)(*8*), without regard to the requirement that the organization hold obligations for members), other than a U.S. branch or U.S. office of such institution or organization;

(B) A foreign branch or office of a U.S. financial institution or a foreign branch or office of a U.S. clearing organization (as defined in §1.163–5(c)(2)(i)(D)(*8*), without regard to the requirement that the organization hold obligations for members);

(C) A foreign corporation for purposes of presenting claims of benefits under an income tax treaty on behalf of its shareholders; or

(D) Any other person acceptable to the IRS.

(iii) *Withholding agreement*—(A) *In general.* The IRS may, upon request, enter into a withholding agreement with a foreign person described in paragraph (e)(5)(ii) of this section pursuant to such procedures as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). Under such withholding agreement, a qualified intermediary shall be generally subject to the applicable withholding and reporting provisions applicable to withholding agents and payors under chapters 3 and 61 of the Code, and section 3406, and the regulations under those provisions, and other withholding provisions of the Code, except to the extent provided under the agreement. A withholding agreement may apply to the entity as a whole or to certain specified branches of the institution. The determination of the scope of the agreement shall be made on a branch-by-branch basis.

(B) *Terms of the withholding agreement.* Generally, the agreement shall specify the type of certification and documentation upon which the qualified intermediary may rely to ascertain the nationality and residence of beneficial owners and U.S. payees who receive payments collected by the qualified intermediary and, if necessary, entitlement to the benefits of a reduced rate under an income tax treaty. It shall specify if the qualified intermediary may assume primary withholding responsibility in accordance with paragraph (e)(5)(iv) of this section. It shall specify the extent to which applicable return filing and information reporting requirements are modified so that, in appropriate cases, the qualified intermediary may report payments to the IRS on an aggregated basis, without having to disclose the identity of individual customers. However, the qualified intermediary may be required to provide to the IRS the name and address of those foreign customers who benefit from a reduced rate under an income tax treaty pursuant to the qualified intermediary arrangement for purposes of verifying entitlement to such benefits, particularly under an applicable Limitation on Benefits provision. Under the agreement, a qualified intermediary may agree to act as an acceptance agent to perform the duties described in §301.6109–1(d)(3)(iv)(A) of this chapter. The agreement may specify the manner in which applicable procedures for adjustments for underwithholding and overwithholding, including refund procedures apply in the context of a qualified intermediary arrangement and the extent to which applicable procedures may be modified. In particular, a withholding agreement may allow a qualified intermediary to claim refunds of overwithheld amounts on behalf of its customers. If relevant, the agreement shall specify the manner in which the qualified intermediary may deal with payments to other intermediaries. In addition, the agreement must specify the manner in which the IRS will verify compliance with the agreement. In appropriate cases, the IRS may agree to rely on audits performed by an intermediary's approved auditor. In such a case, the IRS' audit may be limited to the audit of the auditor's records (including work papers of the auditor and reports prepared by the auditor indicating the methodology employed to verify the entity's compliance with the agreement). For this purpose, the agreement shall specify which auditor or class of auditors is approved. Generally, an auditor will be approved if it is subject to regulatory supervision under the laws of the country in which a significant part of the intermediary activities under the agreement are expected to occur, its internal procedures require it to verify that the intermediary complies with the terms of the withholding agreement and to report non-compliance findings under the agreement in the same manner as it is required to report other findings of non-compliance with applicable local laws and regulatory requirements, and its relevant records (i.e., work papers and reports) are available to the IRS. The agreement must include provisions for the assessment and collection of tax in the event that failure to comply with the terms of the agreement results in the failure by the withholding agent or the qualified intermediary to withhold and deposit the required amount of tax. Further, the agreement shall specify the procedures by which deposits of amounts

withheld are to be deposited, if different from normally applicable deposit procedures under the Code and applicable regulations. The agreement shall also specify the assets that the qualified intermediary has in the United States or alternative means of collection, if necessary. To determine the terms of any particular withholding agreement, the IRS will consider appropriate factors including whether or not the foreign person agrees to assume primary responsibility as a withholding agent, the type of local knoW–your-customer laws and practices to which it is subject, the extent and nature of supervisory and regulatory control exercised under the laws of the foreign country over the foreign person, the volume of investments in U.S. securities (determined in dollar amounts and number of account holders), and financial condition of the foreign person.

(iv) *Assignment of primary withholding responsibility.* A withholding agent making a payment to a qualified intermediary must presume that the withholding agent has full withholding responsibility for that payment, except as otherwise specified in this paragraph (e)(5)(iv). For this purpose, withholding responsibility means the obligation to withhold as required under the provisions of section 1441, 1442, or 1443, and the regulations under those sections, and the related reporting obligations under §1.1461–1(b)-(2)(ii) and (c)(4)(ii) for payments identified or treated as made to foreign persons. Withholding responsibility also means obligations imposed on payors under chapter 61 of the Code (and the regulations under those provisions) and, if applicable, under section 3405 or 3406 (and the regulations under those sections). A qualified intermediary that assumes primary withholding responsibility vis-a-vis a withholding agent must assume such responsibility for all payments made to any one account. Any qualified intermediary may agree with the withholding agent to assume primary withholding responsibility, but only if expressly permitted to do so under its agreement with the IRS. Generally, reporting or withholding liability arising from a payment to a U.S. person (or treated as or presumed to be made to a U.S. person) under any provision of the Code or applicable regulations thereunder may not be assigned to a qualified intermediary except where the qualified intermediary is a foreign branch of a U.S. financial institution or except to the extent that the qualified intermediary has a branch in the United States and establishes to the satisfaction of the IRS that its U.S. branch can adequately fulfill the qualified intermediary's obligations on behalf of the qualified intermediary regarding information reporting under chapter 61 of the Code and the regulations under the applicable provisions of that chapter and, if necessary, backup withholding under section 3406 and the regulations under that section (even though the U.S. branch is not a qualified intermediary).

(v) *Information to withholding agent regarding applicable withholding rates*— (A) *General rule.* The qualified intermediary must separate the assets that generate payments of reportable amounts (as described in paragraph (e)(3)(vi) of this section) that are associated with its withholding certificate furnished to the withholding agent into the categories described in paragraph (e)(5)(v)(B) of this section, and provide that information to the withholding agent so that the withholding agent may determine the applicable withholding rate applicable to each category. The information may be furnished in any manner that the parties choose. For example, if the withholding agent maintains separate accounts for each category of assets described in paragraph (e)(5)(v)(B) of this section, the intermediary must provide information sufficient for the withholding agent to allocate assets appropriately among the various accounts. If the withholding agent does not maintain separate accounts, it may require the intermediary to attach a statement to the intermediary withholding certificate under paragraph (e)(3)(ii)(E) of this section providing the information described in this paragraph (e)(5)(v).

(B) *Categories of assets.* A payment of a reportable amount (as defined in paragraph (e)(3)(vi) of this section) must be associated with one of the three categories of assets set forth in paragraphs (e)(5)(v)(B)(*1*) through (*3*) of this section and may be associated with only one of these three categories. Additional or different categories of assets may be specified, however, under procedures prescribed by the IRS (see §602.602–1(d) of this chapter) or in the qualified intermediary agreement. No information is required regarding assets that do not generate a reportable amount described in paragraph (b)(3)(vi) of this section. The information provided to the withholding agent, and any update thereof, shall be considered an integral part of the intermediary withholding certificate. The three categories of assets required to be identified to the withholding agent are as follows:

(*1*) The first category of assets consists of assets that are associated with non-U.S. payees to which the intermediary certificate relates, and the applicable withholding rate. If different withholding rates apply, the withholding agent must indicate the applicable rate for each class of non-U.S. payees to which different withholding rates apply and the assets associated with each class. In the case of a qualified intermediary that has assumed primary withholding responsibility, the intermediary must simply certify the amount of assets for which it assumes primary withholding responsibility because they are assets for which it holds the appropriate documentation and are not described in the other two categories.

(*2*) The second category of assets consists of assets that are associated with all U.S. payees to which the certificate relates. The qualified intermediary must furnish a Form W–9 (or an acceptable substitute form) for each U.S. payee described in paragraph (d)(2) of this section or, in the absence of a Form W–9, the name and address of the U.S. payee or such information it has available regarding the payee. The identity of U.S. payees described in paragraph (d)(3) of this section need not be disclosed to the withholding agent.

(*3*) The third category of assets consists of assets that are associated with payees for whom the qualified intermediary holds no documentation, or holds documentation that it knows or has reason to know is unreliable and for which it has no actual knowledge that the payees are U.S. persons. A qualified intermediary that has assumed primary withholding responsibility need not furnish information regarding this category of assets.

(C) *Updating the information.* The intermediary must update the information furnished to the withholding agent in ac-

cordance with this paragraph (e)(5)(v) as often as is necessary in order to enable the withholding agent to withhold at the appropriate rate on each payment and to report such income for purposes of chapter 3 or 61 of the Code and sections 3402, 3405 and 3406 (and the regulations under those provisions). See paragraph (e)(4)(ii)(D) of this section regarding how changes in the information affect the validity of a withholding certificate. See §1.1441–1(b)(3)(v)(C) for consequences if the information is not updated as required.

(f) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1998.

(2) *Transition rules*—(i) *Special rules for existing documentation.* For purposes of paragraphs (d)(3) and (e)(2)(i) of this section, a withholding agent that on December 31, 1998, holds a Form W–8, 8233, 1001, 4224, 1078, or a statement described in §1.1441–5 in effect prior to January 1, 1999 (see §1.1441–5 as contained in 26 CFR part 1, revised April 1, 1997) under the regulations in effect prior to January 1, 1999(see 26 CFR parts 1 and 35a, revised April 1, 1997), that is a valid certificate or statement as determined under those regulations may treat the certificate or statement as a valid withholding certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a withholding certificate or statement that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (f)(2)(i), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a withholding agent may choose to not take advantage of the transition rule in this paragraph (f)(2)(i) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

(ii) *Lack of documentation for past years.* A taxpayer may elect to apply the provisions of paragraphs (b)(7)(i)(B), (ii), and (iii) of this section, dealing with liability for failure to obtain documentation timely, to all of its open tax years, including tax years that are currently under examination by the IRS. The election is made by simply taking action under those provisions in the same manner as the taxpayer would take action for payments made after December 31, 1998.

§1.1441–2 Amounts subject to withholding.

(a) *In general.* For purposes of the regulations under chapter 3 of the Internal Revenue Code (Code), the term *amounts subject to withholding* means amounts from sources within the United States that constitute either fixed or determinable annual or periodical income described in paragraph (b) of this section or other amounts subject to withholding described in paragraph (c) of this section. For purposes of this paragraph (a), an amount shall not be treated as not being from sources within the United States merely because the source of the amount cannot be determined at the time of payment. See §1.1441–3(d)(1) for determining the amount to be withheld from a payment in the absence of information at the time of payment regarding the source of the amount. Amounts subject to withholding include amounts that are not fixed or determinable annual or periodical income and upon which withholding is specifically required under a provision of this section or another section of the regulations under chapter 3 of the Code (such as corporate distributions that do not constitute dividend income upon which withholding is required under §1.1441–3(c)(1)). Amounts subject to withholding do not include amounts described in §1.1441–1(b)(4)(i) to the extent they involve interest on obligations in bearer form or on foreign-targeted registered obligations (but, in the case of a foreign-targeted registered obligation, only to the extent of those amounts paid to a registered owner that is a financial institution within the meaning of section 871(h)(5)(B)), amounts described in §1.1441–1(b)(4)(ii) (dealing with bank deposit interest and similar types of interest (including original issue discount) described in section 871(i)(2)(A) or 881(d)), amounts described in §1.1441–1(b)(4)(iv) (dealing with interest or original issue discount on certain short-term obligations described in section 871(g)(1)(B) or 881(a)(3)), and amounts described in §1.1441–1(b)(4)(xx) (dealing with income from certain gambling winnings exempt from tax under section 871(j)).

(b) *Fixed or determinable annual or periodical income*—(1) *In general*—(i) *Definition.* For purposes of chapter 3 of the Code and the regulations thereunder, fixed or determinable annual or periodical income is all income included in gross income under section 61 (including original issue discount), except for the items specified in paragraph (b)(2) of this section. Therefore, items of U.S. source income that are excluded from gross income under any provision of law without regard to the identity of the holder, such as interest excluded from gross income under section 103(a), are not fixed or determinable annual or periodical income. See §1.306–3(h) for treating income from the disposition of section 306 stock as fixed or determinable annual or periodical income.

(ii) *Manner of payment.* The term *fixed or determinable annual or periodical* is merely descriptive of the character of a class of income. If an item of income falls within the class of income contemplated in the statute and described in paragraph (a) of this section, it is immaterial whether payment of that item is made in a series of payments or in a single lump sum. Further, the income need not be paid annually if it is paid periodically; that is to say, from time to time, whether or not at regular intervals. The fact that a payment is not made annually or periodically does not, however, prevent it from being fixed or determinable annual or periodical income (e.g., a lump sum payment). In addition, the fact that the length of time during which the payments are to be made may be increased or diminished in accordance with someone's will or with the happening of an event does not disqualify the payment as determinable or periodical. For this purpose, the share of the fixed or determinable annual or periodical income of an estate or trust from sources within the United States which is required to be distributed currently, or which has been paid or credited during the taxable year, to a nonresident alien

beneficiary of such estate or trust constitutes fixed or determinable annual or periodical income.

(iii) *Determinability of amount.* An item of income is fixed when it is to be paid in amounts definitely pre-determined. An item of income is determinable if the amount to be paid is not known but there is a basis of calculation by which the amount may be ascertained at a later time. For example, interest is determinable even if it is contingent in that its amount cannot be determined at the time of payment of an amount with respect to a loan because the calculation of the interest portion of the payment is contingent upon factors that are not fixed at the time of the payment. For purposes of this section, an amount of income does not have to be determined at the time that the payment is made in order to be determinable. An amount of income described in paragraph (a) of this section which the withholding agent knows is part of a payment it makes but which it cannot calculate exactly at the time of payment, is nevertheless determinable if the determination of the exact amount depends upon events expected to occur at a future date. In contrast, a payment which may be income in the future based upon events that are not anticipated at the time the payment is made is not determinable. For example, loan proceeds may become income to the borrower when and to the extent the loan is canceled without repayment. While the cancellation of the debt is income to the borrower when it occurs, it is not determinable at the time the loan proceeds are disbursed to the borrower if the lack of repayment leading to the cancellation of part or all of the debt was not anticipated at the time of disbursement. The fact that the source of an item of income cannot be determined at the time that the payment is made does not render a payment not determinable. See §1.1441–3(d)(1) for determining the amount to be withheld from a payment in the absence of information at the time of payment regarding the source of the amount.

(2) *Exceptions.* For purposes of chapter 3 of the Code and the regulations thereunder, the items of income described in this paragraph (b)(2) are not fixed or determinable annual or periodical income—

(i) Gains derived from the sale of property (including market discount and option premiums), except for gains described in paragraph (b)(3) or (c) of this section;

(ii) Insurance premiums within the meaning of section 4372 paid to a foreign insurer or reinsurer; and

(iii) Any other income that the Internal Revenue Service (IRS) may determine, in published guidance (see §601.601(d)(2) of this chapter), is not fixed or determinable annual or periodical income.

(3) *Original issue discount*—(i) *General rule.* An amount representing original issue discount is fixed or determinable annual or periodical income that is subject to withholding to the extent provided in this paragraph (b)(3) if not otherwise excluded under paragraph (a) of this section. Under sections 871(a)(1)(C) and 881(a)(3), an amount of original issue discount is subject to tax to a foreign beneficial owner of an obligation carrying original issue discount upon a taxable sale or exchange of the obligation or when a payment is made on such obligation. The amount taxable is the amount of original issue discount that accrued while the foreign person held the obligation up to the time that the obligation is sold or exchanged or that a payment is made on the obligation, reduced by any amount of original issue discount that was taken into account prior to that time (due to a payment made on the obligation). In the case of a taxable event due to a payment made on the obligation, the tax due on the amount of taxable original issue discount may not exceed the payment less the tax imposed thereon. A person who is a withholding agent with respect to a payment that, under section 871(a)(1)(C) or 881(a)(3), is taxable to a foreign person holding or disposing of an original issue discount obligation must withhold to the extent provided in this paragraph (b)(3).

(ii) *Amounts actually known to the withholding agent.* A withholding agent must withhold on the taxable amount of original issue discount to the extent that it has actual knowledge of the proportion of the payment that is taxable to the beneficial owner under section 871(a)(1)(C) or 881(a)(3)(A). A withholding agent has actual knowledge if it knows how long the beneficial owner has held the obligation, the terms of the obligation, and the extent to which the beneficial owner purchased the obligation at a premium. A withholding agent is treated as having knowledge if the information is reasonably available. The information is not considered reasonably available if the withholding agent does not have a direct customer relationship with the foreign beneficial owner or such other person who has actual knowledge of the facts relevant to the determination of the amount taxable to the foreign beneficial owner, and has no access to such information in the ordinary course of its business due to the manner in which the obligation is held (e.g., in street name or through intermediaries). In the case of a withholding agent maintaining a direct account relationship with the beneficial owner, knowledge regarding the beneficial owner's holding period and acquisition premium is considered to be reasonably available to the withholding agent. A withholding agent may rely on the most recently published "List of Original Issue Discount Instruments" (IRS Publication 1212 (available from the IRS Forms Distribution Centers) or similar list) published by the IRS in order to determine the amount of taxable OID in any particular transaction.

(iii) *Amounts for which certain documentation is not furnished.* Notwithstanding lack of knowledge (within the meaning of paragraph (b)(3)(ii) of this section), withholding is required on the entire amount of stated interest, if any, and original issue discount on the obligation as determined as of the date of original issue if the withholding agent, pursuant to the provisions in §1.1441–1(b)(3), treats the payment as made to a foreign payee because it cannot reliably associate the payment with documentation and the amount would qualify as portfolio interest if the withholding agent held documentation described in §1.871–14(c)(2). A withholding agent may rely on the most recently published "List of Original Issue Discount Instruments" (IRS Publication 1212 (available from the IRS Forms Distribution Centers) or similar list) published by the IRS in order to determine the amount of taxable OID in any particular transaction. See §1.1441–1(b)(8) for adjustments to any amount that has been overwithheld.

(iv) *Exceptions to withholding.* The obligation to withhold under this para-

graph (b)(3) shall apply only to obligations issued after December 31, 1998, and payable more than 183 days from the date of original issue. Any exemption from withholding pursuant to this paragraph (b)(3) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6049 and backup withholding under section 3406. See §1.6049–5(b)(7) through (15).

(4) *Securities lending transactions and equivalent transactions.* See §§1.871–7(b)(2) and 1.881–2(b)(2) regarding the character of substitute payments as fixed and determinable annual or periodical income. Such amounts constitute income subject to withholding to the extent they are from sources within the United States, as determined under section §§1.861–2(a)(7) and 1.861–3(a)(6). See §§1.6042–3(a)(2) and 1.6049–5(a)(5) for reporting requirements applicable to substitute dividend and interest payments, respectively.

(c) *Other income subject to withholding.* Withholding is also required on the following items of income—

(1) Gains described in sections 631(b) or (c), relating to treatment of gain on disposal of timber, coal, or domestic iron ore with a retained economic interest; and

(2) Gains subject to the 30-percent tax under section 871(a)(1)(D) or 881(a)(4), relating to contingent payments received from the sale or exchange of patents, copyrights, and similar intangible property.

(d) *Exceptions to withholding where no money or property is paid or lack of knowledge*—(1) *General rule.* A withholding agent who is not related to the recipient or beneficial owner has an obligation to withhold under section 1441 only to the extent that, at any time between the date that the obligation to withhold would arise (but for the provisions of this paragraph (d)) and the due date for the filing of return on Form 1042 (including extensions) for the year in which the payment occurs, it has control over, or custody of money or property owned by the recipient or beneficial owner from which to withhold an amount and has knowledge of the facts that give rise to the payment. The exemption from the obligation to withhold under this paragraph (d) shall not apply, however, to distributions with respect to stock or if the lack of control or custody of money or property from which to withhold is part of a pre-arranged plan known to the withholding agent to avoid withholding under section 1441, 1442, or 1443. For purposes of this paragraph (d), a withholding agent is related to the recipient or beneficial owner if it is related within the meaning of section 482. Any exemption from withholding pursuant to this paragraph (d) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under chapter 61 of the Code and backup withholding under section 3406. The exemption from withholding under this paragraph (d) is not a determination that the amounts are not fixed or determinable annual or periodical income, nor does it constitute an exemption from reporting the amount under §1.1461–1(b) and (c).

(2) *Cancellation of debt.* A lender of funds who forgives any portion of the loan is deemed to have made a payment of income to the borrower under §1.61–12 at the time the event of forgiveness occurs. However, based on the rules of paragraph (d)(1) of this section, the lender shall have no obligation to withhold on such amount to the extent that it does not have custody or control over money or property of the borrower at any time between the time that the loan is forgiven and the due date (including extensions) of the Form 1042 for the year in which the payment is deemed to occur. A payment received by the lender from the borrower in partial settlement of the debt obligation does not, for this purpose, constitute an amount of money or property belonging to the borrower from which the withholding tax liability can be satisfied.

(3) *Satisfaction of liability following underwithholding by withholding agent.* A withholding agent who, after failing to withhold the proper amount from a payment, satisfies the underwithheld amount out of its own funds may cause the beneficial owner to realize income to the extent of such satisfaction or may be considered to have advanced funds to the beneficial owner. Such determination depends upon the contractual arrangements governing the satisfaction of such tax liability (e.g., arrangements in which the withholding agent agrees to pay the amount due under section 1441 for the beneficial owner) or applicable laws governing the transaction. If the satisfaction of the tax liability is considered to constitute an advance of funds by the withholding agent to the beneficial owner and the withholding agent fails to collect the amount from the beneficial owner, a cancellation of indebtedness may result, giving rise to income to the beneficial owner under §1.61–12. While such income is annual or periodical fixed or determinable, the withholding agent shall have no liability to withhold on such income to the extent the conditions set forth in paragraphs (d)(1) and (2) of this section are satisfied with respect to this income. Contrast the rules of this paragraph (d)(3) with the rules in §1.1441–3(f)(1) dealing with a situation in which the satisfaction of the beneficial owner's tax liability itself constitutes additional income to the beneficial owner. See, also, §1.1441–3(c)(2)(ii)(B) for a special rule regarding underwithholding on corporate distributions due to underestimating an amount of earnings and profits.

(e) *Payment*—(1) *General rule.* A payment is considered made to a person if that person realizes income whether or not such income results from an actual transfer of cash or other property. For example, realization of income from cancellation of debt results in a deemed payment. A payment is considered made when the amount would be includible in the income of the beneficial owner under the U.S. tax principles governing the cash basis method of accounting. A payment is considered made whether it is made directly to the beneficial owner or to another person for the benefit of the beneficial owner (e.g., to the agent of the beneficial owner). Thus, a payment of income is considered made to a beneficial owner if it is paid in complete or partial satisfaction of the beneficial owner's debt to a creditor. In the event of a conflict between the rules of this paragraph (e)(1) governing whether a payment has occurred and its timing and the rules of §31.3406(a)–4 of this chapter, the rules in §31.3406(a)–4 of this chapter shall apply to the extent that the application of section 3406 is relevant to the transaction at issue.

(2) *Income allocated under section 482.* A payment is considered made to the extent income subject to withholding is allocated under section 482. Further, income arising as a result of a secondary adjustment made in conjunction with a reallocation of income under section 482 from a foreign person to a related U.S. person is considered paid to a foreign person unless the taxpayer to whom the income is reallocated has entered into a repatriation agreement with the IRS and the agreement eliminates the liability for withholding under this section. For purposes of determining the liability for withholding, the payment of income is deemed to have occurred on the last day of the taxable year in which the transactions that give rise to the allocation of income and the secondary adjustments, if any, took place.

(3) *Blocked income.* Income is not considered paid if it is blocked under executive authority, such as the President's exercise of emergency power under the Trading with the Enemy Act (50 U.S.C. App. 5), or the International Emergency Economic Powers Act (50 U.S.C. 1701 et seq).. However, on the date that the blocking restrictions are removed, the income that was blocked is considered constructively received by the beneficial owner (and therefore paid for purposes of this section) and subject to withholding under §1.1441–1. Any exemption from withholding pursuant to this paragraph (e)(3) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under chapter 61 of the Code and backup withholding under section 3406. The exemption from withholding granted by this paragraph (e)(3) is not a determination that the amounts are not fixed or determinable annual or periodical income.

(4) *Special rules for dividends.* For purposes of sections 1441 and 6042, in the case of stock for which the record date is earlier than the payment date, dividends are considered paid on the payment date. In the case of a corporate reorganization, if a beneficial owner is required to exchange stock held in a former corporation for stock in a new corporation before dividends that are to be paid with respect to the stock in the new corporation will be paid on such stock, the dividend is considered paid on the date that the payee or beneficial owner actually exchanges the stock and receives the dividend. See §31.3406(a)–4(a)(2) of this chapter.

(5) *Certain interest accrued by a foreign corporation.* For purposes of sections 1441 and 6049, a foreign corporation shall be treated as having made a payment of interest as of the last day of the taxable year if it has made an election under §1.884–4(c)(1) to treat accrued interest as if it were paid in that taxable year.

(6) *Payments other than in U.S. dollars.* For purposes of section 1441, a payment includes amounts paid in a medium other than U.S. dollars. See §1.1441–3(e) for rules regarding the amount subject to withholding in the case of such payments.

(f) *Effective date.* This section applies to payments made after December 31, 1998.

Par. 8. Section 1.1441–3 is amended by:

1. Revising the section heading, and paragraphs (a) through (f) and (h).

2. Removing paragraphs (g) and (i).

3. Redesignating paragraph (j) as paragraph (g).

4. Removing the language "(j)" and adding "(g)" in its place in the fourth sentence of newly designated paragraph (g)(1) and in the first sentence of newly designated paragraph (g)(2).

5. Removing the language "§1.1441–7(d)" in the last sentence of newly designated paragraph (g)(1) and adding "§1.1441–7(f)" in its place.

6. Removing the authority citation at the end of the section.

The revisions read as follows:

§1.1441–3 Determination of amounts to be withheld.

(a) *Withholding on gross amount.* Except as otherwise provided in regulations under section 1441, the amount subject to withholding under §1.1441–1 is the gross amount of income subject to withholding that is paid to a foreign person. The gross amount of income subject to withholding may not be reduced by any deductions, except to the extent that one or more personal exemptions are allowed as provided under §1.1441–4(b)(6).

(b) *Withholding on payments on certain obligations*—(1) *Withholding at time of payment of interest.* When making a payment on an interest-bearing obligation, a withholding agent must withhold under §1.1441–1 upon the gross amount of stated interest payable on the interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income within the meaning of section 61. To the extent an amount was withheld on an amount of capital rather than interest, see the rules for adjustments, refunds, or credits under §1.1441–1(b)(8).

(2) *No withholding between interest payment dates*—(i) *In general.* A withholding agent is not required to withhold under §1.1441–1 upon interest accrued on the date of a sale of debt obligations when that sale occurs between two interest payment dates (even though the amount is treated as interest under §1.61–7(c) or (d) and is subject to tax under section 871 or 881). See §1.6045–1(c) for reporting requirements by brokers with respect to sale proceeds. See §1.61–7(c) regarding the character of payments received by the acquirer of an obligation subsequent to such acquisition (that is, as a return of capital or interest accrued after the acquisition). Any exemption from withholding pursuant to this paragraph (b)(2)(i) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6045 or 6049 and backup withholding under section 3406. The exemption from withholding granted by this paragraph (b)(2) is not a determination that the accrued interest is not fixed or determinable annual or periodical income under section 871(a) or 881(a) nor does it constitute an exemption from reporting under §1.1461–1(b) and (c) the amount of accrued interest paid.

(ii) *Anti-abuse rule.* The exemption in paragraph (b)(2)(i) of this section does not apply if the sale of securities is part of a plan the principal purpose of which is to avoid tax by selling and repurchasing securities and the withholding agent has actual knowledge or reason to know of such plan.

(c) *Corporate distributions*—(1) *General rule.* A corporation making a distribution with respect to its stock or any intermediary (described in §1.1441–1(e)(3)(i)) making a payment of such a distribution is required to withhold under section

1441, 1442, or 1443 on the entire amount of the distribution, unless it elects to reduce the amount of withholding under the provisions of paragraph (c)(2) of this section. The exemption from withholding provided by this paragraph (c) applies without any requirement to furnish documentation to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6042 or 6045 and backup withholding under section 3406. The exemption from withholding granted by this paragraph (c) does not constitute a determination that the exempted amounts are not fixed or determinable annual or periodical income under sections 871(a) or 881(a) nor does it constitute an exemption from reporting under §1.1461–1(b) and (c) the amount of the distribution.

(2) *Exception to withholding on distributions*—(i) *In general.* An election described in paragraph (c)(1) of this section is made by actually reducing the amount of withholding at the time that the payment is made. An intermediary that makes a payment of a distribution is not required to reduce the withholding based on the distributing corporation's estimate of earnings and profits, even if the distributing corporation itself elects to reduce the withholding on payments of distributions that it itself makes to foreign persons. Conversely, an intermediary may elect to reduce the amount of withholding with respect to the payment of a distribution even if the distributing corporation does not so elect for the payments of distributions that it itself makes of distributions to foreign persons. The amounts with respect to which a distributing corporation or intermediary may elect to reduce the withholding are as follows:

(A) A distributing corporation or intermediary may elect to not withhold on a distribution to the extent it represents a nontaxable distribution payable in stock or stock rights.

(B) A distributing corporation or intermediary may elect to not withhold on a distribution to the extent it represents a distribution in part or full payment in exchange for stock.

(C) A distributing corporation or intermediary may elect to not withhold on a distribution (actual or deemed) to the extent it is not paid out of accumulated earnings and profits or current earnings and profits, based on a reasonable estimate determined under paragraph (c)(2)(ii) of this section.

(D) A regulated investment company or intermediary may elect to not withhold on a distribution representing a capital gain dividend (as defined in section 852(b)(3)(C)) or an exempt interest dividend (as defined in section 852(b)(5)(A)) based on the applicable procedures described under paragraph (c)(3) of this section.

(E) A U.S. Real Property Holding Corporation (defined in section 897(c)(2)) or a real estate investment trust (defined in section 856) or intermediary may elect to not withhold on a distribution to the extent it is subject to withholding under section 1445 and the regulations under that section. See paragraph (c)(4) of this section for applicable procedures.

(ii) *Reasonable estimate of accumulated and current earnings and profits on the date of payment*—(A) *General rule.* A reasonable estimate for purposes of paragraph (c)(2)(i)(C) of this section is a determination made by the distributing corporation at a time reasonably close to the date of payment of the extent to which the distribution will constitute a dividend, as defined in section 316. The determination is based upon the anticipated amount of accumulated earnings and profits and current earnings and profits for the taxable year in which the distribution is made, the distributions made prior to the distribution for which the estimate is made and all other relevant facts and circumstances. A reasonable estimate may be made based on the procedures described in §31.3406(b)(2)–4(c)(2) of this chapter.

(B) *Procedures in case of underwithholding.* A distributing corporation or intermediary that is a withholding agent with respect to a distribution and that determines at the end of the taxable year in which the distribution is made that it underwithheld under section 1441 on the distribution shall be liable for the amount underwithheld as a withholding agent under section 1461. However, for purposes of this section and §1.1461–1, any amount underwithheld paid by a distributing corporation, its paying agent, or an intermediary shall not be treated as income subject to additional withholding even if that amount is treated as additional income to the shareholders unless the additional amount is income to the shareholder as a result of a contractual arrangement between the parties regarding the satisfaction of the shareholder's tax liabilities. In addition, no penalties shall be imposed for failure to withhold and deposit the tax if—

(*1*) The distributing corporation made a reasonable estimate as provided in paragraph (c)(2)(ii)(A) of this section; and

(*2*) Either—

(*i*) The corporation or intermediary pays over the underwithheld amount on or before the due date for filing a Form 1042 for the calendar year in which the distribution is made, pursuant to §1.1461–2(b); or

(*ii*) The corporation or intermediary is not a calendar year taxpayer and it files an amended return on Form 1042X (or such other form as the Commissioner may prescribe) for the calendar year in which the distribution is made and pays the underwithheld amount and interest within 60 days after the close of the taxable year in which the distribution is made.

(C) *Reliance by intermediary on reasonable estimate.* For purposes of determining whether the payment of a corporate distribution is a dividend, a withholding agent that is not the distributing corporation may, absent actual knowledge or reason to know otherwise, rely on representations made by the distributing corporation regarding the reasonable estimate of the anticipated accumulated and current earnings and profits made in accordance with paragraph (c)(2)(ii)(A) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the distributing corporation to reasonably estimate the portion of the distribution treated as a dividend or to properly communicate the information to the withholding agent shall be imputed to the distributing corporation. In such a case, the Internal Revenue Service (IRS) may collect from the distributing corporation any underwithheld amount and subject the distributing corporation to applicable interest and penalties as a withholding agent.

(D) *Example.* The rules of this paragraph (c)(2) are illustrated by the following example:

Example. (i) *Facts.* Corporation X, a publicly traded corporation with both U.S. and foreign shareholders and a calendar year taxpayer, has an accu-

mulated deficit in earnings and profits at the close of 2000. In 2001, Corporation X generates $1 million of current earnings and profits each month and makes an $18 million distribution, resulting in a $12 million dividend. Corporation X plans to make an additional $18 million distribution on October 1, 2002. Approximately one month before that date, Corporation X's management receives an internal report from its legal and accounting department concerning Corporation X's estimated current earnings and profits. The report states that Corporation X should generate only $5.1 million of current earnings and profits by the close of the third quarter due to costs relating to substantial organizational and product changes, but these changes will enable Corporation X to generate $1.3 million of earnings and profits monthly for the last quarter of the 2002 fiscal year. Thus, the total amount of current and earnings and profits for 2002 is estimated to be $9 million.

(ii) *Analysis.* Based on the facts in paragraph (i) of this *Example,* including the fact that earnings and profits estimate was made within a reasonable time before the distribution, Corporation X can rely on the estimate under paragraph (c)(2)(ii)(A) of this section. Therefore, Corporation X may treat $9 million of the $18 million of the October 1, 2002, distribution to foreign shareholders as a non-dividend distribution.

(3) *Special rules in the case of distributions from a regulated investment company*—(i) *General rule.* If the amount of any distributions designated as being subject to section 852(b)(3)(C) or (5)(A) exceeds the amount that may be designated under those sections for the taxable year, then no penalties will be asserted for any resulting underwithholding if the designations were based on a reasonable estimate (made pursuant to the same procedures as are described in paragraph (c)(2)(ii)(A) of this section) and the adjustments to the amount withheld are made within the time period described in paragraph (c)(2)(ii)(B) of this section. Any adjustment to the amount of tax due and paid to the IRS by the withholding agent as a result of underwithholding shall not be treated as a distribution for purposes of section 562(c) and the regulations thereunder. Any amount of U.S. tax that a foreign shareholder is treated as having paid on the undistributed capital gain of a regulated investment company under section 852(b)(3)(D) may be claimed by the foreign shareholder as a credit or refund under §1.1464–1.

(ii) *Reliance by intermediary on reasonable estimate.* For purposes of determining whether a payment is a distribution designated as subject to section 852(b)(3)(C) or (5)(A), a withholding agent that is not the distributing regulated investment company may, absent actual knowledge or reason to know otherwise, rely on the designations that the distributing company represents have been made in accordance with paragraph (c)(3)(i) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the regulated investment company to reasonably estimate the required amounts or to properly communicate the relevant information to the withholding agent shall be imputed to the distributing company. In such a case, the IRS may collect from the distributing company any underwithheld amount and subject the company to applicable interest and penalties as a withholding agent.

(4) *Coordination with withholding under section 1445*—(i) *In general.* A distribution from a U.S. Real Property Holding Corporation (USRPHC) (or from a corporation that was a USRPHC at any time during the five-year period ending on the date of distribution) with respect to stock that is a U.S. real property interest under section 897(c) or from a Real Estate Investment Trust (REIT) with respect to its stock is subject to the withholding provisions under section 1441 (or section 1442 or 1443) and section 1445. A USRPHC making a distribution shall be treated as satisfying its withholding obligations under both sections if it withholds in accordance with one of the procedures described in either paragraph (c)(4)(i)(A) or (B) of this section. A USRPHC must apply the same withholding procedure to all the distributions made during the taxable year. However, the USRPHC may change the applicable withholding procedure from year to year. For rules regarding distributions by REITs, see paragraph (c)(4)(i)(C) of this section.

(A) *Withholding under section 1441.* The USRPHC may choose to withhold on a distribution only under section 1441 (or 1442 or 1443) and not under section 1445. In such a case, the USRPHC must withhold under section 1441 (or 1442 or 1443) on the full amount of the distribution, whether or not any portion of the distribution represents a return of basis or capital gain. If a reduced tax rate under an income tax treaty applies to the distribution by the USRPHC, then the applicable rate of withholding on the distribution shall be no less than 10-percent, unless the applicable treaty specifies an applicable lower rate for distributions from a USRPHC, in which case the lower rate may apply.

(B) *Withholding under both sections 1441 and 1445.* As an alternative to the procedure described in paragraph (c)(4)(i)(A) of this section, a USRPHC may choose to withhold under both sections 1441 (or 1442 or 1443) and 1445 under the procedures set forth in this paragraph (c)(4)(i)(B). The USRPHC must make a reasonable estimate of the portion of the distribution that is a dividend under paragraph (c)(2)(ii)(A) of this section, and must—

(*1*) Withhold under section 1441 (or 1442 or 1443) on the portion of the distribution that is estimated to be a dividend under paragraph (c)(2)(ii)(A) of this section; and

(*2*) Withhold under section 1445(e)(3) and §1.1445–5(e) on the remainder of the distribution or on such smaller portion based on a withholding certificate obtained in accordance with §1.1445–5(e)(2)(iv).

(C) *Coordination with REIT withholding.* Withholding is required under section 1441 (or 1442 or 1443) on the portion of a distribution from a REIT that is not designated as a capital gain dividend or return of basis. Withholding is required under section 1445 on the portion of the distribution designated by a REIT as a capital gain dividend. See §1.1445–8.

(ii) *Intermediary reliance rule.* A withholding agent that is not the distributing USRPHC must withhold under paragraph (c)(4)(i) of this section, but may, absent actual knowledge or reason to know otherwise, rely on representations made by the USRPHC regarding the determinations required under paragraph (c)(4)(i) of this section. Failure by the withholding agent to withhold the required amount due to a failure by the distributing USRPHC to make these determinations in a reasonable manner or to properly communicate the determinations to the withholding agent shall be imputed to the distributing USRPHC. In such a case, the IRS may collect from the distributing USRPHC any underwithheld amount and subject the distributing USRPHC to applicable interest and penalties as a withholding agent.

(d) *Withholding on payments that include an undetermined amount of income*—(1) *In general.* Where the with-

holding agent makes a payment and does not know at the time of payment the amount that is subject to withholding because the determination of the source of the income or the calculation of the amount of income subject to tax depends upon facts that are not known at the time of payment, then the withholding agent must withhold an amount under §1.1441–1 based on the entire amount paid that is necessary to assure that the tax withheld is not less than 30 percent (or other applicable percentage) of the amount that will subsequently be determined to be from sources within the United States or to be income subject to tax. The amount so withheld shall not exceed 30 percent of the amount paid. In the alternative, the withholding agent may make a reasonable estimate of the amount from U.S. sources or of the taxable amount and set aside a corresponding portion of the amount due under the transaction and hold such portion in escrow until the amount from U.S. sources or the taxable amount can be determined, at which point withholding becomes due under §1.1441–1. See §1.1441–1(b)(8) regarding adjustments in the case of overwithholding. The provisions of this paragraph (d)(1) shall not apply to the extent that other provisions of the regulations under chapter 3 of the Internal Revenue Code (Code) specify the amount to be withheld, if any, when the withholding agent lacks knowledge at the time of payment (e.g., lack of reliable knowledge regarding the status of the payee or beneficial owner, addressed in §1.1441–1(b)(3), or lack of knowledge regarding the amount of original issue discount under §1.1441–2(b)(3)).

(2) *Withholding on certain gains.* Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim regarding the amount of gain described in §1.1441–2(c) if the beneficial owner withholding certificate, or other appropriate withholding certificate, states the beneficial owner's basis in the property giving rise to the gain. In the absence of a reliable representation on a withholding certificate, the withholding agent must withhold an amount under §1.1441–1 that is necessary to assure that the tax withheld is not less than 30 percent (or other applicable percentage) of the recognized gain. For this purpose, the recognized gain is determined without regard to any deduction allowed by the Code from the gains. The amount so withheld shall not exceed 30 percent of the amount payable by reason of the transaction giving rise to the recognized gain. See §1.1441–1(b)(8) regarding adjustments in the case of overwithholding.

(e) *Payments other than in U.S. dollars*—(1) *In general.* The amount of a payment made in a medium other than U.S. dollars is measured by the fair market value of the property or services provided in lieu of U.S. dollars. The withholding agent may liquidate the property prior to payment in order to withhold the required amount of tax under section 1441 or obtain payment of the tax from an alternative source. However, the obligation to withhold under section 1441 is not deferred even if no alternative source can be located. Thus, for purposes of withholding under chapter 3 of the Code, the provisions of §31.3406(h)–2(b)(2)(ii) of this chapter (relating to backup withholding from another source) shall not apply. If the withholding agent satisfies the tax liability related to such payments, the rules of paragraph (f) of this section apply.

(2) *Payments in foreign currency.* If the amount subject to withholding tax is paid in a currency other than the U.S. dollar, the amount of withholding under section 1441 shall be determined by applying the applicable rate of withholding to the foreign currency amount and converting the amount withheld into U.S. dollars on the date of payment at the spot rate (as defined in §1.988–1(d)(1)) in effect on that date. A withholding agent making regular or frequent payments in foreign currency may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently for all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner. The U.S. dollar amount so determined shall be treated by the beneficial owner as the amount of tax paid on the income for purposes of determining the final U.S. tax liability and, if applicable, claiming a refund or credit of tax.

(f) *Tax liability of beneficial owner satisfied by withholding agent*—(1) *General rule.* In the event that the satisfaction of a tax liability of a beneficial owner by a withholding agent constitutes income to the beneficial owner and such income is of a type that is subject to withholding, the amount of the payment deemed made by the withholding agent for purposes of this paragraph (f) shall be determined under the gross-up formula provided in this paragraph (f)(1). Whether the payment of the tax by the withholding agent constitutes a satisfaction of the beneficial owner's tax liability and whether, as such, it constitutes additional income to the beneficial owner, must be determined under all the facts and circumstances surrounding the transaction, including any agreements between the parties and applicable law. The formula described in this paragraph (f)(1) is as follows:

$$\text{Payment} = \frac{\text{Gross payment without withholding}}{\text{1-(tax rate)}}$$

(2) *Example.* The following example illustrates the provisions of this paragraph (f):

Example. College X awards a qualified scholarship within the meaning of section 117(b) to foreign student, FS, who is in the United States on an F visa. FS is a resident of a country that does not have an income tax treaty with the United States. The scholarship is $20,000 to be applied to tuition, mandatory fees and books, plus benefits in kind consisting of room and board and roundtrip air transportation. College X agrees to pay any U.S. income tax owed by FS with respect to the scholarship. The fair market value of the room and board measured by the amount College X charges non-scholarship students is $6,000. The cost of the roundtrip air transportation is $2,600. Therefore, the total fair market value of the scholarship received by FS is $28,600. However, the amount taxable is limited to the fair market value of the benefits in kind ($8,600) because the portion of the scholarship amount for tuition, fees, and books is not included in gross income under section 117. The applicable rate of withholding is 14 percent under section 1441(b). Therefore, under the gross-up formula, College X is deemed to make a payment of $10,000 ($8,600 divided by (1–.14). The U.S. tax that must be deducted and withheld from the payment under section 1441(b) is $1,400 (.14 × $10,000). College X reports scholarship income of $30,000 and $1,400 of U.S. tax withheld on Forms 1042 and 1042–S.

* * * * *

(h) *Effective date.* Except as otherwise provided in paragraph (g) of this section, this section applies to payments made after December 31, 1998.

Par. 9. Section 1.1441–4 is amended by:

1. Revising the section heading, and paragraph (a).

2. Paragraph (b)(1) is amended by:

a. Revising of paragraphs (b)(1)(i) and (b)(1)(ii).

b. Removing the period at the end of paragraph (b)(1)(iii) and adding a semicolon in its place.

c. Removing the language "or" at the end of paragraph (b)(1)(iv) and adding a semicolon in its place.

d. Removing the period at the end of paragraph (b)(1)(v) and adding " ; or" in its place.

e. Adding paragraph (b)(1)(vi).

3. Adding four sentences at the end of paragraph (b)(2)(i).

4. Paragraph (b)(2)(ii) is amended by:

a. Revising paragraph (b)(2)(ii) heading and introductory text, and paragraph (b)(2)(ii)(A).

b. Redesignating paragraph (b)(2)(ii)(H) as paragraph (b)(2)(ii)(J) and amending newly designated paragraph (b)(2)(ii)(J) by removing the period and adding "; and" in its place.

c. Redesignating paragraphs (b)(2)(ii)(B), (C), (D), (E), (F) and (G) as paragraphs (b)(2)(ii)(D), (E), (F), (G), (H) and (I), respectively.

d. Adding new paragraphs (b)(2)(ii)(B), (C), and (K).

e. Removing the period at the end of newly designated paragraph (b)(2)(ii)(D) and the comma at the end of newly designated paragraphs (b)(2)(ii)(E), (F), (G), and (H) and adding a semicolon in each place.

f. Removing the language ", and" and adding a semicolon in its place in newly designated paragraph (b)(2)(ii)(I).

5. Removing the concluding text immediately following paragraph (b)(2)(iv)(C).

6. Revising paragraph (b)(2)(v).

7. Removing the language "statement" and adding the language "withholding certificate" in each place in paragraph (b)(2)(i).

8. Removing the language "Director of the Foreign Operations District" in paragraphs (b)(2)(i) fourth sentence, (b)(2)(iii) fourth and fifth sentences, and (b)(3) first sentence, and adding the language "Assistant Commissioner (International)" in each place.

9. Adding paragraph (b)(6).

10. Revising paragraphs (c), (d), (e), (f), and (g) .

11. Removing paragraphs (h) and (i).

12. Removing the OMB parenthetical and the authority citation at the end of the section.

The revisions and additions read as follows:

§1.1441–4 Exemptions from withholding for certain effectively connected income and other amounts.

(a) *Certain income connected with a U.S. trade or business*—(1) *In general.* No withholding is required under section 1441 on income otherwise subject to withholding if the income is (or is deemed to be) effectively connected with the conduct of a trade or business within the United States and is includible in the beneficial owner's gross income for the taxable year. For purposes of this paragraph (a), an amount is not deemed to be includible in gross income if the amount is (or is deemed to be) effectively connected with the conduct of a trade or business within the United States and the beneficial owner claims an exemption from tax under an income tax treaty because the income is not attributable to a permanent establishment in the United States. To claim a reduced rate of withholding because the income is not attributable to a permanent establishment, see §1.1441–6(b)(1). This paragraph (a) does not apply to income of a foreign corporation to which section 543(a)(7) applies for the taxable year or to compensation for personal services performed by an individual. See paragraph (b) of this section for compensation for personal services performed by an individual.

(2) *Withholding agent's reliance on a claim of effectively connected income*—(i) *In general.* Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim of exemption based upon paragraph (a)(1) of this section if, prior to the payment to the foreign person, the withholding agent can reliably associate the payment with a Form W–8 upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii). For purposes of this paragraph (a), a withholding certificate is valid only if, in addition to other applicable requirements, it includes the taxpayer identifying number of the person whose name is on the Form W–8 and represents, under penalties of perjury, that the amounts for which the certificate is furnished are effectively connected with the conduct of a trade or business in the United States. In the absence of a reliable claim that the income is effectively connected with the conduct of a trade or business in the United States, the income is presumed not to be effectively connected, except as otherwise provided in paragraph (a)(2)(ii) or (3) of this section. See §1.1441–1(e)(4)(ii)(C) for the period of validity applicable to a certificate provided under this section and §1.1441–1(e)(4)(ii)(D) for changes in circumstances arising during the taxable year indicating that the income to which the certificate relates is not, or is no longer expected to be, effectively connected with the conduct of a trade or business within the United States. A withholding certificate shall be effective only for the item or items of income specified therein. The provisions of §1.1441–1(b)(3)(iv) dealing with a 90-day grace period shall apply for purposes of this section.

(ii) *Special rules for U.S. branches of foreign persons*—(A) *U.S. branches of certain foreign banks or foreign insurance companies.* A payment to a U.S. branch described in §1.1441–1(b)(2)(iv)(A) is presumed to be effectively connected with the conduct of a trade or business in the United States without the need to furnish a certificate, unless the U.S. branch provides a U.S. branch withholding certificate described in §1.1441–1(e)(3)(v) that represents otherwise. If no certificate is furnished but the income is not, in fact, effectively connected income, then the branch must withhold whether the payment is collected on behalf of other persons or on behalf of another branch of the same entity. See §1.1441–1(b)(2)(iv) and (6) for general rules applicable to payments to U.S. branches of foreign persons.

(B) *Other U.S. branches.* See §1.1441–1(b)(2)(iv)(E) for similar procedures for other U.S. branches to the extent provided in a determination letter from the district director or the Assistant Commissioner (International).

(3) *Income on notional principal contracts*—(i) *General rule.* A withholding agent that pays amounts attributable to a notional principal contract described in §1.863–7(a) or 1.988–2(e) shall have no obligation to withhold on the amounts paid under the terms of the notional principal contract regardless of whether a

withholding certificate is provided. However, a withholding agent must file returns under §1.1461–1(b) and (c) reporting the income that it must treat as paid to a foreign person and as effectively connected with the conduct of a trade or business in the United States under the provisions of this paragraph (a)(3). Except as otherwise provided in paragraph (a)(3)(ii) of this section, a withholding agent must so treat the income unless it can reliably associate the payment with a withholding certificate upon which it can rely to treat the payment as an amount that is not effectively connected. Income on a notional principal contract does not include the amount characterized as interest under the provisions of §1.446–3(g)(4).

(ii) *Exception for certain payments.* A payment to a foreign financial institution (within the meaning of §1.165–12(c)-(1)(iv)) shall not be treated as effectively connected with the conduct of a trade or business within the United States for purposes of paragraph (a)(3)(i) of this section even if no withholding certificate is furnished if the payee provides a representation in a master agreement that governs the transactions in notional principal contracts between the parties (for example an International Swaps and Derivatives Association (ISDA) Agreement, including the Schedule thereto) or in the confirmation on the particular notional principal contract transaction that the counterparty is a U.S. person or a non-U.S. branch of a foreign person.

(b) * * * (1) * * *

(i) Such compensation is subject to withholding under section 3402 (relating to withholding on wages) and the regulations under that section;

(ii) Such compensation would be subject to withholding under section 3402 but for the provisions of section 3401(a) (not including paragraph (a)(6) of that section) and the regulations under that section. This paragraph (b)(1)(ii) does not apply to payments to a nonresident alien individual from any trust described in section 401(a), any annuity plan described in section 403(a), or any annuity, custodial account, or retirement income account described in section 403(b). Instead, these payments are subject to withholding under this section to the extent they are exempted from the definition of wages under section 3401(a)(12) or to the extent they are from an annuity, custodial account, or retirement income account described in section 403(b). Thus, for example, payments to a nonresident alien individual from a trust described in section 401(a) are subject to withholding under section 1441 and not under section 3405 or 3406;

* * * * *

(vi) Compensation that is exempt from withholding under section 3402 by reason of section 3402(e), provided that the employee and his employer enter into an agreement under section 3402(p) to provide for the withholding of income tax upon payments of amounts described in §31.3401(a)–3(b)(1) of this chapter. An employee who desires to enter into such an agreement should furnish his employer with Form W–4 (withholding exemption certificate) (or such other form as the Internal Revenue Service (IRS) may prescribe). See section 3402(f) and the regulations thereunder and §31.3402(p)–1 of this chapter.

(2) * * * (i) * * * The withholding agent may rely on an accepted withholding certificate only if the IRS has not objected to the certificate. For purposes of this paragraph (b)(2)(i), the IRS will be considered to have not objected to the certificate if it has not notified the withholding agent within a 10-day period beginning from the date that the withholding certificate is forwarded to the IRS pursuant to paragraph (b)(2)(v) of this section. After expiration of the 10-day period, the withholding agent may rely on the withholding certificate retroactive to the date of the first payment covered by the certificate. The fact that the IRS does not object to the withholding certificate within the 10-day period provided in this paragraph (b)(2)(i) shall not preclude the IRS from examining the withholding agent at a later date in light of facts that the withholding agent knew or had reason to know regarding the payment and eligibility for a reduced rate and that were not disclosed to the IRS as part of the 10-day review process.

(ii) *Withholding certificate claiming withholding exemption.* The statement claiming an exemption from withholding shall be made on Form 8233 (or an acceptable substitute or such other form as the IRS may prescribe). Form 8233 shall be dated, signed by the beneficial owner under penalties of perjury, and contain the following information—

(A) The individual's name, permanent residence address, taxpayer identifying number (or a copy of a completed Form W–7 or SS–5 showing that a number has been applied for), and the U.S. visa number, if any;

(B) The individual's current immigration status and visa type;

(C) The individual's original date of entry into the United States;

* * * * *

(K) Any other information as may be required by the form or accompanying instructions in addition to, or in lieu of, the information described in this paragraph (b)(2)(ii).

* * * * *

(v) *Copies of Form 8233.* The withholding agent shall forward one copy of each Form 8233 that is accepted under paragraph (b)(2)(iv) of this section to the Assistant Commissioner (International), within five days of such acceptance. The withholding agent shall retain a copy of Form 8233.

* * * * *

(6) *Personal exemption*—(i) *In general.* To determine the tax to be withheld at source under §1.1441–1 from remuneration paid for personal services performed within the United States by a nonresident alien individual and from scholarship and fellowship income described in paragraph (c) of this section, a withholding agent may take into account one personal exemption pursuant to sections 873(b)(3) and 151 regardless of whether the income is effectively connected. For purposes of withholding under section 1441 on remuneration for personal services, the exemption must be prorated upon a daily basis for the period during which the personal services are performed within the United States by the nonresident alien individual by dividing by 365 the number of days in the period during which the individual is present in the United States for the purpose of performing the services and multiplying the result by the amount of the personal exemption in effect for the taxable year. See §31.3402(f)(6)–1 of this chapter.

(ii) *Multiple exemptions.* More than one personal exemption may be claimed

in the case of a resident of a contiguous country or a national of the United States under section 873(b)(3). In addition, residents of a country with which the United States has an income tax treaty in effect may be eligible to claim more than one personal exemption if the treaty so provides. Claims for more than one personal exemption shall be made on the withholding certificate furnished to the withholding agent. The exemption must be prorated on a daily basis in the same manner as described in paragraph (b)(6)(i) of this section.

(iii) *Special rule where both certain scholarship and compensation income are received.* The fact that both non-compensatory scholarship income and compensation income (including compensatory scholarship income) are received during the taxable year does not entitle the taxpayer to claim more than one personal exemption amount (or more than the additional amounts permitted under paragraph (b)(6)(ii) of this section). Thus, if a nonresident alien student receives non-compensatory taxable scholarship income from one withholding agent and compensation income from another withholding agent, no more than the total personal exemption amount permitted under the Internal Revenue Code or under an income tax treaty may be taken into account by both withholding agents. For this purpose, the withholding agent may rely on a representation from the beneficial owner that the exemption amount claimed does not exceed the amount permissible under this section.

(c) *Special rules for scholarship and fellowship income*—(1) *In general.* Under section 871(c), certain amounts paid as a scholarship or fellowship for study, training, or research in the United States to a nonresident alien individual temporarily present in the United States as a nonimmigrant under section 101(a)(15)(F), (J), (M), or (Q) of the Immigration and Nationality Act are treated as income effectively connected with the conduct of a trade or business within the United States. The amounts described in the preceding sentence are those amounts that do not represent compensation for services. Such amounts (as described in the second sentence of section 1441(b)) are subject to withholding under section 1441, but at the lower rate of 14 percent. That rate may be reduced under the provisions of an income tax treaty. Claims of a reduced rate under an income tax treaty shall be made under the procedures described in §1.1441–6(b)(1). Therefore, claims for reduction in withholding under an income tax treaty on amounts described in this paragraph (c)(1) may not be made on a Form 8233. However, if the payee is receiving both compensation for personal services (including compensatory scholarship income) and non-compensatory scholarship income described in this paragraph (c)(1) from the same withholding agent, claims for reduction of withholding on both types of income may be made on Form 8233.

(2) *Alternate withholding election.* A withholding agent may elect to withhold on the amounts described in paragraph (c)(1) of this section at the rates applicable under section 3402, as if the income were wages. Such election shall be made by obtaining a Form W–4 (or an acceptable substitute or such other form as the IRS may prescribe) from the beneficial owner. The fact that the withholding agent asks the beneficial owner to furnish a Form W–4 for such fellowship or scholarship income or to take such income into account in preparing such Form W–4 shall serve as notice to the beneficial owner that the income is being treated as wages for purposes of withholding tax under section 1441.

(d) *Annuities received under qualified plans.* Withholding is not required under section §1.1441–1 in the case of any amount received as an annuity if the amount is exempt from tax under section 871(f) and the regulations under that section. The withholding agent may exempt the payment from withholding if, prior to payment, it can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner in accordance with §1.1441–1(e)(1)(ii). A beneficial owner withholding certificate furnished for purposes of claiming the benefits of the exemption under this paragraph (d) is valid only if, in addition to other applicable requirements, it contains a taxpayer identifying number.

(e) *Per diem of certain alien trainees.* Withholding is not required under section 1441(a) and §1.1441–1 on per diem amounts paid for subsistence by the United States Government (directly or by contract) to any nonresident alien individual who is engaged in any program of training in the United States under the Mutual Security Act of 1954, as amended (22 U.S.C. chapter 24). This rule shall apply even though such amounts are subject to tax under section 871. Any exemption from withholding pursuant to this paragraph (e) applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6041 and backup withholding under section 3406. The exemption from withholding granted by this paragraph (e) is not a determination that the amounts are not fixed or determinable annual or periodical income.

(f) *Failure to receive withholding certificates timely or to act in accordance with applicable presumptions.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold an appropriate withholding certificate or other appropriate documentation at the time of payment or does not act in accordance with applicable presumptions described in paragraph (a)(2)(i), (2)(ii), or (3) of this section.

(g) *Effective date*—(1) *General rule.* This section applies to payments made after December 31, 1998.

(2) *Transition rules.* A withholding agent that on December 31, 1998, holds a Form 4224 or 8233 that is a valid certificate as determined under the regulations in effect prior to January 1, 1999 (see CFR part 1 revised, April 1, 1997), may treat the certificate as a valid withholding certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a withholding certificate or statement that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstand-

ing the three preceding sentences, a withholding agent may choose to not take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

§1.1441–4T [Removed]

Par. 10. Section 1.1441–4T is removed.

Par. 11. Sections 1.1441–5 and 1.1441–6 are revised to read as follows:

§1.1441–5 Withholding on payments to partnerships, trusts, and estates.

(a) *Rules of withholding applicable to payments to partnerships.* This paragraph (a) describes the determinations that a withholding agent must make when making a payment to a person that may be a partnership (as defined in §1.1441–1(c)-(6)(ii)(C)). Such determinations are made in order to determine a withholding agent's obligations under chapters 3 and 61 of the Internal Revenue Code (Code) and sections 3402, 3405, and 3406 (and applicable regulations under those provisions) to withhold and report payments of amounts subject to withholding under chapter 3 of the Code and the regulations thereunder. The reliance provisions stated in this paragraph (a) are subject to the presumptions described in §1.1441–1(b)(3) and paragraph (d) of this section, including §1.1441–1(b)(3)(ix) regarding the withholding agent's actual knowledge or reason to know that the presumptions are not correct. For similar presumptions for reporting and withholding on amounts not subject to withholding under chapter 3 of the Code (e.g., foreign source income, broker proceeds) that may be paid to a foreign partnership, see §1.6049–5(d)(2) through (5).

(1) The withholding agent must determine whether the payee is a U.S. or a foreign person. For this purpose, the withholding agent may treat the payee as U.S. or foreign if it can reliably associate the payment with a Form W–9 described in §1.1441–1(d) or a Form W–8 described in §1.1441–1(e)(2)(i) or (3)(i). In the absence of documentation, see §1.1441–1-(b)(3) and paragraph (d) of this section for applicable presumptions of foreign or U.S. status and other relevant characteristics.

(2) If the payee is determined to be a foreign person, the withholding agent must determine whether the foreign payee is acting for its own account or for the account of others (i.e., as an intermediary, as defined in §1.1441–1(e)(3)(i)). The withholding agent may treat the payee as a foreign intermediary if it can reliably associate the payment with a Form W–8 described in §1.1441–1(e)(3)(ii), (iii), or (v), within the meaning of §1.1441–1(b)-(3)(v)(A).

(3) If the foreign payee is determined to act as an intermediary described in §1.1441–1(e)(3)(i), the withholding agent must determine whether or not the payee is a qualified intermediary. The withholding agent may treat the payee as a qualified intermediary only if it can reliably associate the payment with a Form W–8 described in §1.1441–1(e)(3)(ii). A foreign payee that is treated as an intermediary with respect to a payment is subject to the provisions applicable to intermediaries in §1.1441–1(e)(3) or (5). In such a case, the provisions of paragraph (c) of this section do not apply to the payment.

(4) If the foreign payee is determined to act for its own account (or is so presumed), the withholding agent must determine the status of the payee as a partnership. The withholding agent may treat the payee as a domestic or as a foreign partnership if it can reliably associate the payment with a Form W–9 furnished in accordance with §1.1441–1(d)(2) or (4) (for a domestic partnership) or a Form W–8 described in paragraph (c)(2)(iv) or (3)(iii) of this section (for a foreign partnership). See §1.1441–1(e)(4)(viii) for reliance on the payee's representations on a Form W–8. In the absence of documentation, see §1.1441–1(b)(3)(ii) and paragraph (d)(2) of this section for applicable presumptions of status.

(5) If the foreign payee is determined to be a foreign partnership and the withholding agent has determined (or presumes) that the partnership is acting for the account of its partners, then the withholding agent must determine whether the payment represents income effectively connected with the partnership's conduct of a U.S. trade or business. The withholding agent may treat the payment as effectively connected if it can reliably associate the payment with a Form W–8 described in paragraph (c)(3)(iii) of this section representing that the income is effectively connected or if it so presumes in accordance with the provisions in §1.1441–4(a)(2)(ii) or (3). In the absence of documentation, the payment is generally presumed to be non-effectively connected. See §1.1441–4(a)(2)(i). See §§1.1461–1(c)(2)(ii)(A), 1.6031–1 and 1.6031(b)–1T for reporting requirements applicable to the withholding agent and to the partnership.

(6) If the withholding agent cannot reliably treat the payment as effectively connected income nor presume that it is so connected, then the withholding agent must determine whether the partnership is a withholding foreign partnership described in paragraph (c)(2)(i) of this section. The withholding agent may treat the foreign partnership as a withholding partnership if it can reliably associate the payment with a Form W–8 described in paragraph (c)(2)(iv) of this section. In the absence of a reliable Form W–8, the foreign partnership is presumed to be a non-withholding foreign partnership described in paragraph (c)(3)(i) of this section. In such a case, under paragraph (c)(1)(i) of this section, the withholding agent must treat the partners, rather than the partnership, as payees. See paragraph (d) of this section for determining the status of the partners as U.S. or foreign persons in the absence of documentation. See §§1.1461–1(c)(2)(ii)(A), 1.6031–1 and 1.6031(b)–1T for reporting requirements applicable to the withholding agent and to the partnership.

(7) If the withholding agent determines that the payee is a U.S. partnership, or so presumes in accordance with paragraph (d)(2) of this section in the absence of documentation, the withholding agent is not required to withhold under paragraph (b)(1) of this section because the partnership is treated as a U.S. payee. See paragraph (b)(2) of this section for withholding requirements applicable to a domestic partnership with foreign partners. See §§1.1461–1(c)(2)(ii)(A), 1.6031–1 and 1.6031(b)–1T for reporting requirements applicable to the withholding agent and to the partnership.

(8) In order to determine whether to rely on a claim for a reduced rate under a tax treaty by a person that the withholding agent treats as a partnership or as a partner in a partnership, the withholding

agent must apply the provisions of §1.894–1T(d). For applicable procedures regarding reliance by a withholding agent on a claim for benefits under a tax treaty in such a situation, see §1.1441–6(b)(4).

(b) *Domestic partnerships*—(1) *Exemption from withholding on payment to domestic partnerships.* A payment to a person that the withholding agent may treat as a domestic partnership is treated as a payment to a U.S. payee. Therefore, a payment to a domestic partnership is not subject to withholding under section 1441 even though it may have partners that are foreign persons. A withholding agent may treat the person to whom the payment is made as a domestic partnership if it can reliably associate the payment with a Form W–9 furnished by the partnership in accordance with the procedures under §1.1441–1(d)(2) or (4) or based upon the presumptions described in paragraph (d)(2) of this section.

(2) *Withholding by a domestic partnership*—(i) *In general.* A domestic partnership is required to withhold under §1.1441–1 as a withholding agent on the gross amount of items of income subject to withholding that are includible in the distributive share of income of a partner that is a foreign person. Pursuant to the authority provided under section 702(a), each partner shall take into account separately its distributive share of amounts subject to withholding, and thus the partnership, pursuant to section 703(a)(1), shall separately state these amounts when computing its taxable income. A partnership shall withhold when any distributions that include amounts subject to withholding are made or when guaranteed payments are made. To the extent a foreign partner's distributive share of an amount subject to withholding has not been actually distributed, the partnership is required to withhold on the partner's distributive share of that amount on the earlier of the date that the statement required under section 6031(b) and §1.6031(b)–1T to be provided to that partner is mailed or otherwise furnished to the partner or the due date for furnishing that statement as provided under §1.6031(b)–1T. If a partnership withholds on a distributive share before the amount is actually distributed to the partner, then withholding is not required when the amount is subsequently distributed. Withholding on items of income that are effectively connected income in the hands of the partners who are foreign persons is governed by section 1446 and not by this section. In such a case, partners in a domestic partnership are not required to furnish a withholding certificate in order to claim an exemption from withholding under section 1441(c)(1) and §1.1441–4.

(ii) *Determination by the domestic partnership of the partners' status.* For purposes of determining whether the partners or some other persons are the payees of the partners' distributive shares of any payment made to the partnership and the status of the partners, the partnership shall apply the rules of §1.1441–1(b)(2) and (3), and of paragraphs (c)(1) and (d) of this section (in the case of a partner that is a foreign partnership) and of paragraph (e) of this section (in the case of a partner that is a foreign estate or a foreign trust) in the same manner as if the partnership were making a payment directly to the partners other than in their capacity as partners.

(iii) *Reliance on a partner's claim for reduced withholding.* Absent actual knowledge or reason to know otherwise, a domestic partnership may rely on a claim for reduced withholding under chapter 3 of the Code by a partner, if prior to the time the partnership is required to withhold, the partnership can reliably associate the partner's distributive share of the partnership items with documentation upon which it may rely to treat the partner or another person as a U.S. person under §1.1441–1(d)(2) or (3), as a U.S. beneficial owner under §1.1441–1(d)(4), or as a foreign beneficial owner under §1.1441–1(e)(1)(ii).

(iv) *Rules for reliably associating a payment with documentation.* For rules regarding the reliable association of a payment with documentation, see §1.1441–1(b)(2)(vii).

(v) *Coordination with chapter 61 of the Internal Revenue Code and section 3406.* A domestic partnership is not a payor for purposes of chapter 61 of the Code or section 3406 with respect to payments to its partners in their capacity as partners. Thus, it is not required to make an information return on Form 1099 nor to backup withhold with respect to its partners' distributive share of partnership items. However, it must file returns under section 6031. Such returns are in lieu of making returns under §1.1461–1(b) and (c). See §1.1461–1(c)(2)(ii)(A).

(c) *Foreign partnerships*—(1) *Determination of payee*—(i) *Payments treated as made to partners.* Except as otherwise provided in paragraph (c)(1)(ii) of this section, a payment to a person that the withholding agent may treat as a foreign partnership in accordance with paragraph (c)(2)(i), (3)(i), or (d)(2) of this section is treated as a payment to the partners (looking through partners that are foreign flow-through entities) as follows—

(A) If the withholding agent can reliably associate the partner's distributive share of the payment with a Form W–9, a Form W–8, or other appropriate documentation upon which it can rely to treat the payment as made to a U.S. or foreign beneficial owner under §1.1441–1(d)(4) or (e)(1)(ii), then the beneficial owner so identified is treated as the payee;

(B) If the withholding agent can reliably associate the partner's distributive share with an intermediary certificate described in §1.1441–1(e)(3)(ii), (iii), or (v), then the rules of §1.1441–1(b)(2)(v) shall apply to determine who the payee is in the same manner as if the partner's distributive share of the payment had been paid directly to such intermediary;

(C) If the withholding agent can reliably associate the partner's distributive share with a partnership certificate described in paragraph (c)(2)(iv) or (3)(iii) of this section, then the rules of paragraph (c)(1)(i) or (ii) of this section shall apply to determine whether the payment is treated as made to the partners of the higher-tier partnership under this paragraph (c)(1)(i) or to the higher tier partnership (under the rules of paragraph (c)(1)(ii) of this section), in the same manner as if the partner's distributive share of the payment had been paid directly to such foreign partnership;

(D) If the withholding agent can reliably associate the partner's distributive share with a withholding certificate described in §1.1441–1(e)(3)(i) regarding a foreign trust or estate, then the rules of paragraph (e) of this section shall apply to determine who the payees are; and

(E) If the withholding agent cannot reliably associate the partner's distributive share with a withholding certificate or

other appropriate documentation, the partners are considered to be the payees and the presumptions described in paragraph (d)(3) of this section shall apply to determine the status of the partners.

(ii) *Payments treated as made to the partnership.* A payment to a person that the withholding agent may treat as a foreign partnership in accordance with paragraph (c)(2)(i), (3)(i), or (d)(2) of this section is treated as a payment to the foreign partnership and not to its partners only if—

(A) The withholding agent can reliably associate the payment with a withholding certificate described in paragraph (c)(2)(iv) of this section (dealing with a certificate from a person representing to be a withholding foreign partnership); or

(B) The withholding agent can reliably associate the payment with a withholding certificate described in paragraph (c)(3)(iii) of this section certifying that the payment is income that is effectively connected with the conduct of a trade or business in the United States.

(iii) *Rules for reliably associating a payment with documentation.* For rules regarding the reliable association of a payment with documentation, see §1.1441–1(b)(2)(vii). In the absence of documentation, see §1.1441–1(b)(3) and paragraph (d) of this section for applicable presumptions.

(iv) *Example.* The rules of paragraphs (c)(1)(i) and (ii) of this section are illustrated by the following example:

Example. (i) *Facts.* A foreign partnership, P, has two partners, a corporation, C, and a partnership, P1, both organized in country X. P1 has three partners, a foreign pension fund, a domestic partnership, P2, and a foreign partnership, P3, organized in country Y. P2's partners are foreign pension funds. P holds U.S. Treasury obligations in registered form, on which it receives interest from U.S. custodian, Z. P1 is not a withholding foreign partnership and it does not certify that the interest is effectively connected with the conduct of a U.S. trade or business. P3 is a withholding foreign partnership. P has furnished a valid withholding certificate described in paragraph (c)(3)(iii) of this section to which it has attached valid withholding certificates for C (beneficial owner Form W–8 described in §1.1441–1(e)(2)(i)), P1, and P1's three partners (a Form W–9 for P2, a withholding certificate described in paragraph (c)(2)(iv) of this section for P3 and a beneficial owner Form W–8 described in §1.1441–1(e)(2)(i) for the foreign pension fund). P has furnished appropriate information in accordance with paragraph (c)(3)(iv) of this section upon which the withholding agent can rely to determine which portion of the payment is associated with each withholding certificate.

(ii) *Analysis.* The payment to P is treated as a payment to its partners because none of the conditions described in paragraph (c)(1)(ii) exist under the facts to treat P as the payee (i.e., it is not a withholding foreign partnership and, although it has furnished a withholding certificate described under paragraph (c)(3)(iii) of this section, it is not claiming that the interest is effectively connected with the conduct of a U.S. trade or business). Under paragraph (c)(1)(i)(A) of this section, C, as a partner of P, is treated as a payee because it is not a flow-through entity or an intermediary (based on the documentation furnished for C). Under paragraph (c)(1)(i)(C) of this section, P1 is not treated as a payee because it is a foreign partnership and none of the conditions described under paragraph (c)(1)(ii) of this section exist under the facts to treat P as the payee. Instead, P2 (under paragraph (c)(1)(i)(A) of this section), P3 (under paragraph (c)(1)(ii)(A) of this section), and the foreign pension fund that is a partner of P1 (under paragraph (c)(1)(i)(A) of this section), are treated as the payees of P1's distributive share of the payment to P. P2 is a payee because, although a flow-through entity, it is a domestic partnership (see paragraph (b)(1) of this section). P3 is treated as a payee under paragraph (c)(1)(ii)(A) of this section, irrespective of who its partners are, because it has furnished a valid withholding certificate as a withholding foreign partnership. The foreign pension fund is treated as a payee under paragraph (c)(1)(i)(A) of this section because it has furnished a beneficial owner Form W–8 described in §1.1441–1(e)(2)(i).

(2) *Withholding foreign partnerships*—(i) *Reliance on claim of withholding foreign partnership status.* A withholding foreign partnership is a foreign partnership that has entered into an agreement with the Internal Revenue Service (IRS), as described in paragraph (c)(2)(ii) of this section. A withholding agent that can reliably associate a payment with a certificate described in paragraph (c)(2)(iv) of this section may treat the person to whom it makes the payment as a withholding foreign partnership for purposes of withholding under chapter 3 of the Code, information reporting under chapter 61 of the Code, backup withholding under section 3406, and withholding under other provisions of the Internal Revenue Code. Furnishing such a certificate is in lieu of transmitting to a withholding agent withholding certificates or other appropriate documentation for its partners. Although the withholding foreign partnership generally will be required to obtain withholding certificates or other appropriate documentation from its partners pursuant to its agreement with the IRS, it is not required to attach such documentation to the partnership withholding certificate.

(ii) *Withholding agreement*—(A) *In general.* A foreign partnership may claim withholding foreign partnership status before an agreement is executed with the IRS if it has applied for such status and the IRS authorizes such status on an interim basis under such procedures as the IRS may issue. A withholding foreign partnership must file a partnership return under section 6031(a) to the extent required under the regulations under that section and furnish statements on Form K–1 to its partners under section 6031(b) to the extent required under the regulations under that section. See §§1.6031–1 and 1.6031(b)–1T. See §1.1461–1(c)-(2)(ii)(A) for an exemption from filing Forms 1042 and 1042-S. A foreign withholding partnership that wishes to also be a qualified intermediary under §1.1441–1(e)(5) for payments it receives for persons other than its partners may combine both agreements into one single agreement.

(B) *Terms of withholding agreement.* The IRS may, upon request, enter into a withholding agreement with a foreign partnership pursuant to such procedures as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). Under such withholding agreement, a foreign partnership shall generally be subject to the applicable withholding and reporting provisions applicable to withholding agents and payors under chapters 3 and 61 of the Code, and section 3406, and the regulations under those provisions, and other withholding provisions of the Code, except to the extent provided under the agreement. In particular, the agreement must include provisions for reporting of information on Form 1065 and furnishing K–1 statements to the partners in the manner required under section 6031 and the regulations under that section. Under the agreement, a foreign partnership may agree to act as an acceptance agent to perform the duties described in §301.6109–1(d)(3)(iv)(A) of this chapter. The agreement may specify the manner in which applicable procedures for adjustments for underwithholding and overwithholding, including refund procedures apply to the foreign partnership and its partners and the extent to which applicable procedures may be modified. In particular, a withholding agreement may allow a qualified intermediary to claim refunds of overwithheld amounts on behalf of its customers. In addition, the agreement must specify the manner in which the IRS will audit the foreign partnership's books and records in order to verify

the accuracy of the Forms 1065 filed by the partnership and K–1 statements furnished to the partners as required under section 6031 and the regulations under that section. The agreement shall also specify the assets that the foreign partnership has in the United States or alternative means of collection, if necessary.

(iii) *Withholding responsibility.* A withholding foreign partnership must assume primary withholding responsibility for all payments that are made to it and, therefore, is not required to provide information to the withholding agent regarding each partner's distributive share of the payment (see paragraph (c)(3)(iv) of this section for the requirement to provide distributive share information to the withholding agent in the case of other foreign partnerships). The partnership shall be a withholding agent with respect to each of its partner's distributive share of income subject to withholding that is paid to the partnership. Therefore, the withholding agent is not required to withhold any amount under chapter 3 of the Code on a payment to a foreign partnership that has furnished a withholding certificate representing that it is a withholding foreign partnership, unless it has actual knowledge or reason to know that the certificate is incorrect. The foreign partnership shall withhold the payments under the same procedures and at the same time as is prescribed for withholding by a domestic partnership under paragraph (b)(2) of this section, except that, for purposes of determining the partner's status, the provisions of paragraph (d)(4)(iv) of this section shall apply and paragraph (b)(2)(ii) of this section shall not apply.

(iv) *Withholding certificate from a withholding foreign partnership.* The rules of §1.1441–1(e)(4) shall apply to withholding certificates described in this paragraph (c)(2)(iv). A withholding certificate furnished by a withholding foreign partnership is valid with regard to any partner on whose behalf the certificate is furnished only if it is furnished on a Form W–8 (or an acceptable substitute form or such other form as the IRS may prescribe), it is signed under penalties of perjury by a partner with authority to sign for the partnership, its validity has not expired, and it contains the information, statement, and certifications described in this paragraph (c)(2)(iv) as follows—

(A) The name, permanent residence address (as described in §1.1441–1(e)-(2)(ii)), and the employer identification number of the partnership, and the country under the laws of which the partnership is created or governed;

(B) A certification that the partnership is a withholding foreign partnership within the meaning of paragraph (c)(2)(i) of this section; and

(C) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (c)(2)(iv).

(3) *Other foreign partnerships*—(i) *Reliance on claim of foreign partnership status.* A withholding agent that can reliably associate a payment with a certificate described in paragraph (c)(3)(iii) of this section may treat the person to whom it makes the payment as a foreign partnership that is not a withholding foreign partnership. Such reliance is permitted for purposes of withholding under chapter 3 of the Code, information reporting under chapter 61 of the Code, backup withholding under section 3406, and withholding under other provisions of the Internal Revenue Code. For purposes of this paragraph (c)(3)(i), a payment that the withholding agent can reliably associate with a withholding certificate described in paragraph (c)(3)(iii) of this section that would be valid except for the fact that some or all of the withholding certificates or other appropriate documentation required to be attached are lacking or are unreliable, or that information for allocating the payment among the partners is lacking or is unreliable, shall nevertheless be treated as a payment to a foreign partnership.

(ii) *Reliance on claim of reduced withholding by a partnership for its partners.* This paragraph (c)(3)(ii) describes the manner in which a withholding agent may rely on a claim of reduced withholding when making a payment to a foreign partnership that is not a withholding foreign partnership. To the extent that a withholding agent treats a payment to a foreign partnership as a payment to its partners in accordance with paragraph (c)(1) of this section, it may rely on a claim for reduced withholding by a partner if, prior to the payment, the withholding agent can reliably associate the payment with a withholding certificate described in paragraph (c)(3)(iii) of this section pertaining to the partner unless the withholding agent has actual knowledge or reason to know that the withholding certificate is unreliable. The certificate will be considered to pertain to the partner if the appropriate withholding certificate for the partner is attached to the partnership's withholding certificate. An appropriate withholding certificate for a partner includes a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) or, if applicable, documentary evidence described in §1.1441–6(b)(2)(i) or in §1.6049–5(c)(1) (for a partner claiming to be a foreign person and a beneficial owner, determined under the provisions of §1.1441–1(c)(6)), the applicable certificates described in §1.1441–1(d)(2) or (3) (for a partner claiming to be a U.S. payee), an intermediary withholding certificate described in §1.1441–1(e)(3)(ii) or (iii), a U.S. branch withholding certificate described in §1.1441–1(e)(3)(v), or a partnership withholding certificate described in paragraph (c)(2)(iv) or (3)(iii) of this section. Except where the partnership certificate is provided for income claimed to be effectively connected with the conduct of a trade or business in the United States, a claim must be presented for each portion of the payment that represents an item of income includible in the distributive share of the partner as required under paragraph (c)(3)(iii)(C) of this section. When making a claim for several partners, the partnership may present a single partnership withholding certificate to which the partners' certificates are attached. Where the partnership certificate is provided for income claimed to be effectively connected with the conduct of a trade or business in the United States, the claim may be presented without having to identify the partner's distributive share of the payment if the certificate contains the certification described in paragraph (c)(3)(iii)(E) of this section.

(iii) *Withholding certificate from a foreign partnership that is not a withholding foreign partnership.* A withholding certificate furnished by a foreign partnership that is not a withholding foreign partnership is valid only if it is furnished on a Form W–8 (or an acceptable substitute form or such other form as the IRS may

prescribe), it is signed under penalties of perjury by a partner with authority to sign for the partnership, its validity has not expired, it contains the information, statement, and certifications described in this paragraph (c)(3)(iii), and the withholding certificates or other appropriate documentation for all of the partners are attached (except that certificates for partners are not required to be attached for a certificate furnished solely for income claimed to be effectively connected with the conduct of a trade or business in the United States, regardless of any partner's status as a U.S. person). The rules of §1.1441–1(e)(4) shall apply to withholding certificates described in this paragraph (c)(3)(iii). The information, statement, and certifications required on the withholding certificate are as follows:

(A) The name, permanent residence address (as described in §1.1441–1(e)-(2)(ii)), and the employer identification number of the partnership, and the country under the laws of which the partnership is created or governed.

(B) A representation that the person whose name is on the certificate is a foreign partnership.

(C) A statement attached to the certificate that provides such information as may be required by the form and accompanying instructions, including sufficient information to the withholding agent to determine the amount required to be withheld from amounts paid to the partnership, such as each partner's distributive share of amounts to which the certificate relates, prepared in the manner described in paragraph (c)(3)(iv) of this section. No statement is required for a certificate furnished for income claimed to be effectively connected with the conduct of a trade or business in the United States.

(D) If the withholding certificates are required to be attached to the partnership's withholding certificate, a statement either that the attached withholding certificates represent all of the partners or that the partners for whom withholding certificates are lacking are separately identified in the statement required under paragraph (c)(3)(iv) of this section.

(E) A certification that the income is effectively connected with the conduct of a trade or business in the United States, if applicable.

(F) Any other information or certification as may be required by the form or accompanying instructions in addition to, or in lieu of, the information and certifications described in this paragraph (c)(3)(iii).

(iv) *Information to the withholding agent regarding each partner's distributive share.* The partnership must furnish information sufficient for the withholding agent to determine each partner's distributive share of reportable amounts (described in §1.1441–1(e)(3)(vi)). The sum of all partners' distributive shares, expressed as a percentage, must equal, but not exceed one hundred percent. For purposes of this paragraph (c)(3)(iv), the rules of §1.1441–1(e)(3)(iv) regarding the information to furnish to the withholding agent shall apply.

(v) *Withholding by a foreign partnership.* A foreign partnership described in this paragraph (c)(3) that receives an amount subject to withholding under chapter 3 of the Code shall be deemed to have satisfied any obligation under such chapter to withhold on the amount with respect to any partner to the extent that the partner's distributive share of the payment can be reliably associated with a withholding certificate described in paragraph (c)(3)(iii) of this section pertaining to the partner that the partnership has furnished to a withholding agent and the partnership does not know and has no reason to know that the correct amount has not been withheld under chapter 3 of the Code and the regulations under such chapter.

(d) *Presumptions regarding payee's status in the absence of documentation*— (1) *In general.* This paragraph (d) contains the applicable presumptions for determining the status of the partnership and its partners in the absence of documentation. The provisions of §1.1441–1(b)(3)(iv) (regarding the 90-day grace period) and §1.1441–1(b)(3)(vii) through (ix) shall apply for purposes of this paragraph (d).

(2) *Determination of partnership status as domestic or foreign in the absence of documentation.* In the absence of a valid representation of domestic partnership status in accordance with paragraph (b)(1) of this section and of foreign partnership status in accordance with paragraph (c)(2)(i) or (3)(i) of this section, the withholding agent shall determine the status of the payee as a corporation, a partnership or otherwise, based upon the presumptions set forth in §1.1441–1(b)-(3)(ii). If, based upon these presumptions, the withholding agent treats the payee as a partnership, the partnership shall be presumed to be a foreign partnership if the withholding agent has actual knowledge of the payee's employer identification number and that number begins with the two digits "98," if the withholding agent's communications with the payee are mailed to an address in a foreign country, or if the payment is made outside the United States (as defined in §1.6049–5(e)). For rules regarding reliable association with a withholding certificate from a domestic or a foreign partnership, see §1.1441–1(b)(2)(vii).

(3) *Determination of partners' status in the absence of certain documentation.* If the withholding agent treats the payee as a foreign partnership in accordance with paragraph (c)(2)(i), (3)(i), or (d)(2) of this section, the presumptions described in this paragraph (d)(3) shall apply when the withholding agent cannot reliably associate a payment with partner documentation. The provisions of paragraphs (d)(3)(i), (ii), and (iii) of this section are not relevant to a payment that a withholding agent can reliably associate with a withholding certificate described in paragraph (c)(2)(iv) of this section.

(i) *Documentation regarding the status of a partner is lacking or unreliable.* Any portion of a payment that the withholding agent cannot reliably associate with a partner because a withholding certificate or other appropriate documentation for that partner is lacking or unreliable is presumed to be made to foreign payee. Therefore, under §1.1441–1(b)(1), the withholding agent must withhold 30 percent from payments to the partnership of amounts subject to withholding that are allocable to such partner or group of partners.

(ii) *Information regarding the allocation of payment is lacking or unreliable.* If a withholding agent can reliably associate a payment with a group of partners but lacks reliable information to determine how much of the payment is allocable to each partner in the group, the payment, to

the extent it cannot reliably be allocated, is presumed to be allocable entirely to the partner in the group with the highest applicable withholding rate or, if the rates are equal, to the partner in the group with the highest U.S. tax liability, as the withholding agent shall estimate, based on its knowledge and available information. If a withholding certificate attached to the partnership certificate is another partnership certificate or an intermediary certificate described in §1.1441–1(e)(3)(iii), the rules of this paragraph (d)(3)(ii) apply by treating the share of the payment allocable to the other partnership or the intermediary certificate as if the payment were made directly to the foreign partnership or intermediary.

(iii) *Certification that the foreign partnership has furnished documentation for all of the persons to whom the intermediary certificate relates is lacking or unreliable.* If the certification required under paragraph (c)(3)(iii)(D) of this section (that the attached withholding certificates and other appropriate documentation represent all of the partners in the partnership) is lacking or is unreliable and, as a result, the withholding agent cannot reliably determine how much of the payment is allocable to each of the partners or group of partners for which the withholding agent holds a withholding certificate or other appropriate documentation, then none of the payment can reliably be associated with any one partner and the entire payment is presumed to be made to a foreign payee.

(iv) *Determination by a withholding foreign partnership of the status of its partners.* For purposes of determining whether the partners or some other persons are the payees of the partners' distributive shares of any payment made to a withholding foreign partnership, the partnership shall apply the rules of §1.1441–1(b)(2), and of paragraph (c)(1) of this section (in the case of a partner that is a foreign partnership) and of paragraph (e) (in the case of a partner that is a foreign estate or a foreign trust), in the same manner as if the partnership were making a payment directly to the partners other than in their capacity as partners. Further, the provisions of paragraphs (d)(3)(i), (ii), and (iii) of this section shall apply to determine the status of partners and the applicable withholding rates to the extent that, at the time the foreign partnership is required to withhold on the amount, it cannot reliably associate the amount with documentation for any one or more of its partners. See §§1.6031–1 and 1.6031–1T for reporting and filing requirements applicable to a withholding foreign partnership.

(4) *Examples.* The rules of this paragraph (d) may be illustrated by the following examples:

Example 1. (i) *Facts.* FP is a foreign partnership receiving U.S. source interest that would qualify as portfolio interest described in section 871(h)(2)(B) if the statement described in section 871(h)(5) were furnished. FP has three partners, A, B, and C. FP furnishes to the withholding agent a partnership withholding certificate described in paragraph (c)(3)(iii) of this section to which it attaches a Form W–9 for A and a beneficial owner Form W–8 for B. Nothing on A's Form W–9 indicates that A is an exempt recipient within the meaning of §1.6049–4(c)(1)(i). No documentation is attached for C. The partnership has one single account with the withholding agent. It furnishes a statement to the withholding agent under paragraph (c)(3)(iv) of this section indicating that A's, B's, and C's respective distributive shares of the payments are 40%, 40%, and 20% and represents, in accordance with paragraph (c)(3)(iii)(D) of this section, that there are only three partners.

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, the withholding agent may rely on FP's withholding certificate and A's Form W–9 to treat A as a U.S. beneficial owner under §1.1441–1(d)(4)(i) and as a U.S. payee under paragraph (c)(1)(i)(A) of this section to the extent of 40 percent of the payment. Under §1.1441–1(b)(1), the withholding agent is not required to withhold on A's share of the payment. Under §1.6049–4(a), the withholding agent must comply with information reporting obligations (i.e., file a Form 1099) with respect to A who is treated as a U.S. payee under paragraph (c)(1)(i)(A) of this section and §1.6049–5(d)(1) for purposes of the information reporting provisions of chapter 61 of the Code and the regulations thereunder. Absent actual knowledge or reason to know otherwise, the withholding agent may also rely on FP's withholding certificate and B's Form W–8 to treat B as a foreign beneficial owner under §1.1441–1(e)(1)(ii)(A)(1) and paragraph (c)(1)(i)(A) of this section. Thus, under §1.1441–1(b)(1), the withholding agent may rely on B's claim for portfolio interest treatment for B's share of the payment. Under §1.1461–1(b)(1) and (c)(1), the withholding agent must report the payment to B on Forms 1042 and 1042-S unless, under section 6031 and the regulations under that section, the partnership is required to file a return. Because the withholding agent cannot associate the documentation (as defined in §1.1441–1(b)(3)(vii)) for C's share of the interest income, the withholding agent must, under paragraph (d)(3)(i) of this section, treat that amount as a payment made to an unidentified foreign partner and withhold 30 percent under section 1441 in accordance with §1.1441–1(b)(1).

Example 2. The facts are the same as in *Example 1*, but the partnership has furnished no information under paragraph (c)(3)(iv) of this section regarding how much of the payment to the foreign partnership is attributable to A and C. Under paragraph (d)(3)(ii) of this section, the payment allocable to group A-C is presumed made entirely to A or to C, depending of who of A or C is subject to the highest withholding rate. A is not subject to withholding because it has furnished a valid Form W–9. C is subject to a 30-percent withholding rate under §1.1441–1(b)(1) because it is presumed to be an unidentified foreign partner under paragraph (d)(3)(i) of this section. Therefore, under paragraph (d)(3)(ii) of this section, the portion of the payment that the withholding agent can associate with A and C is subject to withholding at a 30-percent rate. The withholding agent may ignore the fact that A has furnished a valid Form W–9 supporting his claim of exemption from withholding as a U.S. person because it has no reliable information on how much of the payment is allocable to A. Because the withholding agent has a Form W–9 for the U.S. individual partner, it must also report A's distributive share on a Form 1099. To the extent that A's exact share is not known, the entire amount should be reported on the Form 1099.

(e) *Trusts and estates.* [Reserved]

(f) *Failure to receive withholding certificate timely or to act in accordance with applicable presumptions.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold an appropriate withholding certificate or other appropriate documentation at the time of payment or fails to rely on the presumptions set forth in §1.1441–1(b)(3) or in paragraph (d) or (e) of this section.

(g) *Effective date*—(1) *General rule.* This section applies to payments made after December 31, 1998.

(2) *Transition rules.* A withholding agent that on December 31, 1998, holds a withholding certificate that is valid under the regulations in effect prior to January 1, 1999 (see 26 CFR parts 1 and 35a, revised April 1, 1997), may treat it as a valid withholding certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a withholding certificate or statement that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a withholding agent may choose to not take advantage of the transition rule in this paragraph (g)(2) with respect to one or more with-

holding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

§1.1441–6 Claim of reduced withholding under an income tax treaty.

(a) *In general.* The rate of withholding on a payment of income subject to withholding may be reduced to the extent provided under an income tax treaty in effect between the United States and a foreign country. Most benefits under income tax treaties are to foreign persons who reside in the treaty country. In some cases, benefits are available under an income tax treaty to U.S. citizens or U.S. residents or to residents of a third country. See paragraph (b)(5) of this section for claims of benefits by U.S. persons. If the requirements of this section are met, the amount withheld from the payment may be reduced at source to account for the treaty benefit. See also §1.1441–4(b)(2) for rules regarding claims of reduced rate of withholding under an income tax treaty in the case of compensation from personal services.

(b) *Reliance on claim of reduced withholding under an income tax treaty*—(1) *In general.* Absent actual knowledge or reason to know otherwise, a withholding agent may rely on a claim that a beneficial owner is entitled to a reduced rate of withholding based upon an income tax treaty if, prior to the payment, the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) (not including §1.1441–1(e)(1)(ii)(B) relating to documentary evidence). Except as otherwise provided in paragraph (b)(2) or (3) of this section, for purposes of this paragraph (b)(1), a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) is valid only if it includes the beneficial owner's taxpayer identifying number and certifies that the taxpayer has complied with the advance ruling requirements described in paragraph (e) of this section (if applicable), and, if the beneficial owner is a person related to the withholding agent within the meaning of section 482, that the beneficial owner will file the statement required under §301.6114–1(d) of this chapter (if applicable). The requirement to file an information statement under section 6114 for income subject to withholding applies only to amounts received during the calendar year that, in the aggregate, exceed $500,000. See §301.6114–1(d) of this chapter. The Internal Revenue Service (IRS) may apply the provisions of §1.1441–1(e)(1)(ii)(B) to notify the withholding agent that the certificate cannot be relied upon to grant benefits under an income tax treaty. A beneficial owner's taxpayer identifying number on a withholding certificate is valid for purposes of establishing proof of residence in a treaty country only if the taxpayer identifying number is certified by the IRS in accordance with the procedures set forth in paragraph (c) of this section. However, absent actual knowledge or reason to know otherwise, a withholding agent may rely on a taxpayer identifying number without having to inquire as to whether the taxpayer identifying number is certified, if the number appears correct on its face and the permanent residence address on the certificate is in the country whose tax treaty with the United States is invoked. See §1.1441–1(e)(4)(viii) regarding reliance on a withholding certificate by a withholding agent. The provisions of §1.1441–1(b)(3)(iv) dealing with a 90-day grace period shall apply for purposes of this section.

(2) *Exemption from requirement to furnish a taxpayer identifying number and special documentary evidence rules for certain income*—(i) *General rule.* In the case of income described in paragraph (b)(2)(ii) of this section, a withholding agent may rely on a beneficial owner withholding certificate described in paragraph (b)(1) of this section even if the person whose name is on the certificate has not provided a taxpayer identifying number. In the case of payments made outside the United States (as defined in §1.6049–5(e)) with respect to an offshore account (as defined in §1.6049–5(c)(1)), a withholding agent may, as an alternative to a withholding certificate described in paragraph (b)(1) of this section, rely on a certificate of residence described in paragraph (c)(3) of this section or documentary evidence described in paragraph (c)(4) of this section, relating to the beneficial owner, that the withholding agent has reviewed and maintains in its records in accordance with §1.1441–1(e)(4)(iii). In the case of a payment to a person other than an individual, the certificate of residence or documentary evidence must be accompanied by the certifications described in paragraphs (c)(5)(i) and (ii) of this section regarding limitation on benefits and whether the amount paid is derived by such person or by one of its interest holders. The withholding agent maintains the reviewed documents by retaining either the documents viewed or a photocopy thereof and noting in its records the date on which, and by whom, the documents were received and reviewed. This paragraph (b)(2)(i) shall not apply to amounts that are exempt from withholding based on a claim that the income is effectively connected with the conduct of a trade or business in the United States.

(ii) *Income to which special rules apply.* The income to which paragraph (b)(2)(i) of this section applies is dividends and interest from stocks and debt obligations that are actively traded, dividends from any redeemable security issued by an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a–1), dividends, interest, or royalties from units of beneficial interest in a unit investment trust that are (or were, upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933(15 U.S.C. 77a) and amounts paid with respect to loans of securities described in this paragraph (b)(2)(ii). For purposes of this paragraph (b)(2)(ii), a stock or debt obligation is actively traded if it is actively traded within the meaning of section 1092(d) and §1.1092(d)–1 when documentation is provided.

(3) *Competent authority agreements.* The procedures described in this section may be modified to the extent the U.S. competent authority may agree with the competent authority of a country with which the United States has an income tax treaty in effect.

(4) *Eligibility for reduced withholding under an income tax treaty in the case of a payment to a person other than an individual*—(i) *General rule.* The withholding imposed under section 1441, 1442, or 1443 on any payment to a foreign person is eligible for reduction under the terms of an income tax treaty only to the extent

that such payment is treated as derived by a resident of an applicable treaty jurisdiction, such resident is a beneficial owner of the payment, and all other applicable requirements for benefits under the treaty are satisfied. A payment received by an entity is treated as derived by a resident of an applicable treaty jurisdiction to the extent that the payment is subject to tax in the hands of a resident of that jurisdiction. For this purpose, a payment received directly by an entity that is treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of the jurisdiction to the extent that the interest holders in the entity are residents of the jurisdiction. For purposes of the preceding sentence, interest holders do not include any direct or indirect interest holders that are themselves treated as fiscally transparent entities by the applicable treaty jurisdiction. A payment received by an entity that is not treated as fiscally transparent by the applicable treaty jurisdiction shall be considered a payment subject to tax in the hands of a resident of such jurisdiction only if the entity is itself a resident of that jurisdiction. If the entity is a wholly-owned entity that is disregarded for federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single member is a foreign person, amounts paid to such entity may nevertheless be treated as derived by a resident of a treaty country if the entity is treated by the applicable treaty country as deriving the income as a resident of that country. The provisions of §1.894–1T(d)(1) through (4) shall apply for purposes of determinations made under this paragraph (b)(4).

(ii) *Withholding certificates*—(A) *In general.* The type of withholding certificate or other appropriate documentation that must be furnished by a person claiming a reduced rate of withholding under an income tax treaty depends upon the status of the entity under the laws of the applicable treaty jurisdiction. For example, if the person receiving the payment is a foreign entity but the persons eligible for benefits under the applicable income tax treaty are the entity's interest holders in the foreign entity receiving the payment, rather than the entity itself, then the entity shall be treated as a foreign partnership for purposes of determining which withholding certificate is appropriate irrespective of the fact that the entity may be treated as a corporation for U.S. tax purposes. If, conversely, the person eligible for benefits under an income tax treaty is the entity rather than the interest holders, then the entity shall be treated as a corporation for purposes of determining which withholding certificate is appropriate irrespective of the fact that the entity may be treated as a partnership for U.S. tax purposes. In the event of a claim for dual treatment described in paragraph (b)(4)(iii) of this section, multiple withholding certificates may have to be furnished. Multiple withholding certificates may also have to be furnished if the entity receives income for which a reduction of withholding is claimed under a provision of the Internal Revenue Code (e.g., portfolio interest) and income for which a reduction of withholding is claimed under an income tax treaty. Absent actual knowledge or reason to know otherwise, a withholding agent may rely on the representations on the certificate that the beneficial owner derives the income and is a resident of the applicable treaty country, within the meaning of §1.894–1T(d) and the applicable income tax treaty, without having to inquire into the truthfulness of these representations or to research foreign law.

(B) *Certification by qualified intermediary.* A foreign corporation that is a qualified intermediary described in §1.1441–1(e)(5)(ii)(C) for purposes of claiming reduced rates of withholding under an income tax treaty for its shareholders (who are treated as deriving the income paid to the corporation as resident of an applicable treaty jurisdiction) may furnish a single Form W–8 for its shareholders for amounts for which it claims the benefit of a reduced rate of withholding under an applicable income tax treaty. The Form W–8 shall be one described under §1.1441–1(e)(3)(ii).

(iii) *Multiple claims of treaty benefits.* A withholding agent may make a payment to a foreign entity that is simultaneously claiming a reduced rate of tax on its own behalf for a portion of the payment and a reduced rate on behalf of persons in their capacity as interest holders in that entity for the same or for another portion of the payment. In the case of concurrent and inconsistent claims of treaty benefits for the same amount, the withholding agent may choose to reject the claim and request that a consistent claim be submitted or it may choose which reduction to apply. In the case of concurrent and consistent claims (e.g., the entity that is paid the amount claims a reduced rate for a portion of the payment and an interest holder claims a different reduced rate for the balance of the payment), the withholding agent may, at its option, accept such dual claim based, as appropriate, on withholding certificates furnished by such persons with respect to their respective shares of such payment, even though the withholding agent holds different withholding certificates that requires it to treat the entity inconsistently with respect to different payments or with respect to different portions of the same payment. See paragraph (b)(4)(iv) *Example 2* of this section. If the withholding agent does not accept claims of reduced rate presented by any one or more of the interest holders, or by the entity, any interest holder or the entity may subsequently claim a refund or credit of any amount so withheld to the extent the holder's or entity's share of such withholding exceeds the amount of tax due under section 894 (in the case of a foreign person) or under section 1 or 11 (in the case of a U.S. person).

(iv) *Examples.* This paragraph (b)(4) is illustrated by the following examples:

Example 1. (i) *Facts.* Entity A is a business organization formed under the laws of country Y that has an income tax treaty with the United States. A receives U.S. source royalties from withholding agent R and claims a reduced rate of withholding under the U.S.–Y tax treaty on its own behalf (rather than on behalf of its interest holders). A furnishes a beneficial owner withholding certificate described in paragraph (b)(1) of this section that represents that A is a resident of country Y (within the meaning of the U.S.–Y tax treaty) and the beneficial owner of the royalties (within the meaning of the U.S.–Y tax treaty).

(ii) Analysis. Absent actual knowledge or reason to know otherwise, R may rely on the representation that A is a resident of country Y and a beneficial owner of the royalty income within the meaning of the U.S.-Y tax treaty.

Example 2. (i) *Facts.* The facts are the same as under Example 1, except that one of A's interest holders, T, is an entity organized in country Z. The U.S.–Z tax treaty reduces the rate on royalties to zero whereas the rate on royalties under the U.S.–Y tax treaty is only reduced to 5 percent. T furnishes a beneficial owner withholding certificate to A that represents that T is deriving its distributive share of the royalty income paid to A as a resident of country Z (within the meaning of §1.894–1T(d)(1) and the U.S.–Z tax treaty) and is the beneficial owner of the royalty income (within the meaning of the U.S.-Z tax treaty). A furnishes to R an intermediary with-

holding certificate described in §1.1441–1(e)(3)(iii) to which it attaches T's beneficial owner withholding certificate for the portion of the payment that T claims as its distributive share of the royalty income. A also furnishes to R a beneficial owner withholding certificate for itself for the portion of the payment that T does not claim as its distributive share.

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on the documentation furnished by A in order to treat the royalty payment to a single foreign entity (A) as derived by different residents of tax treaty countries as a result of concurrent and consistent claims presented under different treaties. R may, at its option, grant dual treatment, that is, a reduced rate of zero percent under the U.S.–Z treaty on the portion of the royalty payment that T claims to derive as a resident of country Z and a reduced rate of 5 percent under the U.S.–Y treaty for the balance. However, under paragraph (b)(4)(iii) of this section, R may, at its option, treat A as the only relevant person deriving the royalty and grant benefits under the U.S.–Y treaty only.

Example 3. (i) *Facts.* Entity A is a business organization formed under the laws of the United States and is classified as a partnership for U.S. tax purposes. A's partners are S and T. S is an entity organized in country Z. T is an entity organized in country X. Under the laws of country Z, A is treated as an entity taxable at the entity level. Therefore, S is treated as a shareholder for purposes of the laws of country Z and is not required to take A's income into account for purposes of determining its tax liability under those laws. Distributions from A are treated as distributions from a corporate entity for purposes of the tax laws of Country Z. Under the laws of country X, A is treated as a fiscally transparent entity and T is required to take into account its distributive share of A's income for purposes of determining its tax liability under those laws. A receives U.S. source royalties that are not connected with a trade or business. The United States has a tax treaty with countries Z and X under which the rate on royalties is reduced to zero. Both S and T furnish a beneficial owner certificate to A representing that they are resident of their respective countries and a beneficial owner of their respective distributive share of royalty income. A has actual knowledge of the tax treatment of S and T in their respective countries.

(ii) *Analysis.* Because A is a partnership for U.S. tax purposes, S and T are each taxable on their respective distributive share of the royalty income under section 881(a). However, under §1.1441–5(b)(1), the payment of royalty to A is not a payment subject to withholding. Instead, under §1.1441–5(b)(2), A must withhold on each partner's distributive share of U.S. source royalty income and may apply the rules of this section to determine the extent to which the 30-percent withholding rate under section 1442 should be reduced under the income tax treaties with countries Z and X. Because A has actual knowledge of the tax treatment of S in country Z as a shareholder of A and not as a partner (or owner of a fiscally transparent entity), A may not rely on the certificate furnished by S in order to reduce the rate of withholding under the U.S.–Z tax treaty. Therefore, it withholds 30 percent of S's distributive share of royalty income. A may rely on T's certificate to treat T as deriving its distributive share of A's royalty income as a resident of country X and as a beneficial owner. Therefore, A withholds on T's distributive share of royalty income at the reduced rate under the U.S.–X tax treaty.

Example 4. (i) *Facts.* Entity A is a business organization formed under the laws of country Y. A receives from withholding agent R U.S. source royalties and U.S. source interest income that is potentially eligible for the portfolio interest exemption under section 871(h) and 881(c). A's interest holders are S, an individual who resides in country Y, T, an individual who resides in country Z, and U, an individual resident in the United States. The United States has a tax treaty with both country Y and country Z. The U.S.–Y tax treaty reduces the rate on royalties to 5 percent, and the U.S.–Z tax treaty reduces the rate to zero. A is classified as a partnership under U.S. tax principles. Under the tax laws of country Y, A is treated as a fiscally transparent entity and S is required to include in income his distributive share of A's income. A furnishes to R an intermediary withholding certificate described in §1.1441–5(c)(3)(iii) to which it attaches—

(A) A Form W–9 for U; and

(B) Beneficial owner withholding certificates for S and T that represent that S and T are foreign persons. For purposes of claiming the reduced rate under each applicable tax treaty, each of S's and T's certificates represents that S and T are deriving their distributive share of the royalty income as a resident of their respective countries (within the meaning of §1.894–1T(d)(1) and of the applicable tax treaty) and as a beneficial owner (within the meaning of the applicable tax treaty).

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on the representations that S and T derive a distributive share of the royalty income as resident of their respective countries and are the beneficial owners of the income. Therefore, R may withhold on S's distributive share of the royalty income paid to A at the 5-percent rate under the U.S.–Y tax treaty. R may withhold on T's distributive share of the royalty income paid to A at the zero rate under the U.S.–Z tax treaty, even though A is not organized in, or a resident of, country Z. R may rely on U's Form W–9 to treat U as a U.S. person. Therefore, R does not withhold on U's share of the royalty payment. R also does not withhold on any portion of the interest paid to A because S and T have furnished beneficial owner certificates and U has furnished a Form W–9.

Example 5. (i) *Facts.* The facts are the same as in *Example 4*, except that A represents that it derives the royalty income it receives from R as a resident of country Y (within the meaning of §1.894–1T(d)(1) and the U.S.–Y tax treaty) and as a beneficial owner of the income (within the meaning of the U.S.–Y tax treaty). Neither T nor S represent to derive the royalty income as resident of their respective country. A furnishes an intermediary withholding certificate described in §1.1441–1(e)(3)(iii) to which it attaches a Form W–9 for U and beneficial owner withholding certificates for S and T. No claims of reduced rate under a tax treaty are made on S's or T's certificates. A also furnishes to R its own beneficial withholding certificate in order to claim the reduced rate under the U.S.–Y tax treaty for the royalty income.

(ii) *Analysis.* Absent actual knowledge or reason to know otherwise, R may rely on A's intermediary certificate and the certificates attached thereto in order to treat S and T as foreign beneficial owners for purposes of treating the interest as portfolio interest and to treat U as a U.S. payee. Therefore, R does not withhold on the payment of interest to A. In addition, absent actual knowledge or reason to know otherwise, R may rely on A's beneficial owner certificate in order to reduce the rate of withholding on the royalty income under the U.S.–Y tax treaty.

(5) *Claim of benefits under an income tax treaty by a U.S. person.* In certain cases, a U.S. person may claim the benefit of an income tax treaty. For example, under certain treaties, a U.S. citizen residing in the treaty country may claim a reduced rate of U.S. tax on certain amounts representing a pension or an annuity from U.S. sources. Claims of treaty benefits by a U.S. person may be made by furnishing a Form W–9 to the withholding agent or such other form as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter).

(c) *Proof of tax residence in a treaty country and certification of entitlement to treaty benefits*—(1) *In general.* A beneficial owner establishes proof of its tax residence in a treaty country for purposes of its claim to the withholding agent that a reduced rate of tax applies under an income tax treaty by complying with the procedures described in this paragraph (c) or with such other procedures as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). For purposes of this section, the residence of a beneficial owner must be determined in accordance with the provisions of the applicable U.S. income tax treaty as may be clarified by any applicable regulations thereunder, or technical explanations thereof, or other published guidance.

(2) *Certification of taxpayer identifying number*—(i) *In general.* A taxpayer may certify its taxpayer identifying number as required under paragraph (b)(1) of this section by having the number certified by the IRS either directly as provided under paragraph (c)(2)(ii) of this section or through a qualified intermediary as provided in paragraph (c)(2)(iii) of this section.

(ii) *IRS-certified TIN.* The IRS shall certify a taxpayer identifying number (TIN) upon a certificate of residence described in paragraph (c)(3) of this section to which it shall attach the certifications described in paragraphs (c)(5)(i) and (ii) of this section, if applicable. The taxpayer may provide documentary evidence described in paragraph (c)(4) of this section instead of a certificate of residence. However, a taxpayer (other than a person organized as a corporate body in the applicable treaty jurisdiction) may furnish documentary evidence instead of a certificate of residence only if a certificate of residence is not available to the taxpayer. A certificate of residence is not available for purposes of this paragraph (c)(2)(ii) if the tax administration of the country where the taxpayer claims to be a resident does not have a procedure in effect by

which such certificates are routinely issued or the taxpayer establishes that obtaining such certificate would require an unreasonable amount of time or costs relative to the taxpayer's circumstances (e.g., amount of investments in the United States). A person organized as a corporate body in the applicable treaty jurisdiction may, instead of a certificate of residence, furnish a certificate of incorporation, articles of incorporation, or other official document reflecting the taxpayer's status as a corporate body in that jurisdiction, regardless of whether a certificate of residence described in paragraph (c)(3) of this section is otherwise available. The certificate or documentary evidence must be furnished to the IRS by, or on behalf of, the beneficial owner upon application for the taxpayer identifying number or at any other time, as permitted under such procedures as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). If the tax residence of the beneficial owner changes, the beneficial owner shall notify the IRS of that change within 30 days thereof. This requirement is in addition to the notification requirements described in §1.1441–1(e)-(4)(ii)(D) regarding notification to a withholding agent in the event of changes in the beneficial owner's circumstances. The IRS may, under the exchange of information provisions of an applicable income tax treaty, exchange information with the relevant foreign competent authority for the purpose of confirming with appropriate tax officials of the other country that the beneficial owner continues to be a tax resident of that country. The IRS may from time to time, in its discretion, request that the beneficial owner reconfirm its residence in the treaty country.

(iii) *Special rules for qualified intermediaries.* The IRS may certify a taxpayer identifying number based upon the certification of a qualified intermediary described in §1.1441–1(e)(5)(ii) regarding the tax residence of any of its account holders, under procedures agreed upon with the IRS. If a new account holder has a TIN at the time it opens an account, the qualified intermediary may rely on a statement by the account or interest holder that appropriate proof of tax residence in the treaty jurisdiction was previously provided to the IRS. In such case, the qualified intermediary must notify the IRS each time that the account or interest holder's address changes to another country or when the account or interest holder terminates its relationship with the qualified intermediary within 30 days of that change.

(3) *Certificate of residence.* A certificate of residence referred to in paragraph (b)(2)(i) or (c)(2)(ii) of this section is a certification issued by the competent authority (or another appropriate tax official) of the treaty country of which the taxpayer claims to be a resident that the taxpayer has filed its most recent income tax return as a resident of that country (within the meaning of the applicable tax treaty). A certificate of residence is valid for a period of three years or such longer period as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter). The competent authorities may agree to a different procedure for certifying residence, in which case such procedure shall govern for payments made to a person claiming to be a resident of the country with which such an agreement is in effect.

(4) *Documentary evidence establishing residence in the treaty country*—(i) *Individuals.* For purposes of this paragraph (c)(4), documentary evidence establishes the residence of an individual in a treaty country if it includes the name, address, and photograph of the person seeking to prove residence, is an official document issued by an authorized governmental body (i.e., a government or agency thereof, or a municipality), and has been issued no more than three years prior to presentation to the IRS or the withholding agent. A document older than three years may be relied upon as proof of residence only if it is accompanied by additional evidence of the person's residence in the treaty country (e.g., a bank statement, utility bills, or medical bills). Documentary evidence must be in the form of original documents or certified copies thereof. Documentary evidence must be accompanied by an affidavit of the taxpayer signed under penalties of perjury that the documentary evidence submitted is true and complete.

(ii) *Persons other than individuals.* For purposes of this paragraph (c)(4), documentary evidence establishes the residence in a treaty country of a person other than an individual if it includes the name of the entity and the address of its principal office in the treaty country, and is an official document issued by an authorized governmental body (e.g., a government or agency thereof, or a municipality).

(5) *Certifications regarding entitlement to treaty benefits*—(i) *Certification regarding conditions under a Limitation on Benefits Article.* A taxpayer that is not an individual must certify to the IRS by way of an affidavit attached to its request for certification of its employer identification number that it meets one or more of the conditions set forth in the Limitation on Benefits Article (if any, or in a similar provision) contained in the applicable tax treaty. The affidavit must describe sufficient facts for the IRS to determine which condition the taxpayer claims to satisfy. The affidavit must be signed by the taxpayer under penalties of perjury.

(ii) *Certification regarding whether the taxpayer derives the income.* A taxpayer that is not an individual shall certify to the IRS by way of an affidavit attached to its request for certification of its employer identification number that any income for which it intends to claim benefits under an applicable income tax treaty is income that will properly be treated as derived by itself as a resident of the applicable treaty jurisdiction within the meaning of §1.894–1T(d)(1). The affidavit must be signed under penalties of perjury. This requirement does not apply if the taxpayer furnishes a certificate of residence that certifies that fact.

(d) *Joint owners.* In the case of a payment to joint owners, each owner must furnish a withholding certificate or, if applicable, documentary evidence or a certificate of residence. The applicable rate of tax on a payment of income to joint owners shall be the highest applicable rate.

(e) *Related party dividends under U.S.-Denmark income tax treaty.* Article VI(3) of the income tax treaty between the United States and Denmark (see 1950–1 C.B. 77; see also §601.601(d)(2) of this chapter) reduces the rate of tax on dividends between related corporations to 5 percent subject to the condition that the relationship between the domestic and foreign corporations was not arranged or maintained for the purpose of securing the reduced rate. A domestic corporation that makes a distribution derived by a resident

of Denmark may treat this condition as satisfied if, prior to the payment, a request has been made to the IRS for a private letter ruling determining that the relationship between the corporation and the Danish resident was not arranged or maintained for such purpose and the IRS has either issued a favorable ruling (and the ruling has not been revoked) or is considering the ruling request.

(f) *Failure to receive withholding certificate timely.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold an appropriate withholding certificate or other appropriate documentation at the time of payment.

(g) *Effective date*—(1) *General rule.* This section applies to payments made after December 31, 1998.

(2) *Transition rules.* For purposes of this section, a withholding agent that on December 31, 1998, holds a Form 1001 or 8233 that is valid under the regulations in effect prior to January 1, 1999 (see 26 CFR parts 1 and 35a, revised April 1, 1997), may treat it as a valid withholding certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a withholding certificate or statement that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate or in interpretation of the law under the regulations under §1.894–1T(d). Notwithstanding the three preceding sentences, a withholding agent may choose to not take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section. Certificates issued prior to April 1, 1998, that expire at any time after March 31, 1998 (other than by reason of changes in the circumstances of the person whose name is on the certificate) shall remain valid until December 31, 1998.

Par. 12. Section 1.1441–7 is amended by

1. Revising paragraphs (a) through (c).
2. Redesignating paragraph (d) as paragraph (f).
3. Adding new paragraph (d), and paragraphs (e) and (g).
4. Removing the language "(j)" and adding "(g)" in its place in the first sentence of newly designated paragraph (f)(1).
5. Removing the language "(d)" and adding "(f)" in its place in the first sentence of newly designated paragraph (f)(1), in the first sentence of newly designated paragraph (f)(2)(i), and in the first sentence of newly designated paragraph (f)(3).
6. Removing the authority citation at the end of the section.

The revisions read as follows:

§1.1441–7 General provisions relating to withholding agents.

(a) *Withholding agent defined.* For purposes of chapter 3 of the Internal Revenue Code (Code) and the regulations under such chapter, the term withholding agent means any person, U.S. or foreign, that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding, including (but not limited to) a foreign intermediary described in §1.1441–1(e)-(3)(i), a foreign partnership, or a U.S. branch describe din §1.1441–1(b)-(2)(iv)(A) or (E). See §1.1441–1(b)(1) and (2) for determining whether a payment is considered made to a foreign person. Any person who meets the definition of a withholding agent is required to deposit any tax withheld under §1.1461–1(a) and to make the returns prescribed by §1.1461–1(b) and (c), as modified by the terms of an agreement with a qualified intermediary (in the case of a qualified intermediary) or, in the case of a foreign partnership, to make the returns prescribed under section 6031 and the regulations thereunder. When several persons qualify as withholding agents with respect to a single payment, only one tax is required to be withheld and, generally, only one return (on Form 1042, as required under §1.1461–1(b)), is required to be made. See §1.1461–1(b)(2) and (c)(4) for filing procedures when multiple withholding agents are involved. In the case of a withholding agent paying to partners of a withholding foreign partnership described in §1.1441–5(c)(2)(i), the withholding agent may arrange with the partnership to withhold if it is provided the information by the partnership, in which case the partnership does not have to withhold. However, the partnership must still file a partnership return under section 6031(a) and the regulations under that section. The withholding agent does not have to file Forms 1042–S (but does have to file a Form 1042) since the withholding foreign partnership furnishes Forms K–1 to its partners pursuant to section 6031(b) and §1.6031(b)-1T. For purposes of this section and any requirement to withhold under chapter 3 of the Code and the regulations thereunder, a person who, as a nominee described in §1.6031(c)–1T, has furnished to a partnership all of the information required to be furnished under §1.6031(c)–1T(a) shall not be treated as a withholding agent if it has notified the partnership that it is treating the provision of information to the partnership as a discharge of its obligations as a withholding agent.

(b) *Standards of knowledge*—(1) *In general.* A withholding agent must withhold at the full 30-percent rate under section 1441, 1442, or 1443(a) or at the full 4-percent rate under section 1443(b) if it has actual knowledge or reason to know that a claim of U.S. status or of a reduced rate of withholding under section 1441, 1442, or 1443 is incorrect. A withholding agent shall be liable for tax, interest, and penalties to the extent provided under sections 1461 and 1463 and the regulations under those sections if it fails to withhold the correct amount despite its actual knowledge or reason to know the amount required to be withheld. For purposes of the regulations under sections 1441, 1442, and 1443, a withholding agent may rely on information or certifications contained in, or attached to, a withholding certificate or other documentation furnished by or for a beneficial owner or payee unless the withholding agent has actual knowledge or reason to know that the information or certifications are not correct and, if based on such knowledge or reason to know, it should withhold (under chapter 3 of the Code or another withholding provision of the Code) an amount greater than

would be the case if it relied on the information or certifications, or it should report (under chapter 3 of the Code or under another provision of the Code) an amount that would not otherwise be reportable if it relied on the information or certifications. See §1.1441–1(e)(4)(viii) for applicable reliance rules. A withholding agent that has received notification by the Internal Revenue Service (IRS) that a claim of U.S. status or of a reduced rate is incorrect has actual knowledge beginning on the date that is 30 calendar days after the date the notice is received. A withholding agent that fails to act in accordance with the presumptions set forth in §§1.1441–1(b)(3), 1.1441–4(a), 1.1441–5(d) and (e), or 1.1441–9(b)(3) may also be liable for tax, interest, and penalties. See §1.1441–1(b)(3)(ix) and (7).

(2) *Reason to know*—(i) *In general.* A withholding agent shall be considered to have reason to know if its knowledge of relevant facts or statements contained in the withholding certificates or other documentation is such that a reasonably prudent person in the position of the withholding agent would question the claims made.

(ii) *Limits on reason to know in certain cases.* Except as otherwise provided in paragraph (b)(3) of this section, a withholding agent that is a financial institution (including a regulated investment company) with which a customer may open an account has a reason to know with respect to payments of amounts described in §1.1441–6(b)(2)(ii) that a beneficial owner withholding certificate or documentary evidence for a beneficial owner is not reliable only if any one or more of the circumstances described in this paragraph (b)(2)(ii) exist for a withholding certificate. In such a case, the withholding agent may require a new withholding certificate. In the absence of a new certificate, a withholding agent may rely on the withholding certificate only after documentation is provided in support of the claim of foreign status, classification, or reduced rate of tax under a tax treaty.

(A) The permanent residence address on the withholding certificate is an address in the United States. In the case of an individual, trust, or estate, the withholding agent may rely on information in its files that is less than three years old and that supports the beneficial owner's claim of foreign status, despite a U.S. address (for example, a bank has evidence of the diplomatic status of a customer). In the absence of evidence in the withholding agent's files, the agent meets its due diligence obligation for purposes of this paragraph (b)(2)(ii)(A) if it contacts the beneficial owner or its agent in the United States and obtains an explanation in writing supporting the foreign status of the beneficial owner (for example, the beneficial owner is a nonresident alien individual temporarily present in the United States as a teacher; see §301.7701-(b)–3(b)(3) of this chapter) and documentation supporting the claim of foreign status is attached to the beneficial owner's statement (for example, in the case of a nonresident alien individual teacher, a copy of the relevant pages of the beneficial owner's passport showing the individual's U.S. visa status or a copy of relevant INS documents). In the case of a beneficial owner other than an individual, trust, or estate, the withholding agent must inquire as to whether the person whose name is on the certificate is actually organized or created under the laws of a foreign country.

(B) The payment is directed to a P.O. Box, an in-care-of address, or a U.S. address. In the case of an individual, the withholding agent may rely, for example, on documentary evidence of a type described in §1.1441–6(c)(3) or (4) supporting the beneficial owner's claim of residence in a foreign country to ascertain that the individual is a nonresident alien individual. In the case of a person other than an individual, the withholding agent may rely on other evidence to ascertain that the person whose name is on the certificate is not a U.S. person.

(C) In the case of income for which benefits are claimed under an income tax treaty, the permanent residence address or mailing address is not in the corresponding treaty country. In such a case, the withholding agent may rely, for example, on documentary evidence of a type described in §1.1441–6(c)(3) or (4) supporting the beneficial owner's claim of residence in the country whose benefits under an income tax treaty with the United States are invoked.

(D) The mailing address on the withholding certificate is in the United States or the beneficial owner notifies the withholding agent of a new address for mailing or residential purposes that is in the United States, a P.O. box, or an in-care-address, or, in the case of income for which benefits are claimed under an income tax treaty, the mailing address on the certificate or the new mailing or residential address notified to the withholding agent is not in the treaty country. The withholding agent may, however, rely on documentary evidence of a type described in §1.1441–6(c)(3) or (4) supporting the beneficial owner's claim of residence in a foreign country.

(E) The name of the person on the withholding certificate or documentary evidence indicates that the person's status is a corporation, partnership, trust, estate, or an individual, and the person's claim of status is not consistent with such indication. For example, a person whose name indicates that it is a per se corporation described in §301.7701–2(b)(8)(i) of this chapter represents on a Form W–8 that it is a partnership.

(F) Such other circumstances as the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter).

(3) *Coordinated account information systems.* See §1.1441–1(e)(4)(ix) for application of these rules other than on an account-by-account basis so that a withholding agent that relies on a coordinated account information system for documentation is considered to know or have reason to know the facts recorded in the system.

(c) *Authorized agent*—(1) *In general.* The acts of an agent of a withholding agent (including the receipt of withholding certificates, the payment of amounts of income subject to withholding, and the deposit of tax withheld) are imputed to the withholding agent on whose behalf it is acting. However, if the agent is a foreign person, a withholding agent that is a U.S. person may treat the acts of the foreign agent as its own for purposes of determining whether it has complied with the provisions of this section, but only if the agent is an authorized foreign agent, as defined in paragraph (c)(2) of this section. An authorized foreign agent cannot apply the provisions of this paragraph (c) to appoint another person its authorized foreign agent with respect to the payments it receives from the withholding agent.

(2) *Authorized foreign agent.* An agent is an authorized foreign agent only if—

(i) There is a written agreement between the withholding agent and the foreign person acting as agent;

(ii) The notification procedures described in paragraph (c)(3) of this section have been complied with;

(iii) Books and records and relevant personnel of the foreign agent are available (on a continuous basis, including after termination of the relationship) for examination by the IRS in order to evaluate the withholding agent's compliance with the provisions of chapters 3 and 61 of the Code, section 3406, and the regulations under those provisions; and

(iv) The U.S. withholding agent remains fully liable for the acts of its agent and does not assert any of the defenses that may otherwise be available, including under common law principles of agency in order to avoid tax liability under the Internal Revenue Code.

(3) *Notification.* A withholding agent that appoints an authorized agent to act on its behalf for purposes of §1.871–14-(c)(2), the withholding provisions of chapter 3 of the Code, section 3406 or other withholding provisions of the Internal Revenue Code, or the reporting provisions of chapter 61 of the Code, is required to file notice of such appointment with the Office of the Assistant Commissioner (International). Such notice shall be filed before the first payment for which the authorized agent acts as such. Such notice shall acknowledge the withholding agent liability as provided in paragraph (c)(2)(iv) of this section.

(4) *Liability of U.S. withholding agent.* An authorized foreign agent is subject to the same withholding and reporting obligations that apply to any withholding agent under the provisions of chapter 3 of the Code and the regulations thereunder. In particular, an authorized foreign agent does not benefit from the special procedures or exceptions that may apply to a qualified intermediary. A withholding agent acting through an authorized foreign agent is liable for any failure of the agent, such as failure to withhold an amount or make payment of tax, in the same manner and to the same extent as if the agent's failure had been the failure of the U.S. withholding agent. For this purpose, the foreign agent's actual knowledge or reason to know shall be imputed to the U.S. withholding agent. The U.S. withholding agent's liability shall exist irrespective of the fact that the authorized foreign agent is also a withholding agent and is itself separately liable for failure to comply with the provisions of the regulations under section 1441, 1442, or 1443. However, the same tax, interest, or penalties shall not be collected more than once.

(5) *Filing of returns.* See §1.1461–1-(b)(2)(iii) and (c)(4)(iii) regarding returns required to be made where a U.S. withholding agent acts through an authorized foreign agent.

(d) *United States obligations.* If the United States is a withholding agent for an item of interest, including original issue discount, on obligations of the United States or of any agency or instrumentality thereof, the withholding obligation of the United States is assumed and discharged by—

(1) The Commissioner of the Public Debt, for interest paid by checks issued through the Bureau of the Public Debt;

(2) The Treasurer of the United States, for interest paid by him or her, whether by check or otherwise;

(3) Each Federal Reserve Bank, for interest paid by it, whether by check or otherwise; or

(4) Such other person as may be designated by the IRS.

(e) *Assumed obligations.* If, in connection with the sale of a corporation's property, payment on the bonds or other obligations of the corporation is assumed by a person, then that person shall be a withholding agent to the extent amounts subject to withholding are paid to a foreign person. Thus, the person shall withhold such amounts under §1.1441–1 as would be required to be withheld by the seller or corporation had no such sale or assumption been made.

* * * * *

(g) *Effective date.* Except as otherwise provided in paragraph (f)(3) of this section, this section applies to payments made after December 31, 1998.

Par. 13. Section 1.1441–8T is redesignated as §1.1441–8 and amended as follows:

1. The section heading and paragraph (b) are revised.

2. Paragraphs (c), (d), (e) and (f) are added.

The revisions and additions read as follows:

§1.1441–8 Exemption from withholding for payments to foreign governments, international organizations, foreign central banks of issue, and the Bank for International Settlements.

* * * * *

(b) *Reliance on claim of exemption by foreign government.* Absent actual knowledge or reason to know otherwise, the withholding agent may rely upon a claim of exemption made by the foreign government if, prior to the payment, the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the payment as made to a beneficial owner in accordance with §1.1441–1(e)(1)(ii). A Form W–8 furnished by a foreign government for purposes of claiming an exemption under this paragraph (b) is valid only if, in addition to other applicable requirements, it certifies that the income is, or will be, exempt from taxation under section 892 and the regulations under that section and whether the person whose name is on the certificate is an integral part of a foreign government (as defined in §1.892–2T(a)-(2)) or a controlled entity (as defined in §1.892–2T(a)(3)).

(c) *Income of a foreign central bank of issue or the Bank for International Settlements*—(1) *Certain interest income.* Section 895 provides for the exclusion from gross income of certain income derived by a foreign central bank of issue, or by the Bank for International Settlements, from obligations of the United States or of any agency or instrumentality thereof or from interest on deposits with persons carrying on the banking business if the bank is the owner of the obligations or deposits and does not hold the obligations or deposits for, or use them in connection with, the conduct of a commercial banking function or other commercial activity by such bank. See §1.895–1. Absent actual knowledge or reason to know that a foreign central bank of issue, or the Bank for International Settlements, is operating outside the scope of the exclusion granted by section 895 and the regulations under that section, the withholding agent may rely on a claim of exemption if, prior to the payment, the withholding agent can reliably associate the payment with documentation upon which it can rely to treat the foreign central bank of issue or the Bank

for International Settlements as the beneficial owner of the payment in accordance with §1.1441–1(e)(1)(ii). A Form W–8 furnished by a foreign central bank of issue or the Bank for International Settlements for purposes of claiming an exemption under this paragraph (c)(1) is valid only if, in addition to other applicable requirements, it certifies that the person whose name is on the certificate is a foreign central bank of issue, or the Bank for International Settlements, and that the bank does not, and will not, hold the obligations or the bank deposits covered by the Form W–8 for, or use them in connection with, the conduct of a commercial banking function or other commercial activity.

(2) *Bankers' acceptances.* Interest derived by a foreign central bank of issue from bankers' acceptances is exempt from tax under sections 871(i)(2)(C) and 881(d) and §1.861–2(b)(4). With respect to bankers' acceptances, a withholding agent may treat a payee as a foreign central bank of issue without requiring a withholding certificate if the name of the payee and other facts surrounding the payment reasonably indicate that the payee or beneficial owner is a foreign central bank of issue, as defined in §1.861–2(b)(4).

(d) *Exemption for payments to international organizations.* A payment to an international organization (within the meaning of section 7701(a)(18)) is exempt from withholding on any payment. A withholding agent may treat a payee as an international organization without requiring a withholding certificate if the name of the payee is one that is designated as an international organization by executive order (pursuant to 22 U.S.C. 288 through 288(f)) and other facts surrounding the transaction reasonably indicate that the international organization is the beneficial owner of the payment.

(e) *Failure to receive withholding certificate timely and other applicable procedures.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold a valid withholding certificate described in paragraph (b) or (c)(1) of this section or other appropriate documentation at the time of payment. Further, the provisions of §1.1441–1(e)(4) shall apply to withholding certificates and other documents related thereto furnished under the provisions of this section.

(f) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1998.

(2) *Transition rules.* For purposes of this section, a withholding agent that on December 31, 1998, holds a Form 8709 that is valid under the regulations in effect prior to January 1, 1999 (see 26 CFR part 1, revised April 1, 1997), may treat it as a valid withholding certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a withholding certificate or statement that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (f)(2), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a withholding agent may choose to not take advantage of the transition rule in this paragraph (f)(2) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

Par. 14. Section 1.1441–9 is added to read as follows.

§1.1441–9 Exemption from withholding on exempt income of a foreign tax-exempt organization, including foreign private foundations.

(a) *Exemption from withholding for exempt income.* No withholding is required under section 1441(a) or 1442, and the regulations under those sections, on amounts paid to a foreign organization that is described in section 501(c) to the extent that the amounts are not income includible under section 512 in computing the organization's unrelated business taxable income. See, however, §1.1443–1 for withholding on payments of unrelated business income to foreign tax-exempt organizations and on payments subject to tax under section 4948. For a foreign organization to claim an exemption from withholding under section 1441(a) or 1442 based on its status as an organization described in section 501(c), it must furnish the withholding agent with a withholding certificate described in paragraph (b)(2) of this section. A foreign organization described in section 501(c) may choose to claim a reduced rate of withholding under the procedures described in other sections of the regulations under section 1441 and not under this section. In particular, if an organization chooses to claim benefits under an income tax treaty, the withholding procedures applicable to claims of such a reduced rate are governed solely by the provisions of §1.1441–6 and not of this section.

(b) *Reliance on foreign organization's claim of exemption from withholding*—(1) *General rule.* A withholding agent may rely on a claim of exemption under this section only if, prior to the payment, the withholding agent can reliably associate the payment with a valid withholding certificate described in paragraph (b)(2) of this section.

(2) *Withholding certificate.* A withholding certificate under this paragraph (b)(2) is valid only if it is a Form W–8 and if, in addition to other applicable requirements, the Form W–8 includes the taxpayer identifying number of the organization whose name is on the certificate, and it certifies that the Internal Revenue Service (IRS) has issued a favorable determination letter (and the date thereof) that is currently in effect, what portion, if any, of the amounts paid constitute income includible under section 512 in computing the organization's unrelated business taxable income, and, if the organization is described in section 501(c)(3), whether it is a private foundation described in section 509. Notwithstanding the preceding sentence, if the organization cannot certify that it has been issued a favorable determination letter that is still in effect, its withholding certificate is nevertheless valid under this paragraph (b)(2) if the organization attaches to the withholding certificate an opinion that is acceptable to the withholding agent from a U.S. counsel concluding that the organization is described in section 501(c). If the determination letter or opinion of counsel to which the withholding certificate refers concludes that the organization is described in section 501(c)(3), and the certificate further certifies that the organization is not a private foundation described

in section 509, an affidavit of the organization setting forth sufficient facts concerning the operations and support of the organization for the Internal Revenue Service (IRS) to determine that such organization would be likely to qualify as an organization described in section 509(a)(1), (2), (3), or (4) must be attached to the withholding certificate. An organization that provides an opinion of U.S. counsel or an affidavit may provide the same opinion or affidavit to more than one withholding agent provided that the opinion is acceptable to each withholding agent who receives it in conjunction with a withholding certificate. Any such opinion of counsel or affidavit must be renewed whenever the certificate to which it is attached is required to be renewed.

(3) *Presumptions in the absence of documentation.* Notwithstanding paragraph (b)(1) of this section, if the organization's certification with respect to whether amounts paid constitute income includible under section 512 in computing the organization's unrelated business taxable income is not reliable or is lacking but all other certifications are reliable, the withholding agent may rely on the certificate but the amounts paid are presumed to be income includible under section 512 in computing the organization's unrelated business taxable income. If the certification regarding private foundation status is not reliable, the withholding agent may rely on the certificate but the amounts paid are presumed to be paid to a foreign beneficial owner that is a private foundation.

(4) *Reason to know.* Reliance by a withholding agent on the information and certifications stated on a withholding certificate is subject to the agent's actual knowledge or reason to know that such information or certification is incorrect as provided in §1.1441–7(b). For example, a withholding agent must cease to treat a foreign organization's claim for exemption from withholding based on the organization's tax-exempt status as valid beginning on the earlier of the date on which such agent knows that the IRS has given notice to such foreign organization that it is not an organization described in section 501(c) or the date on which the IRS gives notice to the public that such foreign organization is not an organization described in section 501(c). Similarly, a withholding agent may no longer rely on a certification that an amount is not subject to tax under section 4948 beginning on the earlier of the date on which such agent knows that the IRS has given notice to such foreign organization that it is subject to tax under section 4948 or the date on which the IRS gives notice that such foreign organization is a private foundation within the meaning of section 509(a).

(c) *Failure to receive withholding certificate timely and other applicable procedures.* See applicable procedures described in §1.1441–1(b)(7) in the event the withholding agent does not hold a valid withholding certificate or other appropriate documentation at the time of payment. Further, the provisions of §1.1441–1(e)(4) shall apply to withholding certificates and other documents related thereto furnished under the provisions of this section.

(d) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1998.

(2) *Transition rules.* For purposes of this section, a withholding agent that on December 31, 1998, holds a Form W–8, 1001 or 4224 or a statement that is valid under the regulations in effect prior to January 1, 1999, (see 26 CFR parts 1 and 35a, revised April 1, 1997), may treat it as a valid withholding certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a withholding certificate or statement that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998, by reason of the immediately preceding sentence). The rule in this paragraph(d)(2), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a withholding agent may choose to not take advantage of the transition rule in this paragraph (d)(2) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

Par. 15. Sections 1.1442–1 and 1.1442–2 are revised to read as follows:

§1.1442–1 Withholding of tax on foreign corporations.

For regulations concerning the withholding of tax at source under section 1442 in the case of foreign corporations, foreign governments, international organizations, foreign tax-exempt corporations, or foreign private foundations, see §§1.1441–1 through 1.1441–9.

§1.1442–2 Exemption under a tax treaty.

For regulations providing for a claim of reduced withholding tax under section 1442 by certain foreign corporations pursuant to the provisions of an income tax treaty, see §1.1441–6.

Par. 16. Section 1.1442–3 is added to read as follows:

§1.1442–3 Tax exempt income of a foreign tax-exempt corporations.

For regulations providing for a claim of exemption for income exempt from tax under section 501(a) of a foreign tax-exempt corporation, see §1.1441–9. See §1.1443–1 for withholding rules applicable to foreign private foundations and to the unrelated business income of foreign tax-exempt organizations.

Par. 17. Section 1.1443–1 is revised to read as follows:

§1.1443–1 Foreign tax-exempt organizations.

(a) *Income includible under section 512 in computing unrelated business taxable income.* In the case of a foreign organization that is described in section 501(c), amounts paid to the organization includible under section 512 in computing the organization's unrelated business taxable income are subject to withholding under §§1.1441–1, 1.1441–4, and 1.1441–6 in the same manner as payments of the same amounts to any foreign person that is not a tax-exempt organization. Therefore, a foreign organization receiving amounts includible under section 512 in computing the organization's unrelated business taxable income may claim an exemption from withholding or a reduced rate of withholding with respect to that income in the same manner as a foreign person that is not a tax-exempt organization. See §1.1441–9(b)(3) for presumption that amounts are includible

under section 512 in computing the organization's unrelated business taxable income in the absence of a reliable certification.

(b) *Income subject to tax under section 4948*—(1) *In general*. The gross investment income (as defined in section 4940(c)(2)) of a foreign private foundation is subject to withholding under section 1443(b) at the rate of 4 percent to the extent that the income is from sources within the United States and is subject to the tax imposed by section 4948(a) and the regulations under that section. Withholding under this paragraph (b) is required irrespective of the fact that the income may be effectively connected with the conduct of a trade or business in the United States by the foreign organization. See §1.1441–9(b)(3) for applicable presumptions that amounts are subject to tax under section 4948. The withholding imposed under this paragraph (b)(1) does not obviate a private foundation's obligation to file any return required by law with respect to such organization, such as the form that the foundation is required to file under section 6033 for the taxable year.

(2) *Reliance on a foreign organization's claim of foreign private foundation status.* For reliance by a withholding agent on a foreign organization's claim of foreign private foundation status, see §1.1441–9(b) and (c).

(3) *Applicable procedures.* A withholding agent withholding the 4-percent amount pursuant to paragraph (b)(1) of this section shall treat such withholding as withholding under section 1441(a) or 1442(a) for all purposes, including reporting of the payment on a Form 1042 and a Form 1042–S pursuant to §1.1461–1(b) and (c). Similarly, the foreign private foundation shall treat the 4-percent withholding as withholding under section 1441(a) or 1442(a), including for purposes of claims for refunds and credits.

(4) *Claim of benefits under an income tax treaty.* The withholding procedures applicable to claims of a reduced rate under an income tax treaty are governed solely by the provisions of §1.1441–6 and not by this section.

(c) *Effective date*—(1) *In general.* This section applies to payments made after December 31, 1998.

(2) *Transition rules.* For purposes of this section, a withholding agent that on December 31, 1998, holds an affidavit or opinion of counsel described in §1.1443–1(b)(4)(i) in effect prior to January 1, 1999 (see §1.1443–1(b)(4)(i) as contained in 26 CFR part 1, revised April 1, 1997) that is valid under these provisions may treat it as a valid withholding certificate until December 31, 1999. However, a withholding agent may choose to not take advantage of the transition rule in this paragraph (c)(2) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

Par. 18. Section 1.1445-5 is amended by revising the second sentence of paragraph (b)(1) to read as follows:

§1.1445-5 Special rules concerning distributions and other transactions by corporations, partnerships, trusts, and estates.

* * * * *

(b) *** (1) *** For rules coordinating the withholding under section 1441 (or section 1442 or 1443) and under section 1445 on distributions from a corporation, see §1.1441–3(b)(4). ***

* * * * *

Par. 19. Sections 1.1461–1 and 1.1461–2 are revised to read as follows:

§1.1461–1 Payment and returns of tax withheld.

(a) *Payment of withheld tax*—(1) *Deposits of tax.* Every withholding agent who withholds tax pursuant to chapter 3 of the Internal Revenue Code (Code) and the regulations under such chapter shall deposit such amount of tax with a Federal reserve bank or authorized financial institution as provided in §1.6302–2(a). If for any reason the total amount of tax required to be returned for any calendar year pursuant to paragraph (b) of this section has not been deposited pursuant to §1.6302–2, the withholding agent shall pay the balance of tax due for such year at such place as the Internal Revenue Service (IRS) shall specify. The tax shall be paid when filing the return required under paragraph (b)(1) of this section for such year, unless the IRS specifies otherwise. See paragraph (b)(2) of this section when there are multiple withholding agents.

(2) *Penalties for failure to pay tax.* For penalties and additions to the tax for failure to timely pay the tax required to be withheld under chapter 3 of the Code, see sections 6656, 6672, and 7202 and the regulations under those sections.

(b) *Income tax return*—(1) *General rule.* A withholding agent shall make an income tax return on Form 1042 (or such other form as the IRS may prescribe) for income paid during the preceding calendar year that the withholding agent is required to report on an information return on Form 1042–S (or such other form as the IRS may prescribe) under paragraph (c)(1) of this section. See section 6011 and §1.6011–1(c). The withholding agent must file the return on or before March 15 of the calendar year following the year in which the income was paid. The return must show the aggregate amount of income paid and tax withheld required to be reported on all the Forms 1042–S for the preceding calendar year by the withholding agent, in addition to such information as is required by the form and accompanying instructions. Withholding certificates or other statements or information provided to a withholding agent are not required to be attached to the return. A return must be filed under this paragraph (b)(1) even though no tax was required to be withheld during the preceding calendar year. The withholding agent must retain a copy of Form 1042 for the applicable statute of limitations on assessments and collection with respect to the amounts required to be reported on the Form 1042. See section 6501 and the regulations thereunder for the applicable statute of limitations. Adjustments to the total amount of tax withheld, as described in §1.1461–2, shall be stated on the return as prescribed by the form and accompanying instructions.

(2) *Multiple withholding agents*—(i) *General rule.* Except as otherwise provided in paragraph (b)(2)(ii), (iii), (iv), or (v) of this section, no Form 1042 is required to be filed under paragraph (b)(1) of this section if a return is filed by another withholding agent reporting the same income in compliance with the provisions of this paragraph (b) and any remaining tax due is paid by such other withholding agent with the return in accordance with the provisions of paragraph (a) of this section.

(ii) *Payment to a qualified intermediary.* A U.S. withholding agent making a payment to a qualified intermediary (as defined in §1.1441–1(e)(5)(ii)) must file a return under paragraph (b)(1) of this section, regardless of whether the qualified intermediary assumes primary withholding responsibility for the payment, as described in §1.1441–1(e)(5)(iv) and regardless of whether the qualified intermediary is also required to file a return under the terms of its agreement with the IRS. A qualified intermediary's agreement with the IRS shall specify the extent, if any, to which the intermediary is subject to filing requirements under this section.

(iii) *Payment to a non-qualified intermediary.* A withholding agent making a payment to a foreign intermediary that is not a qualified intermediary described in §1.1441–1(e)(5)(ii) must file a return under paragraph (b)(1) of this section to report such payments. The foreign intermediary is not required to make a return to report the payments that it itself makes to the persons for whom it collects the payments to the extent that the withholding agent represents to the intermediary that it will file such a return or that it has done so.

(iv) *Payment to or through an authorized foreign agent.* Both the U.S. withholding agent making a payment to or through an authorized foreign agent (defined in §1.1441–7(c)) and the authorized foreign agent are required to file a return under paragraph (b)(1) of this section.

(v) *Payments to foreign partnerships.* A withholding agent making a payment to a foreign partnership shall file a return under paragraph (b)(1) of this section in the same manner as is required for a withholding agent making a payment to a qualified intermediary.

(vi) *Payments to a U.S. branch of certain foreign banks, securities dealers, or insurance companies.* A withholding agent making a payment to a U.S. branch described in §1.1441–1(b)(2)(iv) must file a return under paragraph (b)(1) of this section, irrespective of the fact that the branch is treated as a U.S. person or is presumed to receive income that is effectively connected with its conduct of a trade or business in the United States.

(3) *Payments to wholly-owned entities.* A withholding agent making a payment to a wholly-owned entity that is disregarded for Federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall file a return under paragraph (b)(1) of this section.

(4) *Amended returns.* An amended return may be filed on a Form 1042X or such other form as the IRS may prescribe. An amended return must include such information as the form or accompanying instructions shall require, including, with respect to any information that has changed from the time of the filing of the return, the information that was shown on the original return and the corrected information.

(c) *Information returns*—(1) *Filing requirement*—(i) *In general.* A withholding agent (other than an individual who is not acting in the course of a trade or business with respect to the payment) must make an information return on Form 1042–S (or such other form as the IRS may prescribe) to report the amounts specified in paragraph (c)(2) of this section that were paid during the preceding calendar year. One Form 1042–S shall be prepared for each beneficial owner (except as otherwise provided in paragraph (c)(4) of this section regarding multiple withholding agents). The Form 1042–S shall be prepared in such manner as the form and accompanying instructions prescribe. One copy of the Form 1042–S shall be filed with the IRS on or before March 15 of the calendar year following the year in which the item of income was paid. It shall be filed with a transmittal form as provided in the instructions to the Form 1042–S and to the transmittal form. Withholding certificates or other statements or documentation provided to a withholding agent are not required to be attached to the information return. Another copy of the Form 1042–S shall be furnished to the payee on or before March 15 of the calendar year following the year in which the item of income was paid. The withholding agent shall retain a copy of each Form 1042–S for the statute of limitations on assessment and collection applicable to the Form 1042 to which the Form 1042–S relates.

(ii) *Joint owners.* In the case of joint owners, a single Form 1042–S may be prepared. However, upon request of any one of the owners, the withholding agent shall furnish to such owner its own Form 1042–S. Where more than one Form 1042–S is issued with respect to a single payment to joint owners, the aggregate amount of items paid and tax withheld reported on the Forms 1042–S cannot exceed the amounts paid to the joint owners and tax withheld thereon. If a single Form 1042–S is prepared, the form shall state the name of only one owner and that name shall be that of any person whose status the withholding agent relied upon to determine the applicable rate of withholding tax.

(2) *Amounts subject to reporting*—(i) *In general.* Subject to the exceptions described in paragraph (c)(2)(ii) of this section, the amounts required to be reported on a Form 1042–S are amounts paid to foreign persons (including persons who are presumed to be foreign) that consist of amounts subject to withholding (as defined in §1.1441–2(a)) under section 1441, 1442, or 1443. This includes (but is not limited to)—

(A) The entire amount of corporate distributions (whether deemed or actual) paid to a foreign person, irrespective of any estimate of the portion of the distribution that represents a taxable dividend;

(B) Amounts deemed paid to a foreign person as described in §1.1441–2(d) (dealing with exceptions to withholding where no money or property is paid), except where the amount is exempt from withholding due to lack of knowledge;

(C) Amounts that are (or are presumed to be) effectively connected with the conduct of a trade or business in the United States, irrespective of the fact that no withholding certificate is required to be furnished by the payee or beneficial owner. In the case of amounts paid on a notional principal contract described in §1.1441–4(a)(3) that are presumed to be effectively connected with the conduct of a trade or business in the United States, the amount required to be reported is limited to the net income from the notional principal contract as described in §1.446–3(d). Effectively connected nonperiodic payments are reportable for the year in which an actual payment is made;

(D) Interest (including original issue discount) that is not exempt from reporting as provided under §1.6049–8, dealing with certain interest on deposits with banks paid to Canadian residents;

(E) Amounts representing interest paid on an obligation that is sold between interest payment dates;

(F) Amounts paid to foreign governments, international organizations, or the Bank for International Settlements, whether or not documentation must be provided;

(G) Interest (including original issue discount) paid with respect to foreign-targeted registered obligations described in §1.871–14(e)(2) to the extent the documentation requirements described in §1.871–14(e)(3) and (4) are satisfied (taking into account the provisions of §1.871–14(e)(4)(ii), if applicable).

(ii) *Exceptions to reporting.* The amounts listed in paragraphs (c)(2)(ii)(A) through (G) of this section are not required to be reported on a Form 1042–S—

(A) Any item paid by a partnership, trust or estate to the extent the item is required to be reported by the partnership under section 6031 or by the trust or estate under sections 6012(a) and 6034A, and the regulations under those sections;

(B) Any item required to be reported on a Form W–2, including an item required to be shown on Form W–2 solely by reason of §1.6041–2 (relating to return of information as to payments to employees) or §1.6052–1 (relating to information regarding payment of wages in the form of group-term life insurance);

(C) Any item required to be reported on Form 1099, and such other forms as are prescribed pursuant to the information reporting provisions of sections 6041 through 6050P and the regulations under these sections;

(D) Amounts paid on a notional principal contract described in §1.1441–4(a)-(3)(i) that are not effectively connected with the conduct of a trade or business in the United States (or treated as not effectively connected pursuant to §1.1441–4-(a)(3)(ii));

(E) Amounts required to be reported on Form 8288 (U.S. Withholding Tax Return for Dispositions by Foreign Persons of U.S. Real Property Interests) or Form 8804 (Annual Return for Partnership Withholding Tax (Section 1446)). A withholding agent that must report a distribution partly on a Form 8288 or 8804 and partly on a Form 1042–S may elect to report the entire amount on a Form 8288 or 8804;

(F) Original issue discount for which no withholding is required under §1.1441–2(b)(3); and

(G) Amounts described in §1.1441–1-(b)(4)(xviii) (dealing with certain amounts paid by the U.S. government).

(3) *Required information.* The information required to be furnished under this paragraph (c)(3) shall be based upon the information provided by or on behalf of the beneficial owner (e.g., a beneficial owner withholding certificate or documentary evidence), as corrected and supplemented based on the withholding agent's actual knowledge. The Form 1042–S must include the following information, if applicable—

(i) The name, address, and taxpayer identifying number of the withholding agent;

(ii) A description of each category of income paid (e.g., interest, dividends, royalties, etc.) and the aggregate amount in each category expressed in U.S. dollars;

(iii) The rate of withholding applied;

(iv) The name and permanent residence address of the beneficial owner (or of the payee if the beneficial owner is unknown, or of the person receiving the amount if the payee is also unknown);

(v) The taxpayer identifying number of the beneficial owner if required under §1.1441–1(e)(4)(vii) to be stated on a beneficial owner withholding certificate (or if actually known to the withholding agent making the return). In the case of a financial institution, actual knowledge exists with respect to accounts maintained for customers only if such taxpayer identifying number was stated on a Form W–8 furnished for another payment made through the same account or through another account, the information for which can be retrieved through a centralized account information system (as described in §1.1441–1(e)(4)(ix)) containing both accounts; and

(vi) Such information as the form or the instructions may require in addition to, or in lieu of, information required under this paragraph (c)(3).

(4) *Multiple withholding agents*—(i) *In general.* Except as otherwise provided in this paragraph (c)(4), no information return is required to be made under paragraph (c)(1)(i) of this section if a return is filed by another withholding agent reporting the same amount pursuant to the provisions of this paragraph (c).

(ii) *Payments to a qualified intermediary or a withholding foreign partnership.* A withholding agent making a payment to a qualified intermediary (described in §1.1441–1(e)(5)(ii)) or to a withholding foreign partnership (described in §1.1441–5(c)(2)(i)) must report the payment on a single Form 1042–S or as otherwise directed by the form or the accompanying instructions to the form and must provide a copy of the Form 1042–S to the intermediary or partnership (but is not required to provide the Form 1042–S to the beneficial owners or partners). The Form 1042–S must report the different categories of payments based on different types of income and applicable withholding rates.

(iii) *Payments to an authorized foreign agent*—(A) *Filing obligation of foreign authorized agent.* An authorized foreign agent (as described in §1.1441–7(c)(2)) is subject to the filing requirements described in paragraph (c)(1)(i) of this section because it is a withholding agent. Therefore, to the extent the U.S. withholding agent for which it is acting is not reporting the information required under this paragraph (c), it must report the information required to be reported under paragraph (c)(3) or (4)(vi) of this section.

(B) *Filing obligations of the U.S. withholding agent.* A U.S. withholding agent making a payment to an authorized foreign agent is exempted from the requirement under paragraph (c)(4)(iv) of this section to make a return on Form 1042–S for each beneficial owner and may, instead, make a return on a single Form 1042–S to report the payment made to the authorized foreign agent. The exemption in this paragraph (c)(4)(iii)(B) shall apply only to the extent the authorized foreign agent complies with the filing requirements under paragraph (c)(4)(iii)(A) of this section.

(iv) *Payments to other intermediaries or foreign partnerships.* Payment of an amount to a foreign intermediary described in §1.1441–1(e)(3)(i) that is not a qualified intermediary or to a foreign partnership that is not a withholding foreign partnership described in §1.1441–5-(c)(2)(i) may not be shown on a single Form 1042–S but must be reported on separate Forms 1042–S for each benefi-

cial owner or payee whose name appears on a withholding certificate attached to the intermediary's or partnership withholding certificate that is from a qualified intermediary or a withholding foreign partnership. Payments to an intermediary for the account of undocumented owners or to a foreign partnership for the account of undocumented partners should be reported on a single Form 1042–S made out to the intermediary and bearing the mention "unknown owners".

(v) *Payments to a U.S. branch of certain foreign entities.* Payment of an amount to the U.S. branch of a foreign entity described in §1.1441–1(b)(2)(iv) shall be reported—

(A) On a single Form 1042-S as effectively connected income if the withholding agent cannot reliably associate documentation with the payment to the U.S. branch;

(B) On a single Form 1042-S as an amount paid to an intermediary if the withholding agent can reliably associate the payment with a U.S. branch withholding certificate described in §1.1441–1(e)-(3)(v) furnished as evidence of an agreement between the branch and the withholding agent to treat the branch as a U.S. person; or

(C) On separate Forms 1042-S for each beneficial owner or payee whose name appears on a withholding certificate or other appropriate documentation attached to the U.S. branch withholding certificate.

(vi) *Required information.* An information return on a Form 1042–S by a withholding agent reporting payments to an intermediary, to a foreign partnership, or to a U.S. branch must contain the information contained in this paragraph (c)(4)(vi). The information on the Form 1042–S must be based upon the withholding certificates furnished by the payee, as corrected and supplemented by the withholding agent based on its actual knowledge or reason to know other facts:

(A) The name, address, and taxpayer identifying number of the withholding agent.

(B) A description of each category of income paid (e.g., interest, dividends, royalties, etc.) and the aggregate amount in each category expressed in U.S. dollars.

(C) The rate of withholding applied.

(D) The basis for not withholding or withholding at a reduced rate.

(E) The name, address, and taxpayer identifying number of the payee.

(F) In the case of payments described in paragraph (c)(4)(iv) of this section, the information described in paragraphs (c)(3)(iv) and (v) of this section regarding the person for whom a Form 1042–S is required to be prepared under paragraph (c)(4)(iv).

(G) Such information as the form or instructions may require in addition to, or in lieu of, the information required under this paragraph (c)(4)(vi).

(5) *Payments to single-member entity.* A withholding agent that, upon reliance on a valid withholding certificate, treats a payment as made to a wholly-owned entity that is disregarded to federal tax purposes under §301.7701–2(c)(2) of this chapter as an entity separate from its owner and whose single owner is a foreign person shall make an information return on Form 1042–S in the name of the foreign single owner, using the owner's taxpayer identifying number if such a number is required to be stated on the form.

(6) *Special rules in the case of claims of treaty benefits by hybrid entities or their interest holders.* A withholding agent must make an information return on a Form 1042–S for each beneficial owner (within the meaning of the applicable tax treaty) upon whose withholding certificate or other appropriate documentation the withholding agent relies to reduce the rate of withholding under a tax treaty. Therefore, in the case of concurrent and consistent claims of reduced rates under several tax treaties by the entity and by one or more interest holders, the withholding agent must make an information return for the entity and for each of the interest holders claiming to derive an allocable share of amounts paid to the entity as a resident of an applicable treaty country.

(7) *Effect of grace period on filing requirements.* A withholding agent who relies on the provisions of §1.1441–1(b)-(3)(iv) to treat the payee as a foreign person during a 90-day grace period while awaiting the documentation must make an information return on a Form 1042–S to report all payments to such person during the grace period even if such person is (or is presumed to be) a U.S. person based upon documentation furnished to the withholding agent when the grace period expired or subsequently, or based upon applicable presumptions in §1.1441–1-(b)(3).

(8) *Magnetic media reporting.* A withholding agent that makes 250 or more Form 1042–S information returns for a taxable year must file Form 1042–S returns on magnetic media. See §301.6011–2 of this chapter for requirements applicable to a withholding agent that files Forms 1042–S with the IRS on magnetic media and publications of the IRS relating to magnetic media filing.

(d) *Report of taxpayer identifying numbers.* When so required under procedures that the IRS may prescribe in published guidance (see §601.601(d)(2) of this chapter), a withholding agent must attach to the Form 1042 a list of all the taxpayer identifying numbers (and corresponding names) that have been furnished to the withholding agent and upon which the withholding agent has relied to grant a reduced rate of withholding and that are not otherwise required to be reported on a Form 1042–S under the provisions of this section.

(e) *Indemnification of withholding agent.* A withholding agent is indemnified against the claims and demands of any person for the amount of any tax it deducts and withholds in accordance with the provisions of chapter 3 of the Code and the regulations under that chapter. A withholding agent that withholds based on a reasonable belief that such withholding is required under chapter 3 of the Code and the regulations under that chapter is treated for purposes of section 1461 and this paragraph (e) as having withheld tax in accordance with the provisions of chapter 3 of the Code and the regulations under that chapter. In addition, a withholding agent is indemnified against the claims and demands of any person for the amount of any payments made in accordance with the grace period provisions set forth in §1.1441–1(b)(3)(iv). This paragraph (e) does not apply to relieve a withholding agent from tax liability under chapter 3 of the Code or the regulations under that chapter.

(f) *Amounts paid not constituting gross income.* Any amount withheld in accordance with §1.1441–3 shall be reported and paid in accordance with this section, even though the amount paid to the beneficial owner may not constitute gross in-

come in whole or in part. For this purpose, a reference in this section and §1.1461–2 to an amount shall, where appropriate, be deemed to refer to the amount subject to withholding under §1.1441–3.

(g) *Extensions of time to file Forms 1042 and 1042–S.* The IRS may grant an extension of time in which to file a Form 1042 or a Form 1042–S. Form 2758, Application for Extension of Time to File Certain Excise, Income, Information, and Other Returns (or such other form as the IRS may prescribe), must be used to request an extension of time for a Form 1042. Form 8809, Request for Extension of Time to File Information Returns (or such other form as the IRS may prescribe) must be used to request an extension of time for a Form 1042–S. The request must contain a statement of the reasons for requesting the extension and such other information as the forms or instructions may require. It must be mailed or delivered not later than March 15 of the year following the end of the calendar year for which the return will be filed.

(h) *Penalties.* For penalties and additions to the tax for failure to file returns or furnish statements in accordance with this section, see sections 6651, 6662, 6663, 6721, 6722, 6723, 6724(c), 7201, 7203, and the regulations under those sections.

(i) *Effective date.* This section shall apply to returns required for payments made after December 31, 1998.

§1.1461–2 Adjustments for overwithholding or underwithholding of tax.

(a) *Adjustments of overwithheld tax*—(1) *In general.* A withholding agent that has overwithheld under chapter 3 of the Internal Revenue Code (Code) and made a deposit of the tax as provided in §1.6302–2(a) may adjust the overwithheld amount either pursuant to the reimbursement procedure described in paragraph (a)(2) of this section or pursuant to the set-off procedure described in paragraph (a)(3) of this section. Adjustments under this paragraph (a) may only be made within the time prescribed under paragraph (a)(2) or (3) of this section. After such time, an adjustment to the amount overwithheld can only be claimed by the beneficial owner with the Internal Revenue Service (IRS) pursuant to the procedures described in chapter 65 of the Code. For purposes of this section, the term overwithholding means any amount actually withheld (determined before application of the adjustment procedures under this section) from an item of income pursuant to chapter 3 of the Code or the regulations thereunder in excess of the actual tax liability due, regardless of whether such overwithholding was in error or appeared correct at the time it occurred.

(2) *Reimbursement of tax*—(i) *General rule.* Under the reimbursement procedure, the withholding agent repays the beneficial owner or payee for the amount overwithheld. In such a case, the withholding agent may reimburse itself by reducing, by the amount of tax actually repaid to the beneficial owner or payee, the amount of any deposit of tax made by the withholding agent under §1.6302–2(a)-(1)(iii) for any subsequent payment period occurring before the end of the calendar year following the calendar year of overwithholding. Any such reduction that occurs for a payment period in the calendar year following the calendar year of overwithholding shall be allowed only if—

(A) The withholding agent states, on a timely filed (not including extensions) Form 1042–S for the calendar year of overwithholding, the amount of tax withheld and the amount of any actual repayment; and

(B) The withholding agent states on a timely filed (not including extensions) Form 1042 for the calendar year of overwithholding, that the filing of the Form 1042 constitutes a claim for credit in accordance with §1.6414–1.

(ii) *Record maintenance.* If the beneficial owner is repaid an amount of withholding tax under the provisions of this paragraph (a)(2), the withholding agent shall keep as part of its records a receipt showing the date and amount of repayment and the withholding agent must provide a copy of such receipt to the beneficial owner. For this purpose, a canceled check or an entry in a statement is sufficient provided that the check or statement contains a specific notation that it is a refund of tax overwithheld.

(3) *Set-offs.* Under the set-off procedure, the withholding agent may repay the beneficial owner by applying the amount overwithheld against any amount which otherwise would be required under chapter 3 of the Code or the regulations thereunder to be withheld from income paid by the withholding agent to such person before the earlier of the due date (without regard to extensions) for filing the Form 1042–S for the calendar year of overwithholding or the date that the Form 1042–S is actually filed with the IRS. For purposes of making a return on Form 1042 or 1042–S (or an amended form) for the calendar year of overwithholding and for purposes of making a deposit of the amount withheld, the reduced amount shall be considered the amount required to be withheld from such income under chapter 3 of the Code and the regulations thereunder.

(4) *Examples.* The principles of this paragraph (a) are illustrated by the following examples:

Example 1. (i) N is a nonresident alien individual who is a resident of the United Kingdom. In December 1999, a domestic corporation C pays a dividend of $100 to N, at which time C withholds $30 and remits the balance of $70 to N. On February 10, 2000, prior to the time that C files its Form 1042, N furnishes a valid Form W–8 described in §1.1441–1(e)(2)(i) upon which C may rely to reduce the rate of withholding to 15 percent under the provisions of the U.S.-U.K. tax treaty. Consequently, N advises C that its tax liability is only $15 and not $30 and requests reimbursement of $15. Although C has already deposited the $30 that was withheld, as required by §1.6302–2(a)(1)(iv), C repays N in the amount of $15.

(ii) During 1999, C makes no other payments upon which tax is required to be withheld under chapter 3 of the Code; accordingly, its return on Form 1042 for such year, which is filed on March 15, 2000, shows total tax withheld of $30, an adjusted total tax withheld of $15, and $30 previously paid for such year. Pursuant to §1.6414–1(b), C claims a credit for the overpayment of $15 shown on the Form 1042 for 1999. Accordingly, it is permitted to reduce by $15 any deposit required by §1.6302–2 to be made of tax withheld during the calendar year 2000. The Form 1042–S required to be filed by C with respect to the dividend of $100 paid to N in 1999 is required to show tax withheld of $30 and tax released of $15.

Example 2. The facts are the same as in *Example 1.* In addition, during 2000, C makes payments to N upon which it is required to withhold $200 under chapter 3 of the Code, all of which is withheld in June 2000. Pursuant to §1.6302–2(a)(1)(iii), C deposits the amount of $185 on July 15, 2000 ($200 less the $15 for which credit is claimed on the Form 1042 for 1999). On March 15, 2001, C Corporation files its return on Form 1042 for calendar year 2000, which shows total tax withheld of $200, $185 previously deposited by C, and $15 allowable credit.

Example 3. The facts are the same as in *Example 1.* Under §1.6032–2(a)(1)(ii)), C is required to deposit on a quarter-monthly basis the tax withheld under chapter 3 of the Code. C withholds tax of $100 between February 8 and February 15, 2000, and deposits $75 [($100 × 90 percent) less $15] of the withheld tax within 3 banking days after Febru-

ary 15, 2000, and by depositing $10 [($100 – $15) less $75] within 3 banking days after March 15, 2000.

(b) *Withholding of additional tax when underwithholding occurs.* A withholding agent may withhold from future payments made to a beneficial owner the tax that should have been withheld from previous payments to such beneficial owner. In the alternative, the withholding agent may satisfy the tax from property that it holds in custody for the beneficial owner or property over which it has control. Such additional withholding or satisfaction of the tax owed may only be made before the date that the Form 1042 is required to be filed (not including extensions) for the calendar year in which the underwithholding occurred. See §1.6302–2 for making deposits of tax or §1.1461–1(a) for making payment of the balance due for a calendar year.

(c) *Definition.* For purposes of this section, the term payment period means the period for which the withholding agent is required by §1.6302–2(a)(1) to make a deposit of tax withheld under chapter 3 of the Code.

(d) *Effective date.* This section applies to payments made after December 31, 1998.

§§1.1461–3 and 1.1461–4 [Removed]

Par. 20. Sections 1.1461–3 and 1.1461–4 are removed.

Par. 21. Sections 1.1462–1 and 1.1463–1 are revised to read as follows:

§1.1462–1 Withheld tax as credit to recipient of income.

(a) *Creditable tax.* The entire amount of the income from which the tax is required to be withheld (including amounts calculated under the gross-up formula in §1.1441–3(f)(1)) shall be included in gross income in the return required to be made by the beneficial owner of the income, without deduction for the amount required to be or actually withheld, but the amount of tax actually withheld shall be allowed as a credit against the total income tax computed in the beneficial owner's return.

(b) *Amounts paid to persons who are not the beneficial owner.* Amounts withheld at source under chapter 3 of the Internal Revenue Code (Code) on payments to a fiduciary, partnership, or intermediary is deemed to have been paid by the taxpayer ultimately liable for the tax upon such income. Thus, for example, if a beneficiary of a trust is subject to the taxes imposed by section 1, 2, 3, or 11 upon any portion of the income received from a foreign trust, the part of any amount withheld at source which is properly allocable to the income so taxed to such beneficiary shall be credited against the amount of the income tax computed upon the beneficiary's return, and any excess shall be refunded. Further, if a partnership withholds an amount under chapter 3 of the Code with respect to the distributive share of a partner that is a partnership or with respect to the distributive share of partners in an upper tier partnership, such amount is deemed to have been withheld by the upper tier partnership.

(c) *Effective date.* This section applies to payments made after December 31, 1998.

§1.1463–1 Tax paid by recipient of income.

(a) *Tax paid.* If the tax required to be withheld under chapter 3 of the Internal Revenue Code is paid by the beneficial owner of the income or by the withholding agent, it shall not be re-collected from the other, regardless of the original liability therefore. However, this section does not relieve the person that did not withhold tax from liability for interest or any penalties or additions to tax otherwise applicable. See §1.1441–7(b)(7) for additional applicable rules.

(b) *Effective date.* This section applies to failures to withhold occurring after December 31, 1989.

Par. 23. Section 1.6041–1 is amended by:

1. Revising paragraph (a)(1).
2. Adding a sentence at the end of paragraph (a)(2) .
3. Revising paragraphs (d)(1) introductory text and (d)(3).
4. Adding a heading for paragraphs (d)(2) and (d)(4).
5. Adding paragraph (d)(5).

The additions and revisions read as follows:

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

(a) *General rule*—(1) *Information returns required*—(i) *Payments required to be reported.* Except as otherwise provided in §§1.6041–3 and 1.6041–4, every person engaged in a trade or business shall make an information return for each calendar year with respect to payments it makes during the calendar year in the course of its trade or business to another person of fixed or determinable income described in paragraph (a)(1)(i)(A) or (B) of this section. For purposes of the regulations under this section, the person described in this paragraph (a)(1)(i) is a payor.

(A) Salaries, wages, commissions, fees, and other forms of compensation for services rendered aggregating $600 or more.

(B) Interest (including original issue discount), rents, royalties, annuities, pensions, and other gains, profits, and income aggregating $600 or more.

(ii) *Information returns required under other provisions of the Internal Revenue Code.* 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). In addition, the payments described in paragraphs (a)(1)(i)(A) and (B) of this section shall not include amounts excepted from the definition of dividends under section 6042(b)(2) and §1.6042–3(b)(1), amounts described in section 6044(b), amounts excepted from reporting under §1.6045–1(g), amounts excepted from the definition of interest under section 6049(b)(2)(C) or (D), §1.6049–4(c), or 1.6049–5(b)(6) through (15). Notwithstanding the preceding sentence, interest with respect to a notional principal contract excluded from the definition of interest under §1.6049–5(b)(15) is reportable under this section. The term interest as used in this paragraph (a)(1)(ii) otherwise includes all interest, other than interest coming within the definition of interest provided in §1.6049–5(a). For example, a closely held corporation borrows money from one of its officers on a promissory note

not in registered form bearing annual stated interest of $300. The corporation also pays royalties to the officer amounting to $400 a year. An information return is required under this paragraph (a)(1) to report the payments to the officer because the interest does not come within the definition of interest in §1.6049–5(a) and the aggregate of interest and royalties exceeds $600.

(2) * * * For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations).

* * * * *

(d) * * * (1) *In general.* Amounts paid in respect of life insurance, endowment, or annuity contracts are required to be reported in returns of information under this section–

* * * * *

(2) *Professional fees.* * * *

(3) *Prizes and awards.* Amounts paid as prizes and awards that are required to be included in gross income under section 74 and §1.74–1 when paid in the course of a trade or business are required to be reported in returns of information under this section.

(4) *Disability payments.* * * *

(5) *Notional principal contracts.* Amounts paid after December 31, 1998, with respect to notional principal contracts referred to in §§ 1.863–7 or 1.988–2(e) to persons who are not described in §1.6049–4(c)(1)(ii) are required to be reported in returns of information under this section. However, a payment made outside the United States (as defined in §1.6049–5(e)) by a non-U.S. payor or a non-U.S. middleman, or by a U.S. payor or U.S. middleman that is not a U.S. person (such as a controlled foreign corporation defined in section 957(a) or certain foreign corporations or foreign partnerships engaged in a U.S. trade or business) or is a foreign branch of a U.S. bank is not reportable under this section if, in the case of a person that is a U.S. payor, a U.S. middleman, or a foreign branch of a U.S. institution, the payor has no actual knowledge that the payee is a U.S. person. The amount required to be reported under this paragraph (d)(5) is limited to the net income from the notional principal contract as described in §1.446–3(d). A non-periodic payment is reportable for the year in which an actual payment is made. Any amount of interest determined under the provisions of §1.446–3(g)(4) (dealing with interest in the case of a significant non-periodic payment) is reportable under this paragraph (d)(5) and not under section 6049 (see §1.6049–5(b)(15)). See §1.6041–4(a)(4) for reporting exceptions regarding payments to foreign persons. See, however, §1.1461–1(c)(1) for reporting amounts described under this paragraph (d)(5) that are paid to foreign persons. The provisions of §1.6049–5(d) shall apply for determining whether a payment with respect to a notional principal contract is made to a foreign person. See §1.6049–4(a) for a definition of payor. For purposes of this paragraph (d)(5), a payor includes a middleman defined in §1.6049–4(f)(4). See §1.6049–5-(c)(5) for a definition of a U.S. payor, a U.S. middleman, a non-U.S. payor, and a non-U.S. middleman.

* * * * *

Par. 24. Section 1.6041–2 is amended by revising paragraph (c) to read as follows:

§1.6041–2 Return of information as to payments to employees.

* * * * *

(c) *Payments to foreign persons.* See §1.6041–4 for reporting exemptions regarding payments to foreign persons. See §1.6049–5(d) for determining whether a payment is made to a foreign person.

Par. 25. Section 1.6041–3 is amended by:

1. Revising the introductory text of the section.

2. Revising paragraphs (a) and (b).

3. Removing the semicolon at the end of paragraphs (d) through (f), and (h) through (j), and adding a period in its place; and removing the language "; and" at the end of paragraph (o), and adding a period in its place.

4. Removing paragraphs (c) and (l).

5. Redesignating paragraphs (d), (e), (f), (g), (h), (i), (j), (k), (m), (n), (o), and (p) as paragraphs (c), (d), (e), (f), (g), (h), (i), (j), (k), (l), (m), and (n), respectively.

6. Revising newly designated paragraphs (f), and (j).

7. Adding new paragraphs (o) and (p), and paragraph (q).

The addition and revisions read as follows:

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

Returns of information are not required under section 6041 and §§1.6041–1 and 1.6041–2 for payments described in paragraphs (a) through (q) of this section. See §1.6041–4 for reporting exemptions regarding payments to foreign persons. See §1.6041–4 for reporting exemptions regarding foreign persons.

(a) Payments of income required to be reported on Forms 1120–S, 941, W–2, and W–3, (however, see §1.6041–2(a) with respect to Forms W–2 and W–3).

(b) Payments by a broker to his customer (but for reporting requirements as to certain of such payments, see sections 6042, 6045, and 6049 and the regulations thereunder in this part).

* * * * *

(f) Compensation and profits paid or distributed by a partnership to the individual partners (but for reporting requirements, see §1.6031–1).

* * * * *

(j) Payments of interest on corporate bonds (but for reporting requirements as to payments of interest on certain corporate bonds, see §1.6049–5).

* * * * *

(o) Payments to individuals as scholarships or fellowship grants within the meaning of section 117(b)(1), whether or not "qualified scholarships" as described in section 117(b). This exception does not apply to any amount of a scholarship or fellowship grant that represents payment for services within the meaning of section 117(c). Instead, these amounts are required to be reported as wages on Form W–2 . See §1.1461–1(c) for applicable reporting requirements for amounts paid to foreign persons.

(p) Per diem of certain alien trainees described under section 1441(c)(6).

(q) Payments made to the following persons:

(1) A corporation described in §1.6049–4(c)(1)(ii)(A), except 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. However, no reporting is required where payment is made to a hospital or extended care facility described in section 501(c)(3) which is exempt from taxation under section 501(a) or to a hospital or extended care facility owned and operated by the United States, a State, the District of Columbia, a possession of the United States, or a political subdivision, agency or instrumentality of any of the foregoing. For reporting requirements as to payments by cooperatives, and to certain other payments, see sections 6042, 6044, and 6049 and the regulations thereunder in this part.

(2) An organization exempt from taxation under section 501(a), as described in §1.6049–4(c)(1)(ii)(B)(*1*), or an individual retirement plan, as described in §1.6049–4(c)(1)(ii)(C).

(3) The United States, as described in §1.6049–4(c)(1)(ii)(D).

(4) A State, the District of Columbia, a possession of the United States, or any political subdivision of any of the foregoing, as described in §1.6049–4(c)(1)(ii)(E).

(5) A foreign government or political subdivision of a foreign government, as described in §1.6049–4(c)(1)(ii)(F).

(6) An international organization, as described in §1.6049–4(c)(1)(ii)(G).

(7) A foreign central bank of issue, as described in §1.6049–4(c)(1)(ii)(H) and the Bank for International Settlements.

(8) Any wholly owned agency or instrumentality of any person described in paragraph (q)(2), (3), (4), (5), (6), or (7) of this section.

Par. 26. Section 1.6041–4 is revised to read as follows:

§1.6041–4 Foreign-related items and other exceptions

(a) *Exempted foreign-related items*—(1) Returns of information are not required for payments that a payor can, prior to payment, associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049-5(d)(2), (3), (4), or (5). However, such payments may be reportable under §1.1461–1(b) and (c). For purposes of this paragraph (a)(1), the provisions in §1.6049-5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. See §1.1441–1(b)-(3)(iii)(B) and (C) for special payee rules regarding scholarships, grants, pensions, annuities, etc. The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code and the regulations under that chapter.

(2) Returns of information are not required for payments of amounts from sources outside the United States (determined under the provisions of part I, subchapter N, chapter 1 of the Internal Revenue Code and the regulations under those provisions) made by a non-U.S. payor or non-U.S. middleman outside the United States. For a definition of non-U.S. payor and non-U.S. middleman, see §1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see §1.6049–5(e).

(3) Returns of information are not required for amounts paid by a foreign intermediary described in §1.1441–1(e)-(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in §1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in §1.1441–1(e)-(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported under §1.6041–1 and were not so reported.

(4) Returns of information are not required for amounts paid with respect to notional principal contracts referred to in §1.863–7 or 1.988–2(e) which the payor may treat as effectively connected income of a foreign payee under the provisions of §1.1441–4(a)(3) or if the payee provides a representation in a master agreement that governs the transactions in notional principal contracts between the parties (for example, an International Swap and Derivatives Association (ISDA) Agreement, including the Schedule thereto) or in the confirmation on the particular notional principal contract transaction that the counterparty is a foreign person. See, however, §1.1461–1(c)(2)(i) for applicable reporting requirements.

(5) Returns of information are not required for the period that the amounts paid represent assets blocked as described in §1.1441–2(e)(3). The exemption in this paragraph (a)(5) shall terminate when payment is deemed to occur in accordance with the provisions of §1.1441–2(e)(3)

(b) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (a) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor or middleman cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (a)(1) of this section furnished by each joint owner upon which the payor or middleman can rely to treat each joint owner as a foreign payee or foreign beneficial owner.

(c) *Conversion into United States dollars of amounts paid in foreign currency.* For rules concerning foreign currency conversion, see §1.6049–4(d)(3)(i).

(d) *Effective date.* The provisions of this section apply to payments made after December 31, 1998.

Par. 27. Section 1.6041–7 is amended by revising the section heading and adding a sentence to the end of paragraph (a) to read as follows:

§1.6041–7 Magnetic media requirement.

(a) * * * High-volume filers of information returns must file their returns on magnetic media. See section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations) for the requirements for filing on magnetic media.

* * * * *

Par. 28. Section 1.6041–8 is added to read as follows:

§1.6041-8 Cross-reference to penalties.

For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6041(a) or (b), see §301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6041(d), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Par. 29. Section 1.6041A–1 is added to read as follows:

§1.6041A–1 Returns regarding payments of remuneration for services and certain direct sales.

(a) through (c) [Reserved].

(d) *Exceptions to return requirement.* [Reserved].

(1) and (2) [Reserved].

(3) *Foreign transactions*—(i) *In general.* No return shall be required under section 6041A with respect to payments described in this paragraph (d)(3).

(A) Returns of information are not required for payments that a payor can, prior to payment, associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049–5(d)(2), (3), (4), or (5). However, such payments may be reportable under §1.1461–1(b) and (c). For purposes of this paragraph (d)(3)(i)(A), the provisions in §1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent.*

(B) Returns of information are not required for payments of remuneration for services and certain direct sales from sources outside the United States (determined under the provisions of part I, subchapter N, chapter 1 of the Internal Revenue Code and the regulations under those provisions) if payments made outside the United States by a non-U.S. payor or non-U.S. middleman. For a definition of non-U.S. payor or non-U.S. middleman, see §1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see §1.6049–5(e).

(ii) *Payor.* The term *payor* has the same meaning as described in §1.6049–4(a)(2).

(iii) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (d)(3)(i) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor or middleman cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (d)(3)(i)(A) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner.

(iv) *Conversion into United States dollars of amount paid in foreign currency.* For rules concerning foreign currency conversion, see §1.6049–4(d)-(3)(i).

(v) *Effective date.* The provisions of this paragraph (d)(3) apply to payments made after December 31, 1998.

(e) [Reserved].

(f) *Statements to be furnished to persons with respect to whom information is required to be furnished*—(1) [Reserved].

(2) *Time for furnishing statement.* [Reserved].

(3) *Contents of statement.* [Reserved].

(g) [Reserved].

(h) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6041A(a) or (b), see §301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6041A(e), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Par. 30. Section 1.6042–2 is amended by:

1. Revising the section heading, adding introductory text to paragraph (a)(1), and revising paragraphs (a)(1)(i) and (a)(1)(ii).

2. Removing the language "1099M" in the first sentence of paragraph (a)(1)(iii) and adding "1099A" in its place.

3. Removing the language "1087" each time it appears in the second sentence of paragraph (a)(4) and adding "1099" in each place, and removing the last sentence.

4. Revising paragraph (d).

5. Revising the heading of paragraph (e) and adding a sentence to the end of paragraph (e).

The revisions and addition read as follows:

§1.6042–2 Returns of information as to dividends paid.

(a) *Requirement of reporting*—(1) An information return on Form 1099 shall be made under section 6042(a) by—

(i) Every person who makes a payment of dividends (as defined in §1.6042–3) to any other person during a calendar year. The information return shall show the aggregate amount of the dividends, the name, address, and taxpayer identifying number of the person to whom paid, the amount of tax deducted and withheld under section 3406 from the dividends, if any, and such other information as required by the forms. An information return is generally not required if the amount of dividends paid to the other person during the calendar year aggregates less than $10 or if the payment is made to a person who is an exempt recipient described in §1.6049–4(c)(1)(ii) unless the payor backup withholds under section 3406 on such payment (because, for example, the payee has failed to furnish a Form W–9 on request), in which case the payor must make a return under this section, unless the payor refunds the amount withheld pursuant to §31.6413(a)–3 of this chapter.

(ii) Every person, except to the extent that he acts as a nominee described in paragraph (a)(1)(iii) of this section, who receives payments of dividends as a nominee on behalf of another person shall make a return of information under this

section for the calendar year of the payment . The information return shall show the aggregate amount of the dividends, the name, address, and taxpayer identification number of the person on whose behalf the dividends are received, the amount of tax deducted and withheld under section 3406 from the dividends, if any, and such other information as required by the forms. An information return is generally not required if the amount of the dividends received on behalf of the other person during the calendar year aggregates less than $10. However, a return of information is not required under this section if—

(A) The record owner is, pursuant to section 6012(a)(3) or (4) and §1.6012–3, required to file a fiduciary return on Form 1041 that is filed for the estate or trust disclosing the name, address, and identifying number of both the record owner and actual owner and furnishes Form K–1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406;

(B) The record owner is a nominee of a banking institution or trust company exercising trust powers, and such banking institution or trust company is, pursuant to section 6012(a)(3) or (4) and §1.6012–3, required to file a fiduciary return on Form 1041 that is filed for the estate or trust disclosing the name, address, and identifying number of both the record owner and the actual owner and furnishes Form K–1 to each actual owner containing the information required to be shown on the form, including amounts withheld under section 3406; or

(C) The record owner is a banking institution or trust company exercising trust powers, or a nominee thereof, and the actual owner is an organization exempt from taxation under section 501(a) for which such banking institution or trust company files an annual return but only if the name, address, and identifying number of the record owner are included on or with the annual return filed for the tax exempt organization).

* * * * *

(d) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6042(a), see §301.6721–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(e) *Magnetic media requirement.* * * * For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations).

Par. 31. Section 1.6042–3 is amended by:

1. Revising paragraphs (a) introductory text and (a)(2).
2. Removing the concluding text immediately following paragraph (a)(2).
3. Adding paragraph (a)(3).
4. Revising paragraph (b).
5. Removing the authority citation at the end of the section.

The addition and revision read as follows:

§1.6042–3 Dividends subject to reporting.

(a) *In general.* Except as provided in paragraph (b) of this section, the term dividend for purposes of this section and §§1.6042–2 and 1.6042–4 means the amounts described in the following paragraphs (a)(1) through (3) of this section—

* * * * *

(2) Any payment made by a stockbroker to any person as a substitute for a dividend. Such a payment includes any payment made in lieu of a dividend to a person whose stock has been borrowed. See §1.6045–2(h) for coordination of the reporting requirements under sections 6042 and 6045(d) with respect to such payments; and

(3) A distribution from a regulated investment company (irrespective of the fact that any part of the distribution may not represent ordinary income (i.e., may, for example, represent a capital gain dividend as defined in section 852(b)(3)(C)).

(b) *Exceptions*—(1) *In general.* For purposes of §§1.6042–2 and 1.6042–4, the amounts described in paragraphs (b)(1)(i) through (vii) of this section are not dividends.

(i) Amounts paid by an insurance company to a policyholder, other than a dividend upon its capital stock.

(ii) Payments (however denominated) by a mutual savings bank, savings and loan association, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares. See, however, section 6049 and the regulations under that section for provisions requiring reporting of these payments.

(iii) Distributions or payments that a payor can, prior to payment, reliably associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049–5(d)(2), (3), (4), or (5). However, such payments may be reportable under §1.1461–1(b) and (c). For purposes of this paragraph (b)(1)(iii), the provisions in §1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code (Code).

(iv) Distributions or payments from sources outside the United States (as determined under the provisions of part I, subchapter N, chapter 1 of the Code and the regulations under those provisions) paid outside the United States by a non-U.S. payor or a non-U.S. middleman. For a definition of non-U.S. payor and non-U.S. middleman, see §1.6049–5(c)(5). For circumstances in which a payment is considered to be made outside the United States, see §1.6049–5(e).

(v) Distributions or payments for the period that the amounts represent assets blocked as described in §1.1441–2(e)(3). The exemption in this paragraph (b)(1)(v) shall terminate when payment is deemed to occur in accordance with the rules of §1.1441–2(e)(3).

(vi) Payments made by a foreign intermediary described in §1.1441–1(e)(3)(i) that it has received in its capacity as an intermediary and that are associated with

a valid withholding certificate described in §1.1441–1(e)(3)(ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in §1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported under §1.6042–2 and were not so reported.

(vii) With respect to amounts paid or credited after December 31, 1982, any amount paid or credited to any person described in §1.6049–4(c)(1)(ii), unless a tax is withheld under section 3406 and is not refunded by the payor in accordance with §31.6413(a)–3 of this chapter (Employment Tax Regulations).

(2) *Payor.* The term *payor* has the same meaning as described in §1.6049–4(a)(2).

(3) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under this paragraph (b) are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor or middleman cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (b)(1)(iii) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (b)(3), the grace period described in §1.6049–5(d)(2)(ii) shall apply only if each payee qualifies for such grace period.

(4) *Conversion into United States dollars of amounts paid in foreign currency.* For rules concerning foreign currency conversion, see §1.6049–4(d)(3)(i).

(5) *Effective date*—(i) *General rule.* The provisions of this paragraph (b) apply to payments made after December 31, 1998.

(ii) *Transition rules.* A payor that, on December 31, 1998, holds a valid Form W–8 or other form upon which it is permitted to rely to hold the payee as a foreign person pursuant to the regulations in effect prior to January 1, 1999 (see 26 CFR parts 1 and 35a, revised April 1, 1997), may treat it as a valid certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a Form W–8 or other form that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the preceding sentence). The rule in this paragraph (b)(5)(ii), however, does not apply to extend the validity period of a withholding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a payor may choose not to take advantage of the transition rule in this paragraph (b)(5)(ii) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

* * * * *

Par. 32. Section 1.6042–4 is amended by revising paragraphs (d)(2)(i)(F) and (f) to read as follows:

§1.6042–4 Statement to recipients of dividend payments.

* * * * *

(d) * * *

(2) * * *

(i) * * *

(F) Any document concerning the solicitation of the Form W–9, as described in §31.3406(h)–3(a) of this chapter, or of the Form W–8 as described in §1.1441–1(e)(1).

* * * * *

(f) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6042(c), see §301.6722–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

* * * * *

§1.6043–2 [Amended]

Par. 33. In §1.6043–2, paragraph (a), the first, second, and last sentences are amended by removing the reference to "1099L" and adding "966" in each place.

Par. 34. Section 1.6044–2 is amended by:

1. Revising the section heading
2. Adding two sentences at the end of paragraph (a)(1).
3. Revising paragraph (e).
4. Revising the heading for paragraph (f) and adding a sentence at the beginning of paragraph (f).

The revisions and additions read as follows:

§1.6044–2 Returns of information as to payments of patronage dividends.

(a) *Requirement of reporting*—(1) *In general.* * * * The organization is required to make an information return regardless of the amount of the payment if the tax imposed by section 3406 is required to be withheld. Thus, in the case of any amount subject to backup withholding under section 3406 and not refunded by the payor before the due date of the information return in accordance with the regulations under section 3406, an information return shall be made even if the payment is not generally reportable because it is made to an exempt recipient described in §1.6049–4(c)(1)(ii) or the amount paid during the calendar year to the recipient aggregates less than $10.

* * * * *

(e) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6044(a), see §301.6721–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(f) *Magnetic media requirement.* For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Procedure and Administration Regulations). * * *

Par. 35. In §1.6044–3, paragraph (c) is revised to read as follows:

§1.6044–3 Amounts subject to reporting.

* * * * *

(c) *Exceptions.* An amount described in paragraph (a) of this section does not include—

(1) Any amount described in §1.6042–3(b); or

(2) With respect to amounts paid or credited after December 31, 1982, any amount paid or credited to any person described in §1.6049–4(c)(1)(ii).

* * * * *

Par. 36. In §1.6044–5, paragraph (c) is revised to read as follows:

§1.6044–Statements to recipients of patronage dividends.

* * * * *

(c) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6044(e), see §301.6722–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

* * * * *

Par. 37. Section 1.6045–1 is amended by:

1. Revising the heading of paragraph (a), paragraph (a) introductory text, and paragraph (a)(1).

2. Removing paragraph (a)(12) and redesignating paragraph (a)(13) as paragraph (a)(12).

3. Adding new paragraph (a)(13).

4. Paragraph (b) is amended by redesignating *Example (1)* through *Example (8)* as *Example 1* through *Example 8*, respectively; removing newly designated *Example 1*(ii); and redesignating *Example 1*(iii) through (vi) as *Example 1*(ii) through (v), respectively.

5. Paragraph (c) is amended by:

a. Redesignating paragraphs (c)(5)(i)-(*a*) through (c)(5)(i)(*f*) as paragraphs (c)(5)(i)(A) through (c)(5)(i)(F), respectively.

b. Redesignating paragraph (c)(5)(ii) and *Example (1)* through *Example (4)* as paragraph (c)(5)(iii) and *Example 1* through *Example 4*, respectively.

c. Adding new paragraph (c)(5)(ii).

6. Paragraph (c)(6) is amended by:

a. Redesignating paragraphs (c)(6)-(i)(*a*) and (c)(6)(i)(*b*) as paragraphs (c)(6)(i)(A) and (c)(6)(i)(B), respectively.

b. Redesignating paragraphs (c)(6)-(ii)(*a*) and (c)(6)(ii)(*b*) as paragraphs (c)(6)(ii)(A) and (c)(6)(ii)(B), respectively.

7. Revising paragraphs (d)(4), (d)(6), (f)(2)(iii) last sentence of introductory text, and (g).

8. In paragraph (h)(2), redesignating *Example (1)* and *Example (2)* as paragraph (h)(2) *Example 1* and *Example 2*, respectively.

9. Revising paragraphs (j), (k), and (l).

10. Removing the authority citation at the end of the section.

The revisions and additions read as follows:

§1.6045–1 Returns of information of brokers and barter exchanges.

(a) *Definitions.* The following definitions apply for purposes of this section, §1.6045–2, and §5f.6045–1 of this chapter:

(1) The term *broker* means any person (other than a person who is required to report a transaction under section 6043), U.S. or foreign, that, in the ordinary course of a trade or business during the calendar year, stands ready to effect sales to be made by others. A broker includes an obligor that regularly issues and retires its own debt obligations or a corporation that regularly redeems its own stock. However, with respect to a sale (including a redemption or retirement) effected at an office outside the United States, a broker includes only a person described as a U.S. payor or U.S. middleman in §1.6049–5(c)(5). In addition, a broker does not include an international organization described in §1.6049–4(c)(1)(ii)(G) that redeems or retires an obligation of which it is the issuer.

* * * * *

(13) The term *person* includes any governmental unit and any agency or instrumentality thereof.

* * * * *

(c) * * *

(5) * * *

(ii) *Determination of profit or loss from foreign currency contracts.* A broker effecting a closing transaction in foreign currency contracts (as defined in section 1256(g)) shall report information with respect to such contracts in the manner prescribed in paragraph (c)(5)(i) of this section. If a foreign currency contract is closed by making or taking delivery, the net realized profit or loss for purposes of paragraph (c)(5)(i)(B) of this section is determined by comparing the contract price to the spot price for the contract currency at the time and place specified in the contract. If a foreign currency contract is closed by entry into an offsetting contract, the net realized profit or loss for purposes of paragraph (c)(5)(i)(B) of this section is determined by comparing the contract price to the price of the offsetting contract. The net unrealized profit or loss in a foreign currency contract for purposes of paragraphs (c)(5)(i)(C) and (D) of this section is determined by comparing the contract price to the broker's price for similar contracts at the close of business of the relevant year.

* * * * *

(d) * * *

(4) *Sale date.* With respect to sales of property that are reportable under this section, a broker must report a sale as occurring on the date the sale is entered on the books of the broker.

* * * * *

(6) *Conversion into United States dollars of proceeds paid in foreign currency*—(i) *Conversion rules.* When a payment is made in a foreign currency, the U.S. dollar amount shall be determined by converting such foreign currency into U.S. dollars on the date of payment at the spot rate (as defined in §1.988–1(d)(1)) or pursuant to a reasonable spot rate convention. For example, a withholding agent may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently with respect to all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner or his or her delegate.

(ii) *Effect of identification under §1.988–5(a), (b), or (c) where the taxpayer effects a sale and a hedge through the same broker*—(A) *In general.* In lieu of the amount reportable under paragraph

(d)(6)(i) of this section, the amount subject to reporting shall be the integrated amount computed under §1.988–5(a), (b) or (c) if—

(*1*) A taxpayer effects through a broker a sale or exchange of nonfunctional currency (as defined in §1.988–1(c)) and hedges all or a part of such sale as provided in §1.988–5(a), (b) or (c) with the same broker; and

(*2*) The taxpayer complies with the requirements of §1.988–5(a), (b) or (c) and so notifies the broker prior to the end of the calendar year in which the sale occurs.

(B) *Effective date.* The provisions of this paragraph (d)(6)(ii) apply to transactions entered into after December 31, 1998.

* * * * *

(f) * * *

(2) * * *

(iii) *Definition.* * * * A barter exchange may treat a member or client as a corporation (and therefore as a corporate member or client) if such member or client provides an exemption certificate as described in §31.3406(h)–3(a) of this chapter or provided that—

* * * * *

(g) *Exempt foreign persons*—(1) *Brokers.* No return of information is required to be made by a broker with respect to a customer who is considered to be an exempt foreign person under this paragraph (g)(1). A broker may treat a customer as an exempt foreign person under the circumstances described in paragraphs (g)(1)(i) through (iii) of this section.

(i) With respect to a sale effected at an office of a broker either inside or outside the United States, the broker may treat the customer as an exempt foreign person if the broker can prior to the payment, associate the payment with documentation upon which it can rely in order to treat the customer as a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii), or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049–5(d)(2), (3), or (4) or (5). For purposes of this paragraph (g)(1)(i), the provisions in §1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor, U.S. middleman, non-U.S. payor, and non-U.S. middleman) shall apply. The provisions of §1.1441–1 shall apply by substituting the terms *broker* and *customer* for the terms *withholding agent* and *payee* and without regard for the fact that the provisions apply to amounts subject to withholding under chapter 3 of the Internal Revenue Code (Code). The provisions of §1.6049–5(d) shall apply by substituting the terms *broker* and *customer* for the terms *payor* and *payee*. For purposes of this paragraph (g)(1)(i), the broker may rely on a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) only to the extent that the certificate includes a certification that the beneficial owner has not been, and at the time the certificate is furnished, reasonably expects not to be present in the United States for a period aggregating 183 days or more during each calendar year to which the certificate pertains.

(ii) With respect to a redemption or retirement of stock or an obligation (the interest or original issue discount on which is described in §1.6049–5(b)(6), (7), (10), or (11) or the dividends on which are described in §1.6042–3(b)(1)(iv)) that is effected at an office of a broker outside the United States by the issuer (or its paying or transfer agent), the broker may treat the customer as an exempt foreign person if the broker is not also acting in its capacity as a custodian, nominee, or other agent of the payee.

(iii) With respect to a sale effected by a broker at an office of the broker either inside or outside the United States, the broker may treat the customer as an exempt foreign person for the period that those proceeds are assets blocked as described in §1.1441–2(e)(3). For purposes of this paragraph (g)(1)(iii) and section 3406, a sale is deemed to occur in accordance with paragraph (d)(4) of this section. The exemption in this paragraph (g)(1)(iii) shall terminate when payment of the proceeds is deemed to occur in accordance with the provisions of §1.1441–2(e)(3).

(2) *Barter exchange.* No return of information is required by a barter exchange with respect to a client or a member that the barter exchange may treat as a foreign person pursuant to the procedures described in paragraph (g)(1) of this section.

(3) *Applicable rules*—(i) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (g)(1)(i) or (2) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the broker or barter exchange cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (g)(1)(i) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (g)(3)(i), the grace period described in §1.6049–5(d)(2)(ii) shall apply only if each payee qualifies for such grace period.

(ii) *Special rules for determining who the customer is.* For purposes of this paragraph (g), the determination of who the customer is shall be made on the basis of the provisions in §1.6049–5(d) by substituting in that section the terms *payor* and *payee* with the terms *broker* and *customer.*

(iii) *Place of effecting sale*—(A) *Sale outside the United States.* For purposes of this paragraph (g), a sale is considered to be effected by a broker at an office outside the United States if, in accordance with instructions directly transmitted to such office from outside the United States by the broker's customer, the office completes the acts necessary to effect the sale outside the United States. The acts necessary to effect the sale may be considered to have been completed outside the United States without regard to whether—

(*1*) Pursuant to instructions from an office of the broker outside the United States, an office of the same broker within the United States undertakes one or more steps of the sale in the United States; or

(*2*) The gross proceeds of the sale are paid by a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account.

(B) *Sale inside the United States.* For purposes of this paragraph (g), a sale that is considered to be effected by a broker at an office outside the United States under paragraph (g)(3)(iii)(A) of this section shall nevertheless be considered to be ef-

fected by a broker at an office inside the United States if either—

(*1*) The customer has opened an account with a United States office of that broker;

(*2*) The customer has transmitted instructions concerning this and other sales to the foreign office of the broker from within the United States by mail, telephone, electronic transmission or otherwise (unless the transmissions from the United States have taken place in isolated and infrequent circumstances);

(*3*) The gross proceeds of the sale are paid to the customer by a transfer of funds into an account (other than an international account as defined in §1.6049-5(e)(4)) maintained by the customer in the United States or mailed to the customer at an address in the United States;

(*4*) The confirmation of the sale is mailed to a customer at an address in the United States; or

(*5*) An office of the same broker within the United States negotiates the sale with the customer or receives instructions with respect to the sale from the customer.

(iv) *Special rules where the customer is a foreign intermediary or certain U.S. branches.* A foreign intermediary, as defined in §1.1441–1(e)(3)(i), is an exempt foreign person, except when the broker has actual knowledge or reason to know (within the meaning of §1.6049–5(c)(3)) that the person for whom the intermediary acts is a U.S. person. For an example of this exception, see §1.6049–5(d)(3)(iv) *Example 7.* In addition, if a foreign intermediary (acting as an intermediary) or a U.S. branch receives a payment from a payor or middleman, which payment the payor or middleman can associate with a valid withholding certificate described in §1.1441–1(e)(3)(ii), (iii), or (v), or in §1.1441–5(c)(3)(iii) furnished by such intermediary or U.S. branch, then the intermediary or U.S. branch is not required to report such payment when it, in turn, pays the amount to the person whose name is on the certificate furnished by the intermediary or U.S. branch to the payor or middleman, unless, and to the extent, the intermediary or U.S. branch knows that the payment is required to be reported under this section and was not so reported. For purposes of the preceding sentence, a foreign intermediary is one that is described in §1.1441–1(e)(3)(i) and a U.S. branch is one that is described in §1.1441–1(b)(2)(iv).

(4) *Examples.* The application of the provisions of this paragraph (g) may be illustrated by the following examples:

Example 1. FC is a foreign corporation that is not a U.S. payor or U.S. middleman described in §1.6049–5(c)(5) that regularly issues and retires its own debt obligations. A is an individual whose residence address is inside the United States, who holds a bond issued by FC that is in registered form (within the meaning of section 163(f) and the regulations under that section). The bond is retired by FP, a foreign corporation that is a broker within the meaning of paragraph (a)(1) of this section and the designated paying agent of FC. FP mails the proceeds to A at A's U.S. address. The sale would be considered to be effected at an office outside the United States under paragraph (g)(3)(iii)(A) of this section except that the proceeds of the sale are mailed to a U.S. address. For that reason, the sale is considered to be effected at an office of the broker inside the United States under paragraph (g)(3)(iii)(B) of this section. Therefore, FC is a broker under paragraph (a)(1) of this section with respect to this transaction because, although it is not a U.S. payor or U.S. middleman, as described in §1.6049–5(c)(5), it is deemed to effect the sale in the United States. FP is a broker for the same reasons. However, under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter, FP, rather than FC, is required to report the payment because FP is responsible for paying the holder the proceeds from the retired obligations. Under paragraph (g)(1)(i) of this section, FP may not treat A as an exempt foreign person and must make an information return under section 6045 with respect to the retirement of the FC bond, unless FP obtains the certificate or documentation described in paragraph (g)(1)(i) of this section.

Example 2. The facts are the same as in *Example 1* except that FP mails the proceeds to A at an address outside the United States. Under paragraph (g)(3)(iii)(A) of this section, the sale is considered to be effected at an office of the broker outside the United States. Therefore, under paragraph (a)(1) of this section, neither FC nor FP is a broker with respect to the retirement of the FC bond. Accordingly, neither is required to make an information return under section 6045.

Example 3. The facts are the same as in *Example 2* except that FP is also the agent of A. The result is the same as in *Example 2*. Neither FP nor FC are brokers under paragraph (a)(1) of this section with respect to the sale since the sale is effected outside the United States and neither of them are U.S. payors (within the meaning of §1.6049–5(c)(5)).

Example 4. The facts are the same as in *Example 1* except that the registered bond held by A was issued by DC, a domestic corporation that regularly issues and retires its own debt obligations. Also, FP mails the proceeds to A at an address outside the United States. Interest on the bond is not described in paragraph (g)(1)(ii) of this section. The sale is considered to be effected at an office outside the United States under paragraph (g)(3)(iii)(A) of this section. DC is a broker under paragraph (a)(1)(i)(B) of this section. DC is not required to report the payment under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter. FP is not required to make an information return under section 6045 because FP is not a U.S. payor described in §1.6049–5(c)(5) and the sale is effected outside the United States. Accordingly, FP is not a broker under paragraph (a)(1) of this section.

Example 5. The facts are the same as in *Example 4* except that FP is also the agent of A. DC is a broker under paragraph (a)(1) of this section. DC is not required to report under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter. FP is not required to make an information return under section 6045 because FP is not a U.S. payor described in §1.6049–5(c)(5) and the sale is effected outside the United States and therefore FP is not a broker under paragraph (a)(1) of this section.

Example 6. The facts are the same as in *Example 4* except that the bond is retired by DP, a broker within the meaning of paragraph (a)(1) of this section and the designated paying agent of DC. DP is a U.S. payor under §1.6049–5(c)(5). DC is not required to report under the multiple broker exception under §5f.6045–1(c)(3)(ii) of this chapter. DP is required to make an information return under section 6045 because it is the person responsible for paying the proceeds from the retired obligations unless DP obtains the certificate or documentary evidence described in paragraph (g)(1)(i) of this section.

Example 7. Customer A owns U.S. corporate bonds issued in registered form after July 18, 1984 and carrying a stated rate of interest. The bonds are held through an account with foreign bank, X, and are held in street name. X is a wholly-owned subsidiary of a U.S. company and is not a qualified intermediary within the meaning of §1.1441–1(e)-(5)(ii). X has no documentation regarding A. A instructs X to sell the bonds. In order to effect the sale, X acts through its agent in the United States, Y. Y sells the bonds and remits the sales proceeds to X. X credits A's account in the foreign country. X does not provide documentation to Y.

(i) *Y's obligations to withhold and report.* Y is not required to report the sales proceeds under the multiple broker exception under §5f.6045–1(c)-(3)(ii), because X is the person responsible for paying the proceeds from the sale to A. However, the portion of the payment that represents interest accrued on the obligation since the last payment date and that is received as part of the total sales proceeds from the transaction is reportable under §1.1461–1(b) and (c)(2)(i)(E), as an amount paid to a foreign person that is subject to withholding under chapter 3 of the Code within the meaning of §1.1441–2(a) (even though no withholding is required under chapter 3 of the Code based on §1.1441–3(b)(2)(i), unless §1.1441–3(b)(2)(ii) applies). The multiple broker exception under the regulations under section 6045 does not affect a withholding agent's obligation to report an amount otherwise required to be reported under §1.1461–1(b) and (c). Under §1.1461–1(c)(3), Y must file Form 1042-S in the name of X who, under §1.1441–1(b)(3)(v)(A), is presumed to be acting for its own account because Y cannot associate the payment of interest with a valid intermediary Form W–8 described in §1.1441–1(e)(3)(ii) or (iii) from X.

(ii) *X's obligations to withhold and report.* X may also have reporting and withholding obligations when it credits A's account with the sales proceeds. Although the sale is considered to be effected at an office outside the United States under paragraph (g)(3)(iii)(A) of this section, X is a broker with respect to the sale because, as a wholly-owned subsidiary of a U.S. company, it meets the definition of a broker under paragraph (a)(1) of this section. Under the presumptions described in §1.6049–5(d)(2), X, as a U.S. payor, must presume that, with respect to the sales proceeds, A is a U.S. person who is not an exempt recipient. Therefore, the payment of sales proceeds to A by X is reportable on a Form 1099 under paragraph (c)(2) of this section. X has no obligation to backup withhold on the payment, based on the exemption under §31.3406(g)–1(e), unless X has actual

knowledge that A is a U.S. person who is not an exempt recipient. X is also a withholding agent with respect to the portion of the sales proceeds that represents accrued interest on the bonds. Based on the presumptions under §§1.6049–5(d)(2) and 1.1441–1(b)(3)(iii)(D), X must presume that A is a foreign person with respect to the interest portion of the payment, because the interest amount is an amount subject to withholding, within the meaning of §1.1441–2(a) (even though a withholding agent is not required to withhold on such amounts). Thus, X is required to file a Form 1042 and 1042–S with respect to the interest portion of the payment. Y's filing of a Form 1042–S with respect to that portion of the payment to X does not meet the conditions for the multiple withholding agent exception under §1.1461–1(c)(4)(i) because Y did not report the payment to X as a payment to an intermediary.

(5) *Effective date*—(i) *General rule.* The provisions of this paragraph (g) apply to payments made after December 31, 1998.

(ii) *Transition rules.* A payor that, on December 31, 1998, holds a valid Form W–8 or other form upon which the payor is permitted to rely to hold the payee as a foreign person pursuant to the regulations in effect prior to January 1, 1999 (see 26 CFR parts 1 and 35a, revised April 1, 1997), may treat it as a valid certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a Form W–8 or other form that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the preceding sentence). The rule in this paragraph (g)(b)(ii), however, does not apply to extend the validity period of a form that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a payor may choose not to take advantage of the transition rule in this paragraph (g)(5)(ii) with respect to one or more withholding certificates and, therefore, to require new withholding certificates conforming to the requirements described in this section.

* * * * *

(j) *Time and place for filing; cross-reference to penalty.* Forms 1096 and 1099 required under this section shall be filed after the last calendar day of the reporting period elected by the broker or barter exchange and on or before the end of the second calendar month following the close of the calendar year of such reporting period with the appropriate Internal Revenue Service Center, the address of which is listed in the instructions for Form 1096. See paragraph (l) of this section for the requirement to file certain returns on magnetic media. For provisions relating to the penalty provided for the failure to file timely a correct information return under section 6045(a), see §301.6721–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(k) *Requirement and time for furnishing statement; cross reference to penalty*—(1) *General requirements.* A broker or barter exchange making a return of information under this section with respect to a transaction shall furnish to the person whose identifying number is (or is required to be) shown on such return a written statement showing the information required by paragraph (c)(5), (d), (f), or (p) of this section and containing a legend stating that such information is being reported to the Internal Revenue Service. If the return of information is not made on magnetic media, this requirement may be satisfied by furnishing to such person a copy of all Forms 1099 with respect to such person filed with the Internal Revenue Service Center. A statement shall be considered to be furnished to a person to whom a statement is required to be made under this paragraph (k) if it is mailed to such person at the last address of such person known to the broker or barter exchange.

(2) *Time for furnishing statements.* A broker or barter exchange may furnish the statements required by this paragraph (k) yearly, quarterly, monthly, or on any other basis, without regard to the reporting period elected by the broker or barter exchange, provided that all statements required to be furnished under this paragraph (k) for a calendar year shall be furnished on or before January 31 of the following calendar year.

(3) *Cross-reference to penalty.* For provisions for failure to furnish timely a correct payee statement, see §301.6724–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(l) *Magnetic media requirement.* For information returns filed after December 31, 1996, see §301.6011–2 of this chapter (Procedure and Administration Regulations) for rules relating to filing information returns on magnetic media. A broker or barter exchange that fails to file a Form 1099 under this section on magnetic media, when required, may be subject to a penalty for each such failure. See paragraph (j) of this section.

* * * * *

§1.6045–1T [Removed]

Par. 38. Section 1.6045–1T is removed.

Par. 39. Section 1.6045–2 is amended as follows:

1. Paragraph (b)(2) is amended by:

a. Removing the period at the end of paragraphs (b)(2)(i)(A), (b)(2)(i)(B), and (b)(2)(i)(C), and adding semicolons in each place.

b. Removing the period and the end of paragraph (b)(2)(i)(D) and adding a semicolon in its place.

c. Removing the language ", or" in paragraph (b)(2)(i)(E) and adding a semicolon in its place.

d. Removing the period at the end of paragraph (b)(2)(i)(F) and adding ", or" in its place.

e. Adding paragraph (b)(2)(i)(G).

2. Revising paragraph (g)(2).

3. Adding paragraph (g)(4).

The revision and additions read as follows:

§1.6045–2 Furnishing statement required with respect to certain substitute payments.

* * * * *

(b) * * *

(2) * * * (i) * * *

(G) A foreign central bank of issue, as defined in §1.6049–4(c)(1)(ii)(H), or the Bank for International Settlements.

* * * * *

(g) * * *

(2) *Magnetic media requirement.* For the requirement to submit the information required by paragraph (a) of this section and by Form 1099 on magnetic media for information returns filed after December 31, 1996, see §301.6011–2 of this chapter (Procedure and Administration Regulations). A broker or barter exchange that

fails to file on magnetic media, when required, may be subject to a penalty under section 6721 for each such failure. See paragraph (g)(4) of this section.

* * * * *

(4) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6045(d) and §1.6045–2(g)(1), including a failure to file on magnetic media, see §301.6721–1 of this chapter. For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6045(d) and §1.6045–2(a), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

* * * * *

§1.6045–2T [Removed]

Par. 40. Section 1.6045–2T is removed.

Par. 41. Section 1.6049–4 is amended by:

1. Removing the reference "section 3451" and adding "section 3406" each place it appears in the following locations in §1.6049–4:

a. Paragraph (b)(2) introductory text, third sentence.

b. Paragraph (b)(2)(iv).

c. Paragraph (b)(4), last sentence.

d. Paragraph (c)(2)(i).

e. Paragraph (c)(2)(ii) concluding text.

f. Paragraph (e)(4), second and last sentences.

g. Paragraph (e)(5)(iv).

h. Paragraph (f)(4)(i), fourth sentence.

2. Revising paragraphs (a), (b)(1), (b)(3), and (c)(1).

3. Removing the reference "§1.6049–5(c)" in paragraphs (b)(5)(i) last sentence, and (d)(2) and adding "§1.6049–5(f)" in its place.

4. Revising paragraph (d)(3).

5. Revising the heading for paragraph (d)(7) and adding a sentence to the end of the paragraph.

6. Removing the reference "§1.6049–5(b)(1)(ii)" in the first sentence of paragraph (d)(8) and adding "1.6049–5(b)(2)" in its place.

7. Removing the reference "paragraph (d)(10)(i)" in paragraph (d)(9)(ii) introductory text, and adding "paragraph (d)(9)(i)" in its place.

8. Removing the reference "paragraph (c)(1)(K)" in the first sentence of paragraph (f)(4)(i) and adding "paragraph (c)(1)(ii)(M)" in its place; and revising the last two sentences of paragraph (f)(4)(i).

9. Revising the last sentence of the Example in paragraph (f)(4)(ii).

10. Adding paragraph (g)(3).

The additions and revisions read as follows:

§1.6049–4 Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

(a) *Requirement of reporting*—(1) *In general.* Except as provided in paragraph (c) of this section, an information return shall be made by a payor, as defined in paragraph (a)(2) of this section, of amounts of interest and original issue discount paid after December 31, 1982. Such return shall contain the information described in paragraph (b) of this section.

(2) *Payor.* A payor is a person described in paragraph (a)(2)(i) or (ii) of this section.

(i) Every person who makes a payment of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter) to any other person during a calendar year; however, persons not treated as payors for purposes of §31.3406(a)–2 of this chapter shall not be treated as payors for purposes of this paragraph (a)(2).

(ii) Every person who collects on behalf of another person payments of the type and of the amount subject to reporting under this section (or under an applicable section under this chapter), including middlemen treated as payors under §31.3406(a)–2 of this chapter, or who otherwise acts as a middleman (as defined in paragraph (f)(4) of this section) with respect to such payment.

(b) *Information to be reported*—(1) *Interest payments.* Except as provided in paragraphs (b)(3) and (5) of this section, in the case of interest other than original issue discount treated as interest under §1.6049–5(f), an information return on Form 1099 shall be made for the calendar year showing the aggregate amount of the payments, the name, address, and taxpayer identification number of the person to whom paid, the amount of tax deducted and withheld under section 3406 from the payments, if any, and such other information as required by the forms. An information return is generally not required if the amount of interest paid to a person aggregates less than $10 or if the payment is made to a person who is an exempt recipient described in paragraph (c)(1)(ii) of this section, unless the payor backup withholds under section 3406 on such payment (because, for example, the payee (i.e., exempt recipient) has failed to furnish a Form W–9 on request), in which case the payor must make a return under this section, unless the payor refunds the amount withheld pursuant to §31.6413(a)–3 of this chapter (Employment Tax Regulations). For reporting interest paid to a Canadian nonresident alien individual, see §1.6049–8.

* * * * *

(3) *Returns made by middleman*—(i) *In general.* Except as provided in paragraph (b)(5) of this section, every person acting as a middleman (as defined in paragraph (f)(4) of this section) shall make an information return for the calendar year. In the case of interest payments (other than original issue discount and other than interest described in §1.6049–8), the information return shall be made on Form 1099 and shall show the aggregate amount of the interest, the name, address, and taxpayer identification number of the person on whose behalf received, the amount of tax withheld under section 3406, if any, and such other information as required by the forms. In the case of original issue discount, the information return shall show the information required to be shown for the person on whose behalf received, as described in paragraph (b)(2) of this section. See §1.6049–5(f) to determine whether a middleman is required to make an information return with respect to original issue discount. A middleman shall make an information return regardless of whether the middleman receives a Form 1099. A middleman shall not be required to make an information return if the payment of interest aggregates less than $10 or if the payment is made to an exempt recipient described in paragraph (c)(1)(ii) of this section, unless the payor backup withholds under section

3406 on such payment (because, for example, the payee has failed to furnish a Form W–9 on request), in which case the payor must make a return under this section, unless the payor refunds the amount withheld pursuant to §31.6413(a)–3 of this chapter (Employment Tax Regulations).

(ii) *Forwarding of interest coupons and original issue discount obligations.* In the case of a middleman who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States, the middleman shall make an information return on Form 1099 for the calendar year showing, in the case of an interest coupon, the information required under paragraph (b)(3)(i) of this section and, in the case of a discount obligation, information required under paragraph (b)(2) of this section. For purposes of this paragraph (b)(3)(ii), a middleman is considered to forward an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States if the middleman forwards the coupon or obligations outside the United States on or after the date when the payee is entitled to be paid or at an earlier date that is within 90 days of such date or if the middleman has actual knowledge that the coupon or obligation is being forwarded outside the United States for presentation, collection, or payment outside the United States. However, the transfer, although subject to information reporting under this section, is not subject to backup withholding under section 3406.

(iii) *Example.* The following example illustrates the provisions of paragraph (b)(3)(ii) of this section:

Example. Individual F, who is entitled to payment on an interest coupon, instructs an office of Bank M in the United States to forward the coupon to Bank N for collection by Bank N outside the United States. Bank M in the United States forwards the interest coupon to Bank N outside the United States. Bank M is required to make an information return for the calendar year under paragraph (b)(3)(ii) of this section showing the aggregate amount of the interest coupon forwarded, the name, address of the permanent residence, and the taxpayer identification number, if any, of Individual F and such other information as the form requires.

* * * * *

(c) *Information returns not required*—(1) *Payment to exempt recipient*—(i) *In general.* No information return is required with respect to any payment made to an exempt recipient described in paragraph (c)(1)(ii) of this section, except to the extent otherwise provided in §1.6049–5(d)(3)(ii) and (iii). However, if the payor backup withholds under section 3406 on such payment (because, for example, the payee has failed to furnish a Form W–9 on request), then the payor is required to make a return under this section, unless the payor refunds the amount withheld in accordance with §31.6413(a)–3 of this chapter (Employment Tax Regulations).

(ii) *Exempt recipient defined.* The term *exempt recipient* means any person described in paragraphs (c)(1)(ii)(A) through (Q) of this section. An exempt recipient is generally exempt from information reporting without filing a certificate claiming exempt status unless the provisions of this paragraph (c)(1)(ii) require a payee to file a certificate. A payor may in any case require a payee not otherwise required to file a certificate under this paragraph (c)(1)(ii) to file a certificate in order to qualify as an exempt recipient. See §31.3406(h)–3(a)(1)(iii) and (c)(2) of this chapter for the certificate that a payee must provide when a payor requires it in order to treat the payee as an exempt recipient under this paragraph (c)(1)(ii). A payor may treat a payee as an exempt recipient based upon a properly completed form as described in §31.3406(h)–3(e)(2) of this chapter, its actual knowledge that the payee is a person described in this paragraph (c)(1)(ii), or the indicators described in this paragraph (c)(1)(ii).

(A) *Corporation.* A corporation, as defined in section 7701(a)(3), whether domestic or foreign, is an exempt recipient. In addition, for purposes of this paragraph (c)(1), the term *corporation* includes a partnership all of whose members are corporations described in this paragraph (c)(1), but only if the partnership files with the payor a certificate meeting the certification requirements of paragraphs (c)(2)(ii)(A)(*1*) through (*5*) o this section. Absent actual knowledge otherwise, a payor may treat a payee as a corporation (and, therefore, as an exempt recipient) if one of the requirements of paragraph (c)(1)(ii)(A)(*1*), (*2*), (*3*), or (*4*), of this section are met before a payment is made.

(*1*) The name of the payee contains an unambiguous expression of corporate status that is Incorporated, Inc., Corporation, Corp., P.C., (but not Company or Co.) or contains the term *insurance company, indemnity company, reinsurance company,* or *assurance company,* or its name indicates that it is an entity listed as a per se corporation under §301.7701–2(b)(8)(i) of this chapter.

(*2*) The payor has on file a corporate resolution or similar document clearly indicating corporate status. For this purpose, a similar document includes a copy of Form 8832, filed by the entity to elect classification as an association under §301.7701–3(b) of this chapter.

(*3*) The payor receives a Form W–9 which includes an EIN and a statement from the payee that it is a domestic corporation.

(*4*) The payor receives a withholding certificate described in §1.1441–1(e)-(2)(i), that includes a certification that the person whose name is on the certificate is a foreign corporation.

(B) *Tax exempt organization*—(1) *In general.* Any organization that is exempt from taxation under section 501(a) is an exempt recipient. A custodial account under section 403(b)(7) shall be considered an exempt recipient under this paragraph. A payor may treat an organization as an exempt recipient under this paragraph (c)(1)(ii)(B) without requiring a certificate if the organization's name is listed in the compilation by the Commissioner of organizations for which a deduction for charitable contributions is allowed, if the name of the organization contains an unambiguous indication that it is a tax-exempt organization, or if the organization is known to the payor to be a tax-exempt organization.

(*2*) *Examples.* The application of the provisions of this paragraph (c)(1)(ii)(B) may be illustrated by the following examples:

Example 1. The following persons maintain accounts at M Bank: N College, O University, and P Church. M may treat N, O, and P as exempt recipients even though such persons have not filed an exemption certificate with M because the names of the organizations contain an unambiguous indication that they are tax exempt organizations.

Example 2. Q is listed in the current edition of Internal Revenue Service Publication 78 as an organization for which deductions are permitted for charitable contributions under section 170(c). Such listing has not been revoked by an announcement published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter). A payor may treat Q as an exempt recipient even though Q has not filed an exemption certificate with the payor.

Example 3. Employer R maintains a section 403(b)(7) custodial account with Regulated Investment Company S on behalf of R's employees. S may treat the account as an exempt recipient even though R or its employees have not filed an exemption certificate with S.

(C) *Individual retirement plan.* An individual retirement plan as defined in section 7701(a)(37) is an exempt recipient. A payor may treat any such plan of which it is the trustee or custodian as an exempt recipient under this paragraph (c)(1) without requiring a certificate.

(D) *United States.* The United States Government and any wholly-owned agency or instrumentality thereof are exempt recipients. A payor may treat a person as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the name of such person reasonably indicates it is described in this paragraph (c)(1).

(E) *State.* A State, the District of Columbia, a possession of the United States, a political subdivision of any of the foregoing, wholly-owned agency or instrumentality of any one or more of the foregoing, and a pool or partnership composed exclusively of any of the foregoing are exempt recipients. A payor may treat a person as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the name of such person reasonably indicates it is described in this paragraph (c)(1) or if such person is known generally in the community to be a State, the District of Columbia, a possession of the United States or a political subdivision or a wholly-owned agency or instrumentality of any one or more of the foregoing (for example, an account held in the name of "Town of S" or "County of T" may be treated as held by an exempt recipient under this paragraph (c)(1)(ii)(E)).

(F) *Foreign government.* A foreign government, a political subdivision of a foreign government, and any wholly-owned agency or instrumentality of either of the foregoing are exempt recipients. A payor may treat a foreign government or a political subdivisions thereof as an exempt recipient under this paragraph (c)(1) without requiring a certificate provided that its name reasonably indicates that it is a foreign government or provided that it is known to the payor to be a foreign government or a political subdivision thereof (for example, an account held in the name of the "Government of V" may be treated as held by a foreign government).

(G) *International organization.* An international organization and any wholly owned agency or instrumentality thereof are exempt recipients. The term *international organization* shall have the meaning ascribed to it in section 7701(a)(18). A payor may treat a payee as an international organization without requiring a certificate if the payee is designated as an international organization by executive order (pursuant to 22 U.S.C. 288 through 288(f)).

(H) *Foreign central bank of issue.* A foreign central bank of issue is an exempt recipient. A foreign central bank of issue is a bank which is by law or government sanction the principal authority, other than the government itself, issuing instruments intended to circulate as currency. See §1.895–1(b)(1). A payor may treat a person as a foreign central bank of issue (and, therefore, as an exempt recipient) without requiring a certificate provided that such person is known generally in the financial community as a foreign central bank of issue or if its name reasonably indicates that it is a foreign central bank of issue.

(I) *Securities or commodities dealer.* A dealer in securities, commodities, or notional principal contracts, that is registered as such under the laws of the United States or a State or under the laws of a foreign country is an exempt recipient. A payor may treat a dealer as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the person is known generally in the investment community to be a dealer meeting the requirements set forth in this paragraph (c)(1) (for example, a registered broker-dealer or a person listed as a member firm in the most recent publication of members of the National Association of Securities Dealers, Inc.).

(J) *Real estate investment trust.* A real estate investment trust, as defined in section 856 and §1.856–1, is an exempt recipient. A payor may treat a person as a real estate investment trust (and, therefore, as an exempt recipient) without requiring a certificate if the person is known generally in the investment community as a real estate investment trust.

(K) *Entity registered under the Investment Company Act of 1940.* An entity registered at all times during the taxable year under the Investment Company Act of 1940, as amended (15 U.S.C. 80a–1), (or during such portion of the taxable year that it is in existence), is an exempt recipient. An entity that is created during the taxable year will be treated as meeting the registration requirement of the preceding sentence provided that such entity is so registered at all times during the taxable year for which such entity is in existence. A payor may treat such an entity as an exempt recipient under this paragraph (c)(1) without requiring a certificate if the entity is known generally in the investment community to meet the requirements of the preceding sentence.

(L) *Common trust fund.* A common trust fund, as defined in section 584(a), is an exempt recipient. A payor may treat the fund as an exempt recipient without requiring a certificate provided that its name reasonably indicates that it is a common trust fund or provided that it is known to the payor to be a common trust fund.

(M) *Financial institution.* A financial institution such as a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, industrial loan association or bank, or other similar organization, whether organized in the United States or under the laws of a foreign country is an exempt recipient. A financial institution also includes a clearing organization defined in §1.163–5(c)(2)(i)(D)(*8*) and the Bank for International Settlements. A payor may treat any person described in the preceding sentence as an exempt recipient without requiring a certificate if the person's name (including a foreign name, such as "Banco" or "Banque") reasonably indicates the payee is a financial institution described in the preceding sentence. In the case of a foreign person, a payor may also treat a person on such list as the Internal Revenue Service may publish or approve (such as in the Thomson Bank Directory or a list approved by the Federal Reserve Board).

(N) *Trust.* A trust which is exempt from tax under section 664(c) (i.e., a charitable remainder annuity trust or a charitable remainder unitrust) or is described in section 4947(a)(1) (relating to certain charitable trusts) is an exempt recipient. A payor which is a trustee of the trust may

treat the trust as an exempt recipient without requiring a certificate.

(O) *Nominees or custodians.* A nominee or custodian.

(P) *Brokers.* A broker as defined in section 6045(c) and §1.6045–1(a)(1).

(Q) *Swap dealers.* A dealer in notional principal contracts as defined in §1.446–3(c)(4)(iii).

(iii) *Exempt recipient no longer exempt.* Any person who ceases to be an exempt recipient shall, no later than 10 days after such cessation, notify the payor in writing when it ceases to be an exempt recipient unless it reasonably appears that the person formerly qualifying as an exempt recipient will not thereafter receive a reportable payment from the payor. If a payor treats a person as an exempt recipient by requiring the exempt recipient to file a certificate claiming exempt status, that person shall revoke the certificate as provided in the preceding sentence. If the exempt recipient terminates its relationship with the payor prior to the time that the notice of change in status is otherwise required, the exempt recipient is not required to notify the payor. If, however, the person who formerly qualified as an exempt recipient later reinstates the relationship with the payor, the person must, prior to receiving a reportable payment from such relationship, notify the payor that it no longer qualifies as an exempt recipient in case the payor relies upon the previous treatment.

* * * * *

(d) * * *

(3) *Conversion into United States dollars of amounts paid in foreign currency*—(i) *Conversion rules.* When a payment is made in foreign currency, the U.S. dollar amount of the payment shall be determined by converting such foreign currency into U.S. dollars on the date of payment at the spot rate (as defined in §1.988–1(d)(1)) or pursuant to a reasonable spot rate convention. For example, a withholding agent may use a month-end spot rate or a monthly average spot rate. A spot rate convention must be used consistently with respect to all non-dollar amounts withheld and from year to year. Such convention cannot be changed without the consent of the Commissioner or the Commissioner's delegate.

(ii) *Special rule for §1.988–5(a) transactions where the payor on both components of a qualified hedging transaction is the same person*—(A) *In general.* Interest or original issue discount on a qualified debt instrument that is part of a qualified hedging transaction under §1.988–5(a) shall be computed for section 6049 reporting purposes under the rules described in §1.988–5(a)(9)(ii) if—

(*1*) The payor on the qualified debt instrument and the counterparty to the §1.988–5(a) hedge are the same person; and

(*2*) The payee complies with the requirements of §1.988–5(a) and so notifies its payor prior to the date required for filing Form 1099 as required by this section.

(B) *Effective date.* The provisions of this paragraph (d)(3)(ii) apply to transactions entered into after December 31, 1998.

* * * * *

(7) *Magnetic media requirement.* * * * For the requirement to submit the information required by Form 1099 on magnetic media for payments after December 31, 1983, see section 6011(e) and §301.6011–2 of this chapter (Regulations on Procedure and Administration).

* * * * *

(f) * * *

(4) * * * (i) * * * A person shall be considered to be a middleman as to any portion of an interest payment made to such person which portion is actually owned by another person, whether or not the other person's name is also shown on the information return filed with respect to such interest payment, except that a husband or wife will not be considered as acting in the capacity of a middleman with respect to his or her spouse. A person who, from within the United States, forwards an interest coupon or discount obligation on behalf of a payee for presentation, collection or payment outside the United States is also a middleman for purposes of this section (but the transfer, although subject to information reporting under this section, does not make the payment subject to backup withholding under section 3406).

(ii) * * *

Example. * * * Broker B is required to make an information return showing the amount of original issue discount treated as paid to A under §1.6049–5(f).

(g) * * *

(3) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6049(a) and §1.6049–4(a)(1), see §301.6721–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

Par. 42. Section 1.6049–5 is amended by:

1. Removing the reference "section 3451" in the third sentence of paragraph (a)(6) and adding "section 3406" in its place.

2. Removing the last sentence of paragraph (a)(6).

3. Revising paragraph (b).

4. Redesignating paragraph (c) as paragraph (f).

5. Adding new paragraphs (c), (d), (e) and (g).

The revisions and additions read as follows:

§1.6049–5 Interest and original issue discount subject to reporting after December 31, 1982.

* * * * *

(b) *Interest excluded from reporting requirement.* The term *interest* or *original issue discount* (OID) does not include—

(1) Interest on any obligation issued by a natural person as defined in §1.6049–4(f)(2), irrespective of whether such interest is collected on behalf of the holder of the obligation by a middleman.

(2) Interest on any obligation if such interest is exempt from taxation under section 103(a), relating to certain governmental obligations, or interest which is exempt from taxation under any other provision of law without regard to the identity of the holder. The holder of a tax exempt obligation that is not in registered form must provide written certification to the payor (other than the issuer of the obligation) that the obligation is exempt from taxation. A statement that interest

coupons are tax exempt on the envelope or shell commonly used by financial institutions to process such coupons, signed by the payee, will be sufficient for this purpose if the envelope is properly completed (i.e., shows the name, address, and taxpayer identification number of the payee). A payor may rely on such written certification in treating such interest as tax exempt for purposes of section 6049. See §1.6049–4(d)(8) with respect to the requirement that the issuer of a taxable obligation shall make an information return if such issuer receives an envelope which improperly claims that the interest coupons contained therein are tax exempt.

(3) Interest on amounts held in escrow to guarantee performance on a contract or to provide security. However, interest on amounts held in escrow with a person described in paragraph (a)(2) or (3) of this section is interest subject to reporting under section 6049.

(4) Interest that a governmental unit pays with respect to tax refunds.

(5) Interest on deposits for security, such as deposits posted with a public utility company. However, interest on deposits posted for security with a person described in paragraph (a)(2) or (3) of this section is interest subject to reporting under section 6049.

(6) Amounts from sources outside the United States (determined under the provisions of part I, subchapter N, chapter 1 of the Internal Revenue Code (Code) and the regulations under those provisions) paid outside the United States by a non-U.S. payor or a non-U.S. middleman (as defined in paragraph (c)(5) of this section). See paragraph (e) of this section for circumstances in which a payment is considered to be made outside the United States.

(7) Portfolio interest, as defined in §1.871–14(b)(1), paid with respect to obligations in bearer form described in section 871(h)(2)(A) or 881(c)(2)(A) or with respect to a foreign-targeted registered obligation described in §1.871–14(e)(2) for which the documentation requirements described in §1.871–14(e)(3) and (4) have been satisfied (other than by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian or nominee of the payee, collects the amount for, or on behalf of, the payee, regardless of whether the middleman is also acting as agent of the payor).

(8) Portfolio interest described in §1.871–14(c)(1)(ii), paid with respect to obligations in registered form described in section 871(h)(2)(B) or 881(c)(2)(B) that is not described in paragraph (b)(7) of this section.

(9) Any amount paid by an international organization described in §1.6049–4(c)(1)(ii)(G) (or its paying, transfer, or other agent that is not also a payee's agent) with respect to an obligation of which the international organization is the issuer.

(10)(i) Amounts paid outside the United States (other than by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian or nominee or other agent of the payee, collects the amount for, or on behalf of, the payee, regardless of whether the middleman is also acting as agent of the payor) with respect to an obligation that: has a face amount or principal amount of not less than $500,000 (as determined based on the spot rate on the date of issuance if in foreign currency); has a maturity (at issue) of 183 days or less; satisfies the requirements of sections 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (as if the obligation would otherwise be a registration-required obligation within the meaning of section 163(f)(2)(A)) (however, an original issue discount obligation with a maturity of 183 days or less from the date of issuance is not required to satisfy the certification requirement of §1.163–5(c)(2)(i)(D)(3)) and is issued in accordance with the procedures of §1.163–5(c)(2)(i)(D); and has on its face the following statement (or a similar statement having the same effect):

> By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and regulations thereunder) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) of the Internal Revenue Code and the regulations thereunder).

(ii) If the obligation is in registered form, it must be registered in the name of an exempt recipient described in §1.6049–4(c)(1)(ii). For purposes of this paragraph (b)(10), a middleman may treat an obligation as described in section 163(f)(2)(B)(i) and (ii)(I) and the regulations under that section if the obligation, or coupons detached therefrom, whichever is presented for payment, contains the statement described in this paragraph (b)(10).

(11) Amounts paid with respect to an account or deposit with a U.S. or foreign branch of a domestic or foreign corporation or partnership that is paid with respect to an obligation described in either paragraph (b)(11)(i) or (ii) of this section, if the branch is engaged in the commercial banking business; and the interest or OID is paid outside the United States (other than by a U.S. middleman (as defined in paragraph (c)(5) of this section) that acts as a custodian, nominee, or other agent of the payee, and collects the amount for, or on behalf of, the payee, regardless of whether the middleman is also acting as agent of the payor).

(i) An obligation is described in this paragraph (b)(11)(i) if it is not in registered form (within the meaning of section 163(f) and the regulations under that section), is described in section 163(f)(2)(B) and issued in accordance with the procedures of §1.163–5(c)(2)(i)(C) or (D), and, in the case of a U.S. branch, is part of a larger single public offering of securities. For purposes of this paragraph (b)(11)(i), a middleman may treat an obligation as described in section 163(f)(2)(B) if the obligation, and any detachable coupons, contains the statement described in section 163(f)(2)(B)(ii)(II) and the regulations under that section.

(ii)(A) An obligation is described in this paragraph (b)(11)(ii) if it produces income described in section 871(i)(2)(A); has a face amount or principal amount of not less than $500,000 (as determined based on the spot rate on the date of issuance if in foreign currency); satisfies the requirements of sections 163(f)(2)(B)(i) and (ii)(I) and the regulations thereunder (as if the obligation would otherwise be a registration-required obligation within the meaning of section 163(f)(2)(A)) and is issued in accordance with the procedures of §1.163–5(c)(2)(i)(C) or (D) (however, an original issue discount obligation with a maturity of 183 days or less from the date of issuance is not required to satisfy the certi-

fication requirement of §1.163–5(c)-(2)(i)(D)(3)). For purposes of this paragraph (b)(11)(ii), a middleman may treat an obligation as described in sections 163(f)(2)(b)(i) and (ii) and the regulations under that section if the obligation, or any detachable coupon, contains the statement described in paragraph (b)(11)(ii)(b) of this section.

(B) The obligation must have on its face, and on any detachable coupons, the following statement (or a similar statement having the same effect):

> By accepting this obligation, the holder represents and warrants that it is not a United States person (other than an exempt recipient described in section 6049(b)(4) and regulations under that section) and that it is not acting for or on behalf of a United States person (other than an exempt recipient described in section 6049(b)(4) and the regulations under that section).

(C) If the obligation is in registered form, it must be registered in the name of an exempt recipient described in §1.6049–4(c)(1)(ii).

(12) Returns of information are not required for payments that a payor can, prior to payment, reliably associate with documentation upon which it may rely to treat the payment as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with paragraph (d)(1) of this section or presumed to be made to a foreign payee under paragraph (d)(2), (3), (4), or (5) of this section. However, such payments may be reportable under §1.1461–1(b) and (c). The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Code. In the event of a conflict between the provisions of §1.1441–1 and paragraph (d) of this section in determining the foreign status of the payee, the provisions of §1.1441–1 shall govern for payments of amounts subject to withholding under chapter 3 of the Code and the provisions of paragraph (d) of this section shall govern in other cases. This paragraph (b)(12) does not apply to interest paid to a Canadian nonresident alien individual as provided in §1.6049–8.

(13) Amounts for the period that the debt obligation with respect to which the interest arises represents an asset blocked as described in §1.1441–2(e)(3). Payment of such amounts, including interest that is past due and OID on obligations that mature on or before the date that the assets are no longer blocked, is deemed to occur in accordance with the rules of §1.1441–2(e)(3).

(14) Payments made by a foreign intermediary described in §1.1441–1(e)(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in §1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported under §1.6049–4 and were not so reported.

(15) Amounts of interest as determined under the provisions of §1.446–3(g)(4) (dealing with interest in the case of a significant non-periodic payment with respect to a notional principal contract). Such amounts are governed by the provisions of section 6041. See §1.6041–1(d)(5).

(c) *Applicable rules*—(1) *Documentary evidence for offshore accounts.* A payor may rely on documentary evidence described in this paragraph (c)(1) instead of a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) in the case of a payment made outside the United States to an offshore account or, in the case of broker proceeds described in §1.6045–1(c)(2), in the case of a sale effected outside the United States (as defined in §1.6045–1(g)(3)(iii)(A)). For purposes of this paragraph (c)(1), an *offshore account* means an account maintained at an office or branch of a U.S. or foreign bank or other financial institution at any location outside the United States (i.e., other than in any of the fifty States or the District of Columbia) and outside of U.S. possessions. Thus, for example, an account maintained in a foreign country at a branch of a U.S. bank or of a foreign subsidiary of a U.S. bank is an offshore account. For the definition of a payment made outside the United States, see paragraph (e) of this section. A payor may rely on documentary evidence if the payor has established procedures to obtain, review, and maintain documentary evidence sufficient to establish the identity of the payee and the status of that person as a foreign person (including, but not limited to, documentary evidence described in §1.1441–6(c)(3) or (4)); and the payor obtains, reviews, and maintains such documentary evidence in accordance with those procedures. A payor maintains the documents reviewed by retaining the original, certified copy, or a photocopy (or microfiche or similar means of record retention) of the documents reviewed and noting in its records the date on which and by whom the document was received and reviewed. Documentary evidence furnished for the payment of an amount subject to withholding under chapter 3 of the Code must contain all of the information that is necessary to complete a Form 1042–S for that payment.

(2) *Other applicable rules.* The provisions of §1.1441–1(e)(4)(i) through (ix) (regarding who may sign a certificate, validity period of certificates, retention of certificates, etc.) shall apply (by substituting the term *payor* for the term *withholding agent* and disregarding the fact that the provisions under §1.1441–1(e)(4) only apply to amounts subject to withholding under chapter 3 of the Code) to withholding certificates and documentary evidence furnished for purposes of this section. See §1.1441–1(b)(2)(vii) for provisions dealing with reliable association of a payment with documentation.

(3) *Standards of knowledge.* A payor may not rely on a withholding certificate or documentary evidence described in paragraph (c)(1) or (4) of this section if it has actual knowledge or reason to know that any information or certification stated in the certificate or documentary evidence is unreliable. A payor has reason to know that information or certifications are unreliable only if the payor would have reason to know under the provisions of §1.1441–7(b)(2)(ii) and (3) that the information and certifications provided on the certificate or in the documentary evidence

are unreliable or, in the case of a Form W–9 (or an acceptable substitute), it cannot reasonably rely on the documentation as set forth in §31.3406(h)–3(e) of this chapter (see the information and certification described in §31.3406(h)–3(e)(2)(i) through (iv) of this chapter that are required in order for a payor reasonably to rely on a Form W–9). The provisions of §1.1441–7(b)(2)(ii) and (3) shall apply for purposes of this paragraph (c)(3) irrespective of the type of income to which §1.1441–7(b)(2)(ii) is otherwise limited. The exemptions from reporting described in paragraphs (b)(10) and (11) of this section shall not apply if the payor has actual knowledge that the payee is a U.S. person who is not an exempt recipient.

(4) *Special documentation rules for certain payments.* This paragraph (c)(4) modifies the provisions of this paragraph (c) for payments to offshore accounts maintained at a bank or other financial institution of amounts that are not subject to withholding under chapter 3 of the Code, other than amounts described in (d)(3)(iii) of this section (dealing with U.S. short-term OID and U.S. bank deposit interest). Amounts are not subject to withholding under chapter 3 of the Code if they are not included in the definition of amounts subject to withholding under §1.1441–2(a) (e.g., deposit interest with foreign branches of U.S. banks, foreign source income, or broker proceeds).

(i) *Alternative documentary evidence.* In the case of payments to which this paragraph (c)(4) applies, the payor may, instead of a beneficial owner withholding certificate described in §1.1441–1(e)(2)(i) or documentary evidence described in paragraph (c)(1) of this section, rely on a customer's declaration of foreign status made on an account opening form that contains the statement described in this paragraph (c)(4)(i) (or such substitute statement as the Internal Revenue Service may prescribe) if the mailing and permanent residence address of the customer is in the country in which the branch or office is located and, under the local laws, regulations, or practices applicable to the type of account or transaction described in this paragraph (c)(4), it is not customary to obtain documentary evidence described in paragraph (c)(1) of this section or, it is customary to obtain such documentary evidence, but it is not customary to request that it be renewed periodically. Reliance on the documentary evidence described in this paragraph (c)(4)(i) is permitted only if there are no indications that the person opening the account is a U.S. person (e.g., permanent residence address is in a foreign country, the person does not have a mailing address in the United States, the person is not employed by a U.S.-based multinational organization). If reliance is not permitted because there are indications of U.S. status (e.g., the person's permanent residence address is in the United States, the person changes his mailing address to the United States, the person is employed by a U.S.-based multinational organization) then the payor must obtain either documentary evidence described in paragraph (c)(1) of this section or a Form W–8 described in §1.1441–1(e)(2)(i) in order to treat the customer as a foreign payee. The form or documentary evidence must be renewed every three years in accordance with the renewal procedures set forth in §1.1441–1(e)(4)(ii)(A) for as long as indicia of U.S. status continue to be present. The statement referred to in this paragraph (c)(4)(i) must appear near the signature line and must read as follows:

> By opening this account and signing below, the account owner represents and warrants that he/she/it is not a U.S. person for purposes of U.S. federal income tax and that he/she/it is not acting for or on behalf of a U.S. person. A false statement or misrepresentation of tax status by a U.S. person could lead to penalties under U.S. law. If your tax status changes and you become a U.S. citizen or a resident, you must notify us within 30 days.

(ii) *Continuous validity of declaration of foreign status subject to due diligence by financial institution.* A declaration of foreign status described in paragraph (c)(4)(i) of this section does not expire if the financial institution complies with the mailing requirement described in paragraph (c)(4)(iii) of this section, unless the financial institution becomes aware of circumstances indicating that the customer may be a U.S. person (including indications described in §1.1441–7(b)(2)(ii), dealing with due diligence standards applicable to financial institutions). If circumstances indicate that the customer may be a U.S. person, then the financial institution may rely on the foreign status of the customer only if it obtains documentary evidence from the customer that is described in paragraph (c)(1) of this section or a beneficial withholding certificate described in §1.1441–1(e)(2)(i). Such documentary evidence or certificate does not expire after the three-year validity period otherwise prescribed for such documentation but must be renewed each time new circumstances occur indicating that the customer may be a U.S. person.

(iii) *Negative confirmation of change of status.* In order for a declaration of foreign status to remain valid, the financial institution must include the following statement on a year-end statement mailed to the customer:

> You have declared to us that you are not a U.S. person and, unless you notify us to the contrary, we will continue to rely on that declaration to treat the account as owned by a non-U.S. person. You have an obligation to notify us if your status changes and you become a U.S. citizen or a U.S. resident. A U.S. person who fails to report earnings on the account could be subject to penalties under U.S. law.

(iv) *Special rule when non-renewable documentary evidence is customary.* If it is customary in the country in which the branch or office is located to obtain documentary evidence described in paragraph (c)(1) of this section, but it is not customary for such documentary evidence to be renewed, then a payor must request such documentary evidence in lieu of the statement described in paragraph (c)(4)(i) of this section. All other requirements described in paragraphs (c)(4)(ii) and (c)(4)(iii) of this section shall apply.

(v) *Exception for existing accounts.* The rules of paragraphs (c)(4)(i) and (iv) of this section shall apply only to accounts opened on or after January 1, 1999.

(5) *U.S. payor, U.S. middleman, non-U.S. payor, and non-U.S. middleman.* The terms *payor* and *middleman* have the meanings ascribed to them under §1.6049–4(a). A *non-U.S. payor* or *non-U.S. middleman* means a payor or middleman other than a U.S. payor or U.S. middleman. The term *U.S. payor* or *U.S. middleman* means—

(i) A person described in section 7701(a)(30) (including a foreign branch or office of such person);

(ii) The government of the United States or the government of any State or political subdivision thereof (or any agency or instrumentality of any of the foregoing);

(iii) A controlled foreign corporation within the meaning of section 957(a);

(iv) A foreign partnership, if at any time during its tax year, one or more of its partners are U.S. persons (as defined in §1.1441–1(c)(2)) who, in the aggregate hold more than 50 percent of the income or capital interest in the partnership or if, at any time during its tax year, it is engaged in the conduct of a trade or business in the United States;

(v) A foreign person 50 percent or more of the gross income of which, from all sources for the three-year period ending with the close of its taxable year preceding the collection or payment (or such part of such period as the person has been in existence), was effectively connected with the conduct of trade or business within the United States; or

(vi) A U.S. branch of a foreign bank or a foreign insurance company described in §1.1441–1(b)(2)(iv).

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

Example 1. FC is a foreign corporation that is not engaged in a trade or business in the United States during the current calendar year. D, an individual who is a resident and citizen of the United States, holds a registered obligation issued by FC in a public offering. Interest is paid on the obligation within the United States by DC, a U.S. corporation that is the designated paying agent of FC. D does not have an account with DC. Although interest paid on the obligation issued by FC is foreign source, the interest paid by DC to D is considered to be interest for purposes of information reporting under section 6049 because it is paid in the United States.

Example 2. The facts are the same as in *Example 1* except that D is a nonresident alien individual who has furnished DC with a Form W–8 in accordance with the provisions of §1.1441–1(e)(1)(ii). By reason of paragraph (b)(12) of this section, the payment of interest by DC to D is not considered to be a payment of interest for purposes of information reporting under section 6049. Therefore, DC is not required to make an information return under section 6049.

Example 3. The facts are the same as in *Example 2* except that D has not furnished a Form W–8 and DC pays interest on the obligation at its branch outside the United States. The payment of interest by DC to D is not considered to be a payment of interest for purposes of information reporting under section 6049 because DC, although a U.S. person is not a middleman or a payor within the meaning of §1.6049–4(a) and (f)(4). Thus, the amount is described in paragraph (b)(6) of this section. Therefore, DC is not required to make an information return under section 6049.

Example 4. The facts are the same as in *Example 3* except that the obligation of FC is held in a custodial account for D by FB, a foreign branch of a U.S. financial institution. By reason of paragraph (c)(5) of this section, FB is considered to be a U.S. middleman. Therefore, FB is required to make an information return unless FB may treat D as a beneficial owner that is a foreign person in accordance with the provisions of §1.1441–1(e)(1)(ii).

Example 5. The facts are the same as in *Example 4* except that the FC obligation is held for D by NC, in a custodial account at NC's foreign branch. NC is a foreign corporation that is a non-U.S. middleman described in paragraph (c)(5) of this section. Under paragraph (b)(6) of this section, the payment by NC to D is not considered to be a payment of interest for purposes of section 6049. Therefore, NC is not required to make an information return under section 6049 with respect to the payment.

(d) *Determination of status as U.S. or foreign payee and applicable presumptions in the absence of documentation*— (1) *Identifying the payee.* The provisions of §1.1441–1(b)(2) shall apply (by substituting the term *payor* for the term *withholding agent*) to identify the payee for purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(1) applies), except to the extent provided in this paragraph (d)(1) in the case of payments of amounts that are not subject to withholding under chapter 3 of the Code. Amounts are not subject to withholding under chapter 3 of the Code if they are not included in the definition of amounts subject to withholding under §1.1441–2(a) (e.g., deposit interest with foreign branches of U.S. banks, foreign source income, or broker proceeds). The exceptions to the application of §1.1441–1(b)(2) to amounts that are not subject to withholding under chapter 3 of the Code are as follows:

(i) The provisions of §1.1441–1(b)(2)(ii), dealing with payments to a U.S. agent of a foreign person, shall not apply. Thus, a payment to a U.S. agent of a foreign person is treated as a payment to a U.S. payee.

(ii) Payments to U.S. branches of certain banks or insurance companies described in §1.1441–1(b)(2)(iv) shall be treated as payments to a foreign payee, irrespective of the fact that the U.S. branch may have arranged with the payor to be treated as a U.S. person for payments of amounts subject to withholding and irrespective of the fact that the branch is treated as a U.S. payor for purposes of paragraph (c)(5) of this section.

(2) *Presumptions of U.S. or foreign status in the absence of documentation*— (i) *In general.* For purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(2) applies), the provisions of §1.1441–1(b)(3)(i), (ii), (iii), (vii), (viii), and (ix) shall apply (by substituting the term *payor* for the term *withholding agent*) to determine the status of a payee as a U.S. or a foreign person and its relevant characteristics (e.g., as an owner or intermediary, or as an individual, corporation, or flow-through entity), irrespective of whether the payments are subject to withholding under chapter 3 of the Code. In addition, the rules of §1.1441–1(b)(2)(vii) shall apply for purposes of determining when a payment can reliably be associated with documentation, by substituting the term *payor* for the term *withholding agent.* For this purpose, the documentary evidence described in paragraph (c)(4) of this section can be treated as documentation with which a payment can be associated.

(ii) *Grace period in the case of indicia of a foreign payee.* When the conditions of this paragraph (d)(2)(ii) are satisfied, the 30-day grace period provisions under section 3406(e) shall not apply and the provisions of this paragraph (d)(2)(ii) shall apply instead. A payor that, at any time during the grace period described in this paragraph (d)(2)(ii), credits an account with amounts reportable under section 6042, 6045, or 6049 with respect to publicly traded securities, or under section 6050N in the case of royalties from a unit investment trust that are (or were upon issuance) publicly offered and are registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77a) may, instead of treating the account as owned by a U.S. person and applying backup withholding under section 3406, choose, in its discretion, to treat the account as owned by a foreign person if, at the beginning of the grace period, the address that the payor has in its records for the account holder is in a foreign country, the payor has been furnished the information contained in a withholding certificate described in §1.1441–1(e)(2)(i) or (3)(i) (by way of a facsimile copy of the certificate or other non-qualified electronic transmission of the information required to be stated on

the certificate), or the payor holds a withholding certificate that is no longer reliable. In the case of a newly opened account, the grace period begins on the date that the payor first credits the account. In the case of an existing account for which the payor holds a Form W–8 or documentary evidence of foreign status, the grace period begins on the date that the payor first credits the account after the existing documentation held with regard to the account can no longer be relied upon (other than because the validity period described in §1.1441–1(e)(4)(ii)(A) has expired). A new account shall be treated as an existing account if the account holder already holds an account at the branch location at which the new account is opened. It shall also be treated as an existing account if an account is held at another branch location if the institution maintains a coordinated account information system described in §1.1441–1(e)(4)(ix). The grace period terminates on the earlier of the close of the 90th day from the date on which the grace period begins, the date that the documentation is provided, or the last day of the calendar year in which the grace period begins. The grace period also terminates when the remaining balance in the account (due to withdrawals or otherwise) is less than 31 percent of the total amounts credited since the beginning of the grace period that would be subject to backup withholding if the provisions of this paragraph (d)(2)(ii) did not apply. At the end of the grace period, the payor shall treat the amounts credited to the account during the grace period as paid to a U.S. or foreign payee depending upon whether documentation has been furnished and the nature of any such documentation furnished upon which the payor may rely to treat the account as owned by a U.S. or foreign payee. If the documentation has not been received on or before the date of expiration of the grace period, the payor may also apply the presumptions described in this paragraph (d) to amounts credited to the account after the date on which the grace period expires (until such time as the payor can reliably associate the documentation with amounts credited). See §31.6413(a)–3(a)(1)(iv) of this chapter for treating backup withheld amounts under section 3406 as erroneously withheld when the documentation establishing foreign status is furnished prior to the end of the calendar year in which backup withholding occurs. If the provisions of this paragraph (d)(2)(ii) apply, the provisions of §31.3406(d)–3 of this chapter shall not apply. For purposes of this paragraph (d)(2)(ii), an account holder's reinvestment of gross proceeds of a sale into other instruments constitutes a withdrawal and a non-qualified electronic transmission of information on a withholding certificate is a transmission that is not in accordance with the provisions of §1.1441–1(e)(4)(iv). See §1.1092(d)–1 for a definition of the term *publicly traded* for purposes of this paragraph (d)(2)(ii).

(iii) *Joint owners.* Amounts paid to accounts held jointly for which a certificate or documentation is required as a condition for being exempt from reporting under paragraph (b) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (b)(12) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (d)(2)(iii), the grace period described in paragraph (d)(2)(ii) of this section shall apply only if each payee qualifies for such grace period.

(3) *Payments to foreign intermediaries*—(i) *Payments of amounts subject to withholding under chapter 3 of the Internal Revenue Code.* In the case of payments of amounts that are subject to withholding under chapter 3 of the Code, the provisions of §1.1441–1(b)(2)(v) and (3)(v) shall apply (by substituting the term *payor* for the term *withholding agent*) to identify the payee and determine the applicable presumptions for purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(3) applies).

(ii) *Payments of amounts not subject to withholding under chapter 3 of the Internal Revenue Code.* Amounts that are not subject to withholding under chapter 3 of the Code that the payor may treat as paid to a foreign intermediary in accordance with §1.1441–1(b)(3)(v)(A) shall be treated as made to an exempt recipient described in §1.6049–4(c)(1)(ii)(M), (O), (P), or (Q) except to the extent that the payor has actual knowledge that any person for whom the intermediary is collecting the payment is a U.S. person who is not an exempt recipient. In the case of such actual knowledge, the payor shall treat the payment that it knows is allocable to such U.S. person as a payment to a U.S. payee who is not an exempt recipient. If the payor does not have sufficient reliable information regarding the portion of the payment to the foreign intermediary that is allocable to such presumed U.S. payee, then the payor shall treat the maximum portion of the payment that could be allocable to such presumed U.S. payee as so allocable.

(iii) *Special rule for payments of certain short-term original issue discount and bank deposit interest*—(A) *General rule.* A payment of U.S. source original issue discount on an obligation with a maturity from the date of issue of 183 days or less (short-term OID) described in section 871(g)(1)(B) or 881(a)(3) or of U.S. source interest (including original issue discount) on deposits with banks and other financial institutions described in section 871(i)(2)(A) or 881(d) that the payor may treat as paid to a foreign intermediary in accordance with the provisions of §1.1441–1(b)(3)(v)(A) shall be treated as paid to an exempt recipient only to the extent that the payor can treat the payment as made to a foreign person that is a beneficial owner in accordance with the provisions of §1.1441–1(e)(1)(ii), or can treat as a payment to a U.S. beneficial owner in accordance with the provisions of §1.1441–1(d)(4) (except to the extent that the payment is associated with a Form W–9 described in §1.1441–1(d)(2) relating to a U.S. payee who is not an exempt recipient), or can rely on the payee's claim that the payee assumes withholding responsibility in accordance with §1.1441–1(e)(5)(iv).

(B) *Payee has not furnished reliable documentation.* If the payment is made to a person described in §1.6049–4(c)(1)(ii) that the payor may treat as an exempt recipient without requiring documentation and the payor may not treat the payee as a foreign intermediary in accordance with the provisions of §1.1441–1(b)(3)(v)(A), then the payee shall be treated as an ex-

empt recipient only if the payor can treat the person as a U.S. person, or if the person has furnished a certificate as a U.S. branch described in §1.1441–1(b)(2)(iv), or the person has furnished a certificate such that the payor can treat the payment as a payment made to a foreign person that is a beneficial owner, or if the payor can treat the person as a foreign person that has furnished an indication to the payor that such person is receiving the payment for its own account. A payor must treat the payee as a foreign person for purposes of this paragraph (d)(3)(iii) if the payor has actual knowledge of the person's employer identification number and that number begins with the two digits "98," if the payor's communications with the person are mailed to an address in a foreign country, or if the payment is made outside the United States (as defined in paragraph (e) of this section). The payor may treat as a U.S. person any person not described in the preceding sentence for purposes of this paragraph (d)(3)(iii). If the payee is treated as a foreign person under this paragraph (d)(3)(iii)(B), it must be treated as not acting for its own account unless it furnishes an indication of beneficial ownership in any manner that the payor and the person may choose, provided the indication is documented in the payor's records. The indication is not required to be under penalties of perjury. The provisions of this paragraph (d)(3)(iii) shall not apply to deposits with banks and other financial institutions that remain on deposit for a period of two weeks or less, to amounts of original issue discount arising from a sale and repurchase transaction that is completed within a period of two weeks or less, or to amounts described in paragraphs (b)(7), (10) and (11) of this section (relating to certain obligations issued in bearer form).

(iv) *Examples.* The rules of this paragraph (d)(3) are illustrated by the following example:

Example 1. A payor, X, makes a payment to Y of U.S. source interest on debt obligations issued prior to July 18, 1984. Therefore, the interest does not qualify as portfolio interest under section 871(h) or 881(d). Y is a non-qualified foreign intermediary that has furnished to X a valid intermediary withholding certificate described in §1.1441–1(e)(3)(iii) to which it has attached a valid Form W–9 for A, and two valid beneficial owner Forms W–8, one for B and one for C. Y's withholding certificate does not contain reliable information regarding B and C's share of the payment. B's withholding certificate (attached to Y's withholding certificate) indicates that B is a foreign pension fund, exempt from U.S. tax under the U.S. income tax treaty with Country T. C's withholding certificate (attached to Y's withholding certificate) indicates that C is a foreign corporation not entitled to a reduced rate of withholding. Under paragraph (b)(12) of this section, X may rely on the withholding certificates to determine the status of A, B, and C for purposes of deciding whether the amounts paid are interest within the meaning of this section. However, because X cannot reliably determine how much of the payment is allocable to B and C, it must presume under paragraph (d)(3)(i) of this section and §1.1441–1(b)(3)(v)(C) that 80 percent of the payment (i.e., all of the payment less A's share) is allocable to C because the rate of withholding applicable to the payment to C is the highest of the withholding rates applicable to B and C. Thus, based on such presumption, X may treat C as a foreign payee under paragraph (b)(12) of this section and, therefore, may treat the payment as not being interest reportable under §1.6049–4(a).

Example 2. The facts are the same as in *Example 1*, except that X can reliably determine C's allocable share, but cannot reliably determine A's and B's share. No withholding is required under chapter 3 of the Code or under section 3406 on the payment to A or B since A is a U.S. person who has furnished a valid Form W–9 and B is an exempt recipient (as defined in §1.6049–4(c)(1)(ii)(B)) and a foreign tax-exempt organization exempt from chapter 3 withholding (see §1.1441–9). However, X estimates that A, as a U.S. person, is subject to a higher U.S. tax liability with respect to the payment than B is, since B is a foreign tax-exempt organization. Therefore, X must presume under paragraph (d)(3)(i) of this section and §1.1441–1(b)(3)(v)(C) that 70 percent of the payment (i.e., all of the payment less C's share) is allocable to A. Consequently, X must report all of the payment on the Form 1099 filed for A under §1.6049–4(a).

Example 3. A payor, X, makes a payment of foreign source interest to Y, a non-qualified foreign intermediary that has furnished an intermediary withholding certificate described in §1.1441–1(e)(3)(iii) to which it has attached a withholding certificate described in §1.1441–1(e)(3)(iii) for Z, that is also a non-qualified foreign intermediary. Beneficial owner certificates are attached to Z's certificate. Under paragraph (d)(1) of this section, X must rely on the provisions of §1.1441–1(b)(2)(v) to treat the payment as made to the persons whose withholding certificates are attached to Z's certificate to the extent both Y and Z have reliably certified in accordance with §1.1441–1(e)(3)(iii)(D) that the certificates that each of them has attached to their respective intermediary withholding certificate represent all of the persons to whom the intermediary withholding certificate relates. X must rely on the provisions of §1.1441–1(b)(2)(v) even though the payment is not an amount subject to withholding under chapter 3 of the Code.

Example 4. A payor, X, makes a payment to Y of foreign source interest and U.S. source dividends. Y has furnished to X a qualified intermediary withholding certificate described in §1.1441–1(e)(3)(ii) for itself. Y indicates that 10 percent of each type of payments is allocable to the category described in §1.1441–1(e)(5)(v)(B)(*3*), relating to assets owned by persons for whom the qualified intermediary does not hold the documentation. X has no actual knowledge that the persons owning the assets are U.S. persons. With respect to the payment of foreign source interest (an amount that is not subject to withholding under chapter 3 of the Code), X must, under paragraph (d)(3)(ii) of this section, treat the payment as made to a foreign payee. Such treatment is effective for purposes of paragraph (b)(12) of this section, meaning that the 10-percent amount is not treated as interest for purposes of reporting under §1.6049–4(a). With respect to the amount of U.S. source dividends, X must, under paragraph (d)(3)(i) of this section, treat the payment as made to a foreign payee (based upon paragraph (d)(3)(i)'s cross-reference to §1.1441–1(b)(3)(v)(B)). Such treatment is effective for purposes of §1.6042–3(b)(1)(iii), meaning that the 10-percent amount is not treated as a dividend for purposes of reporting under §1.6042–2(a).

Example 5. A payor, X, makes a payment of foreign source interest to Y, a non-qualified foreign intermediary that has furnished an intermediary withholding certificate described in §1.1441–1(e)(3)(iii) to which it has attached beneficial owner Forms W–8. In its withholding certificate, Y represents to X that 30 percent of the payment is allocable to a U.S. person who has not furnished a Form W–9 and whom Y cannot treat as an exempt recipient. Under paragraph (d)(3)(ii) of this section, X must treat 70 percent of the payment as made to a foreign payee. X, however, may not rely on the rule of paragraph (d)(3)(ii) of this section to treat the remainder of the payment as made to a foreign payee because X has actual knowledge that the remainder of the payment is allocable to a U.S. person. Under paragraph (d)(3)(ii) of this section, X must treat 30 percent of the payment as made to a U.S. payee who is not an exempt recipient.

Example 6. A payor, X, holds a valid withholding certificate from Y, a qualified intermediary, with which it reliably associates payments made to A, a U.S. individual who maintains an account relationship with Y and who has furnished a valid Form W–9 to Y. Y has furnished A's Form W–9 to X who has set up a separate account for those assets held in Y's name, and which Y has indicated are allocable to A. The assets consist of 10,000 shares of stock of domestic corporation T, publicly traded on a U.S. stock exchange. When dividends are paid on the T stock held in the Y/A account, X credits the dividend amounts to the account and reports the dividend amounts credited to that account on a Form 1099–DIV under section 6042, treating A as the payee in accordance with paragraph (d)(1) of this section (cross-referencing §1.1441–1(b)(2)(v)). When A later instructs Y to sell the shares, X effects the sale and credits the Y/A account with the gross proceeds from the sale of 10,000 shares of the T stock. Under §1.6045–1(c)(2) and paragraph (d)(3)(ii) of this section, X must report the gross proceeds credited to the Y/A account on a Form 1099-B made in the name of A since it has actual knowledge that the gross proceeds are paid to a U.S. person who is not an exempt recipient. See section 1.6045–1(g)(3)(iv).

Example 7. A payor, X, holds a valid withholding certificate from Y, a non-qualified intermediary, and can reliably associate a payment of U.S. short-term OID and proceeds from the sale of shares with the certificate. Y has not attached any certificates or documentary evidence to its certificate and informs X that the payment is allocable to persons for whom it holds no documentation. Under paragraph (d)(3)(iii) of this section, X must, for purposes of this section and section 3406, treat the payment of short-term OID as made to a U.S. payee who is not an exempt recipient. However, under paragraph (d)(3)(ii) of this section, the payment of gross proceeds from the sale of shares is treated as made to a foreign payee. X must rely on this treatment for purposes of determining its reporting obligations under section 6045 and the regulations under that section (see §1.6045–1(g)(1)(i)) and, consequently, its withholding obligations under section 3406 and the regulations under that section.

(4) *Determination of partnership and partners status in the absence of documentation*—(i) *Payments of amounts subject to withholding under chapter 3 of the Internal Revenue Code.* In the case of payments of amounts that are subject to withholding under chapter 3 of the Code, the provisions of §§1.1441–1(b)(3)(ii) and 1.1441–5(c)(1), and (d) shall apply (by substituting the term *payor* for the term *withholding agent*) to determine the status of the payee as a partnership, as a domestic or foreign partnership, and the status of its partners for purposes of this section (and other sections of regulations under this chapter to which this paragraph (d)(4) applies).

(ii) *Payments of amounts not subject to withholding under chapter 3 of the Internal Revenue Code.* In the case of amounts that are not subject to withholding under chapter 3 of the Code, the provisions of §§1.1441–1(b)(3)(ii) and 1.1441–5(c)(1), and (d) shall also apply (by substituting the term *payor* for the term *withholding agent*), subject to the following exceptions—

(A) If, in the absence of documentation, the payor treats the payee as a partnership in accordance with the presumptions set forth in §1.1441–1(b)(3)(ii), the presumptions of §1.1441–5(d)(2) shall not apply to treat the partnership as a foreign partnership; instead, the person treated as a partnership shall be presumed to be a domestic partnership; and

(B) In the case of payments described in §1.1441–5(d)(3)(i) (dealing with lacking or unreliable documentation regarding the status of partners) or in §1.1441–5(d)-(3)(iii), dealing with lacking or unreliable information regarding the number of partners represented by the withholding certificate), the partners are presumed to be U.S. payees who are not exempt recipients and not foreign payees.

(5) *Presumptions for payments to or by foreign trusts or estates.* [Reserved]

(e) *Determination of whether amounts are considered paid outside the United States*—(1) *In general.* For purposes of section 6049 and this section, an amount is considered to be paid by a payor or middleman outside the United States if the payor or middleman completes the acts necessary to effect payment outside the United States. See paragraphs (e)(2), (3), and (4) of this section for further clarification of where amounts are considered paid. A payment shall not be considered to be made within the United States for purposes of section 6049 merely by reason of the fact that it is made on a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account. However, without regard to the location of the account from which the amount is drawn, an amount that is described in paragraph (e)(1)(i) or (ii) of this section and paid by transfer to an account maintained by the payee in the United States or by mail to a United States address is not considered to be paid outside the United States.

(i) The amount is paid by an issuer or the paying agent of the issuer and the obligation is either—

(A) Issued by a U.S. payor, as defined in paragraph (c)(5) of this section;

(B) Registered under the Securities Act of 1933 (15 U.S.C. 77a); or

(C) Listed on an exchange that is registered as a national securities exchange in the United States or included in an interdealer quotation system in the United States.

(ii) The amount is paid by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian, nominee, or other agent of a payee, collects the amount for or on behalf of the payee.

(2) *Amounts paid with respect to deposits or accounts with banks and other financial institutions.* Notwithstanding paragraph (e)(1) of this section, an amount paid by a bank or other financial institution with respect to a deposit or with respect to an account with the institution is considered paid at the branch or office at which the amount is credited unless the amount is collected by the financial institution as the agent of the payee. However, an amount will not be considered to be paid at the branch or office where the amount is considered to be credited unless the branch or office is a permanent place of business that is regularly maintained, occupied, and used to carry on a banking or similar financial business; the business is conducted by at least one employee of the branch or office who is regularly in attendance at such place of business during normal business hours; and the branch or office receives deposits and engages in one or more of the other activities described in §1.864–4-(c)(5)(i). In addition, an amount paid by a bank or other financial institution with respect to a deposit or an account with the institution is not considered paid at a branch or office outside the United States if the customer has transmitted instructions to an agent, branch, or office of the institution from inside the United States by mail, telephone, electronic transmission, or otherwise concerning the deposit or account (unless the transmission from the United States has taken place in isolated and infrequent circumstances).

(3) *Coupon bonds and discount obligations in bearer form.* Notwithstanding paragraph (e)(1) of this section, an amount paid with respect to a bond with coupons attached (including a certificate of deposit with detachable interest coupons) or a discount obligation that is not in registered form (within the meaning of section 163(f) and the regulations thereunder) is considered to be paid where the coupon or the discount obligation is presented to the payor or its paying agent for payment. However, without regard to where the coupon or discount obligation is presented for payment, an amount paid with respect to either a bond with coupons attached or a discount obligation by transfer to an account maintained by the payee in the United States or by mail to the United States is considered paid in the United States if the payment is described in paragraphs (e)(3)(i) and (ii) of this section.

(i) The amount is paid by an issuer or the paying agent of the issuer and the obligation is either—

(A) Issued by a U.S. payor, as defined in paragraph (c)(5) of this section;

(B) Registered under the Securities Act of 1933 (15 U.S.C. 77a); or

(C) Listed on an exchange that is registered as a national securities exchange in the United States or included in a interdealer quotation system in the United States.

(ii) The amount is paid by a U.S. middleman (as defined in paragraph (c)(5) of this section) that, as a custodian, nominee, or other agent of payee, collects the amount for or on behalf of the payee.

(4) *Foreign-targeted registered obligations.* Notwithstanding paragraph (e)(1) of this section, where the payor is the issuer or the issuer's agent, an amount is

considered paid outside the United States with respect to a foreign-targeted registered obligation, as described in §1.871–14(e)(2), if either the amount is paid by transfer to an account maintained by the registered owner outside the United States, or by mail to an address of the registered owner outside the United States, or by credit to an international account. For purposes of this paragraph (e)(4), the term *international account* means the book-entry account of a financial institution (within the meaning of section 871(h)(4)(B)) or of an international financial organization with the Federal Reserve Bank of New York for which the Federal Reserve Bank of New York maintains records that specifically identifies an international financial organization or a financial institution (within the meaning of section 871(h)(4)(B)) as either a non-United States person or a foreign branch of a United States person as registered owner. An international financial organization is a central bank or monetary authority of a foreign government or a public international organization of which the United States is a member to the extent that such central bank, authority, or organization holds obligations solely for its own account and is exempt from tax under section 892 or 895.

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

Example 1. FC is a foreign corporation that is not a U.S. payor or U.S. middleman, as defined in paragraph (c)(5) of this section. A holds FC coupon bonds that are not in registered form under section 163(f) and the regulations thereunder, that were issued by FC in a public offering outside the United States, that are not registered under the Securities Act of 1933 (15 U.S.C. 77a), and that are neither listed on an exchange that is registered as a national securities exchange in the United States nor included in an interdealer quotation system. DC, a U.S. corporation that is engaged in a commercial banking business, is the designated fiscal agent for FC. FB, a foreign branch of DC, is the designated paying agent with respect to the bonds issued by FC. A does not have an account with FB. A presents a coupon from a FC bond for payment to FB at its office outside the United States. FB pays a with a check drawn against a bank account maintained in the United States. For purposes of section 6049, the place of payment of interest on the FC bond by FB to A is considered to be outside the United States under paragraph (e)(3) of this section.

Example 2. The facts are the same as in *Example 1* except that A presents the coupon to FB at its office outside the United States with instructions to transfer funds in payment to a bank account maintained by a in the United States. FB transfers the funds in accordance with a's instructions. Even though the amount is credited to an account in the United States, the place of payment of interest on the FC bonds is considered to be outside the United States under paragraph (e)(3) of this section because the coupon is presented for payment outside the United States; because FC is a foreign person that is not a U.S. payor or U.S. middleman, as defined in paragraph (d)(1) of this section; because FB is not acting as A's agent; and because the obligation is not registered under the Securities Act of 1933 (15 U.S.C. 77a), listed on a securities exchange that is registered as a national securities exchange in the United States, or included in an interdealer quotation system.

Example 3. FC is a foreign corporation that is not a U.S. payor or U.S. middleman, as defined in paragraph (d)(1) of this section. B, a United States citizen, holds a bond issued by FC in registered form under section 163(f) and the regulations thereunder and registered under the Securities Act of 1933 (15 U.S.C. 77a). The bond is not a foreign-targeted registered obligation as defined in §1.871–14(e)(2). DB, a United States branch of a foreign corporation engaged in the commercial banking business, is the registrar of the bonds issued by FC. DB supplies FC with a list of the holders of the FC bonds. Interest on the FC bonds is paid to B and other bondholders by checks prepared by FC at its principal office outside the United States, and B's check is mailed from there to his designated address in the United States. The bond is described in paragraph (e)(1)(i)(B) of this section. The place of payment to B by FC of the interest on the FC bonds is considered to be inside the United States under paragraph (e)(1) of this section.

Example 4. The facts are the same as in *Example 3* except that the checks are prepared and mailed in the United States by DC, a U.S. corporation engaged in the commercial banking business that is the designated paying agent with respect to the bonds issued by FC, and B's check is mailed to his designated address outside the United States. For purposes of section 6049, the place of payment by DC of the interest on the FC bonds is considered to be within the United States under paragraph (e)(1) of this section.

Example 5. Individual C deposits funds in an account with FB, a foreign country X branch of DB, a U.S. corporation engaged in the commercial banking business. FB maintains an office and employees in foreign country X, accepts deposits, and conducts one or more of the other activities listed in §1.864–4(c)(5)(i). The terms of C's deposit provide that it will be payable in six months with accrued interest. On the day that the interest is credited to C's account with FB, C telephones DB from inside the United States and asks DB to direct FB to transfer the funds in his account with FB to an account C maintains in the United States with DB. Transmissions from the United States concerning this account have taken place in isolated and infrequent circumstances. Under paragraph (e)(2) of is section, FB is considered to have paid the interest on C's deposit outside the United States.

Example 6. The facts are the same as in *Example 5* except that C has placed his deposit with FB for an indefinite period of time. Interest will be credited to C's account daily. C has instructed FB to wire the interest at 90-day intervals to C's account with DB within the United States. FB is considered to have paid the interest credited to a's account within the United States under paragraph (e)(2) of this section because the regular crediting of the account disqualifies the transmission from being isolated or infrequent.

Example 7. DC, a U.S. corporation engaged in the commercial banking business, maintains FB, a branch in foreign country X. FB has an office and employees in foreign country X, accepts deposits, and engages in one or more of the other activities listed in §1.864–4(c)(5)(i). D, a United States citizen, purchases a certificate of deposit issued in 1980 by FB. The certificate of deposit has a maturity of 20 years and has detachable interest coupons payable at six-month intervals. D presents some of the coupons at the U.S. office of DC and receives payment in cash. Because the coupon is presented to DC for payment within the United States, DC is considered to have made the payment within the United States under paragraph (e)(3) of this section.

Example 8. FB is recognized by both foreign country X and by the Federal Reserve Bank as a foreign country X branch of DC, a U.S. corporation engaged in the commercial banking business. A local foreign country X bank serves as FB's resident agent in Country X. FB maintains no physical office or employees in foreign country X. All the records, accounts, and transactions of FB are handled at the United States office of DC. E deposits funds in an amount maintained with FB. Interest earned on the deposit is periodically credited to E's account with FB by employees of DC. For purposes of section 6049, the place of payment of the interest on E's deposit with FB is considered to be within the United States by reason of paragraphs (e)(1) and (2) of this section.

Example 9. DC is a U.S. corporation. a holds bonds that were issued by DC in registered form under section 163(f) and the regulations thereunder and that are foreign-targeted registered obligations as defined in §1.871–14(e)(2). DB, a commercial banking business, is the registrar of bonds issued by DC. Interest on the DC bonds is paid to a and other bondholders by check prepared by DB at its principal office inside the United States and mailed from there to a's address outside the United States. The check is drawn on a United States account maintained by DC with DB within the United States. The place of payment to a by DB of the interest on the DC bonds is considered to be outside the United States under paragraph (e)(4) of this section.

* * * * *

(g) *Effective date*—(1) *General rule.* The provisions of paragraphs (b)(6) through (15), (c), (d), and (e) of this section apply to payments made after December 31, 1998.

(2) *Transition rules.* A payor that, on December 31, 1998, holds a valid Form W–8 or other form upon which it is permitted to rely to hold the payee as a foreign person pursuant to the regulations in effect prior to January 1, 1999 (see 26 CFR parts 1 and 35a, revised April 1, 1997), may treat it as a valid certificate until its validity expires under those regulations or, if earlier, until December 31, 1999. Further, the validity of a Form W–8 or other form that is dated prior to January 1, 1998, is valid on January 1, 1998, and would expire at any time during 1998, is extended until December 31, 1998 (and is not extended after December 31, 1998 by reason of the immediately preceding sentence). The rule in this paragraph (g)(2), however, does not apply to extend the validity period of a with-

holding certificate that expires in 1998 solely by reason of changes in the circumstances of the person whose name is on the certificate. Notwithstanding the three preceding sentences, a payor may choose not to take advantage of the transition rule in this paragraph (g)(2) with respect to one or more withholding certificates and, therefore, may require new withholding certificates conforming to the requirements described in this section.

Par. 43. Section 1.6049–6 is amended by:

1. Removing the language, "a reasonable facsimile thereof" in the first sentence of paragraph (d) and adding "an acceptable substitute" in its place.

2. Revising paragraph (e)(3).

The revision reads as follows:

§1.6049–6 Statements to recipients of interest payments and holders of obligations for attributed original issue discount.

* * * * *

(e) * * *

(3) *Cross-reference to penalty.* For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6049(c) and §1.6049–6(a), see §301.6722–1 of this chapter (Procedure and Administration Regulations). See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

* * * * *

Par. 44. Section 1.6049–7 is amended by revising paragraph (c)(4) to read as follows:

§1.6049–7 Returns of information with respect to REMIC regular interests and collateralized debt obligations.

* * * * *

(c) * * *

(4) A foreign central bank of issue (as defined in §1.895–1(b)(1)) or the Bank for International Settlements;

* * * * *

Par. 45. In §1.6049–8, paragraph (a) is amended by removing the last two sentences and adding four sentences in their place to read as follows:

§1.6049–8 Interest and original issue discount paid to residents of Canada.

(a) *Interest subject to reporting requirement.* * * * The payor or middleman may rely upon the permanent residence address (as defined in §1.1441–1(e)-(2)(ii)) as stated on the Form W–8 described in §1.1441–1(e)(2)(i) in order to determine whether the payment is made to a Canadian nonresident alien individual. If the permanent residence address stated on the certificate is in Canada, or if the payor has actual knowledge of the individual's residence address in Canada, the payor must presume that the individual resides in Canada. Amounts described in this paragraph (a) are not subject to backup withholding under section 3406. See §31.3406(g)–1(d) of this chapter.

* * * * *

Par. 46. Section 1.6050A–1 is amended by:

1. Removing the language "Form 1099F" each place it appears and adding "Form 1099–MISC" in its place in paragraphs (a) introductory text, (a) concluding text, (b) and (c)(1) first and second sentences.

2. Adding paragraph (d) to read as follows:

§1.6050A–1 Reporting requirements of certain fishing boat operators.

* * * * *

(d) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050A(a) and §1.6050A–1(a), see §301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6050A(b) and §1.6050A–1(c), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

§1.6050H–1 [Amended]

Par. 47. Section 1.6050H–1 is amended by:

1. Removing the language "§35a.9999–4T, Q/A–5(iii)" and adding "§1.6049–5(c)" in its place in paragraph (d)(2)(ii)(A).

2. Removing the language "§1.6049–5-(b)(2)(iv)" and adding "§1.1441–1(e)(1)" in its place in paragraph (d)(2)(ii)(B).

Par. 48. Section 1.6050N–1 is amended by:

1. Revising the section heading.

2. Revising paragraphs (c) and (d).

3. Adding paragraph (e).

The addition and revisions read as follows:

§1.6050N–1 Statement to recipients of royalties paid after December 31, 1986.

* * * * *

(c) *Exempted foreign-related items—* (1) *In general.* No return shall be required under paragraph (a) of this section for payments of the items described in paragraphs (c)(1)(i) through (iv) of this section.

(i) Returns of information are not required for payments of royalties that a payor can, prior to payment, associate with documentation upon which it may rely to treat as made to a foreign beneficial owner in accordance with §1.1441–1(e)(1)(ii) or as made to a foreign payee in accordance with §1.6049–5(d)(1) or presumed to be made to a foreign payee under §1.6049–5(d)(2), (3), (4), or (5). However, such payments may be reportable under §1.1461–1(b) and (c). For purposes of this paragraph (c)(1)(i), the provisions in §1.6049–5(c) (regarding rules applicable to documentation of foreign status and definition of U.S. payor and non-U.S. payor) shall apply. See §1.1441–1(b)(3)(iii)(B) and (C) for special payee rules regarding scholarships, grants, pensions, annuities, etc. The provisions of §1.1441–1 shall apply by substituting the term *payor* for the term *withholding agent* and without regard to the fact that the provisions apply only to amounts subject to withholding under chapter 3 of the Internal Revenue Code.

(ii) Returns of information are not required for payments of royalties from sources outside the United States (determined under Part I of subchapter N and the regulations under these provisions) made outside the United States by a non-U.S. payor or non-U.S. middleman. For a definition of non-U.S. payor or non-U.S. middleman, see §1.6049–5(c)(5). For cir-

cumstances in which a payment is considered to be made outside the United States, see §1.6049–5(e).

(iii) Returns of information are not required for payments made by a foreign intermediary described in §1.1441–1(e)-(3)(i) that it has received in its capacity as an intermediary and that are associated with a valid withholding certificate described in §1.1441–1(e)(3)(ii) or (iii) and payments made by a U.S. branch of a foreign bank or of a foreign insurance company described in §1.1441–1(b)(2)(iv) that are associated with a valid withholding certificate described in §1.1441–1(e)-(3)(v), which certificate the intermediary or branch has furnished to the payor or middleman from whom it has received the payment, unless, and to the extent, the intermediary or branch knows that the payments are required to be reported and were not so reported.

(2) *Definitions*—(i) *Payor.* For purposes of this section, the term payor shall have the meaning ascribed to it under §1.6049–4(a).

(ii) *Joint owners.* Amounts paid to joint owners for which a certificate or documentation is required as a condition for being exempt from reporting under this paragraph (c) of this section are presumed made to U.S. payees who are not exempt recipients if, prior to payment, the payor cannot reliably associate the payment either with a Form W–9 furnished by one of the joint owners in the manner required in §§31.3406(d)–1 through 31.3406(d)–5 of this chapter, or with documentation described in paragraph (c)(1)(i) of this section furnished by each joint owner upon which it can rely to treat each joint owner as a foreign payee or foreign beneficial owner. For purposes of applying this paragraph (c)(2)(ii), the grace period described in §1.6049–5(d)(2)(ii) shall apply only if each payee qualifies for such grace period.

(d) *Cross-reference to penalties.* For provisions relating to the penalty provided for failure to file timely a correct information return required under section 6050N(a), see §301.6721–1 of this chapter (Procedure and Administration Regulations). For provisions relating to the penalty provided for failure to furnish timely a correct payee statement required under section 6050N(b) and §1.6050N–1-(a), see §301.6722–1 of this chapter. See §301.6724–1 of this chapter for the waiver of a penalty if the failure is due to reasonable cause and is not due to willful neglect.

(e) *Effective date*—This section, except paragraph (c), applies to payee statements due after December 31, 1995, without regard to extensions. For further guidance regarding the substantially similar statement mailing requirements that apply with respect to forms required to be filed after October 22, 1986, and before January 1, 1996 (see Rev. Proc. 84–70 (1984–2 C.B. 716) and §601.601(d)(2) of this chapter). The provisions of paragraph (c) of this section apply to payments made after December 31, 1998.

Par. 49. Section 1.6071–1, is amended by revising paragraphs (c)(7), (c)(8), (c)(11), (c)(13), and (c)(15) to read as follows:

§1.6071–1 Time for filing returns and other documents.

* * * * *

(c) * * *

(7) For provisions relating to the time for filing information returns by persons making certain payments, see §1.6041–2(a)(3) and §1.6041–6.

(8) For provisions relating to the time for filing information returns regarding payments of dividends, see §1.6042–2(c).

* * * * *

(11) For provisions relating to the time for filing information returns with respect to payments of patronage dividends, see §1.6044–2(d).

* * * * *

(13) For provisions relating to the time for filing information returns regarding certain payments of interest, see §1.6049–4(g).

* * * * *

(15) For provisions relating to the time for filing the annual information return on Form 1042–S of the tax withheld under chapter 3 of the Code (relating to withholding of tax nonresident aliens and foreign corporations and tax-free covenant bonds), see §1.1461–1(c).

* * * * *

Par. 50. In §1.6091–1, paragraph (b)(15) is revised to read as follows:

§1.6091–1 Place for filing returns or other documents.

* * * * *

(b) * * *

(15) For the place for filing information returns on Forms 1042–S with respect to certain amounts paid to foreign persons, see instructions to the form.

* * * * *

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 51. The authority for part 31 is amended by adding an entry in numerical order to read in part as follows:

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

Section 31.3401(a)(6)-1 also issued under 26 U.S.C. 1441(c)(4) and 26 U.S.C. 3401(a)(6). * * *

Par. 52. Section 31.3401(a)(6)–1 is amended by:

1. Revising the section heading.
2. Revising the paragraph heading and first sentence of paragraph (e).
3. Adding paragraph (f).
4. Removing the authority citation at the end of the section.

The addition and revisions read as follows:

§31.3401(a)(6)–1 Remuneration for services of nonresident alien individuals.

* * * * *

(e) *Exemption from income tax for remuneration paid for services performed before January 1, 1999.* Remuneration paid for services performed within the United States by a nonresident alien individual before January 1, 1999, is excepted from wages and hence is not subject to withholding if such remuneration is, or will be, exempt from income tax imposed by chapter 1 of the Internal Revenue Code by reason of a provision of the Internal Revenue Code or an income tax convention to which the United States is a party.* * *

(f) *Exemption from income tax for remuneration paid for services performed after December 31, 1998.* Remuneration paid for services performed within the United States by a nonresident alien indi-

vidual after December 31, 1998, is excepted from wages and hence is not subject to withholding if such remuneration is, or will be, exempt from the income tax imposed by chapter 1 of the Internal Revenue Code by reason of a provision of the Internal Revenue Code or an income tax convention to which the United States is a party. An employer may rely on a claim that the employee is entitled to an exemption from tax if it complies with the requirements of §1.1441–1(e)(1)(ii) of this chapter (for a claim based on a provision of the Internal Revenue Code) or §1.1441–4(b)(2) of this chapter (for a claim based on an income tax convention).

§31.3406–0 [Amended]

Par. 53. Section 31.3406–0 is amended by removing the entries in the table for §31.3406(h)–2, paragraphs (e)(1) and (e)(2).

Par. 54. Section 31.3406(d)–3 is amended by:

1. Adding two sentences at the end of paragraph (a).

2. Removing the words "30-day" in the first sentence, revising the word "these" to "the 30-day", and adding the word "may" immediately before the words "apply only if" in the second sentence, and revising the word "those" to "the" in the third sentence in paragraph (b).

3. Revising paragraph (c).

The addition and revision read as follows:

§31.3406(d)–3 Special 30-day rules for certain reportable payments.

(a) * * * For payments made after December 31, 1998, see §1.6049–5(d)(2)(ii) of this chapter for the application of a 90-day grace period in lieu of the 30-day grace period described in this paragraph (a) if, at the beginning of the 90-day grace period, certain conditions are satisfied. If the grace period provisions of §1.6049–5(d)(2)(ii) or §1.1441–1(b)(3)(iv) of this chapter are applied with respect to a new account, the grace period provisions of this paragraph (a) shall not apply to that account.

* * * * *

(c) *Application to foreign payees.* The rules of paragraphs (a) and (b) of this section also apply to a payee from whom the payor is required to obtain a Form W–8 (or an acceptable substitute) or other evidence of foreign status (pursuant to relevant regulations under an applicable Internal Revenue Code section without regard to the requirement to furnish a taxpayer identifying number, and the certifications described in §§31.3406(d)–1(b)(3) and 31.3406(d)–2), provided the payee represents orally or otherwise, before or at the time of the acquisition or sale of the instrument or the establishment of the account, that the payee is not a United States citizen or resident. The 30-day rules described in paragraph (a) or (b) of this section may apply only if the payee does not qualify for, or the payor does not apply, the 90-day grace period described in §1.6049–5(d)(2)(ii) or §1.1441–1(b)(3)(iv) of this chapter.

Par. 55. In §31.3406(g)–1, paragraph (e) is added to read as follows:

§31.3406(g)–1 Exception for payments to certain payees and certain other payments.

* * * * *

(e) *Certain reportable payments made outside the United States by foreign persons, foreign offices of United States banks and brokers, and others.* For reportable payments made after December 31, 1998, a payor is not required to backup withhold under section 3406 on a reportable payment that qualifies for the documentary evidence rule described in §1.6049–5(c)(1) or (4) of this chapter, whether or not documentary evidence is actually provided to the payor, unless the payor has actual knowledge that the payee is a United States person. Further, no backup withholding is required for payments upon which a 30-percent amount was withheld by another payor in accordance with the withholding provisions under chapter 3 of the Internal Revenue Code and the regulations under that chapter. For rules applicable to notional principal contracts, see §1.6041–1(d)(5) of this chapter.

Par. 56. Section 31.3406(h)–2 is amended by:

1. Revising paragraph (a)(3)(i).

2. Revising the penultimate sentence in paragraph (d)

3. Removing the heading of paragraph (e)(1).

4. Removing the paragraph designation (e)(1).

5. Removing paragraph (e)(2).

The revisions read as follows:

§31.3406(h)–2 Special rules.

(a) * * *

(3) *Joint foreign payees*—(i) *In general.* If the relevant payee listed on a jointly owned account or instrument provides a Form W–8 or documentary evidence described in §1.1441–1(e)(1)(ii) regarding its foreign status, withholding under section 3406 applies unless every joint payee provides the statement regarding foreign status (under the provisions of chapters 3 or 61 of the Internal Revenue Code and the regulations under those provisions) or any one of the joint owners who has not established foreign status provides a taxpayer identification number to the payor in the manner required in §§31.3406(d)–1 through 31.3406(d)–5. See §1.6049–5(d)(2)(iii) of this chapter for corresponding joint payees provisions.

* * * * *

(d) * * * If its payee is not subject to withholding under section 3406, the payor must pay or credit the full amount of the payment to the payee, unless, with respect to payments made after December 31, 1998, the payor chooses to apply prior withholding under section 3406 to an amount required to be withheld under another section of the Internal Revenue Code (such as under section 1441) to the extent permitted under procedures prescribed by the Internal Revenue Service (see §601.601(d)(2) of this chapter). * * *

* * * * *

Par. 57. Section 31.6413(a)–3 is amended as follows:

1. Paragraph (a)(1)(ii) is amended by removing the language "or" at the end of the paragraph.

2. In paragraph (a)(1)(iii), the parenthetical "(including the certification relating to foreign status described in §1.6049–5(b)(2)(iv) of this chapter or §1.6045–1(g)(1) of this chapter)" is removed and "(including the documentation described in §1.1441–1(e)(1)(ii), 1.6045–1(g)(3), or 1.6049-5(c) of this chapter)" is added in its place.

3. Paragraph (a)(1)(iii) is further amended by removing the period at the

end of the paragraph and adding "; or" in its place.

4. Paragraph (a)(1)(iv) is added.

5. Paragraphs (a)(2) and (b)(2) are revised.

The addition and revisions read as follows:

§31.6413(a)–3 Repayment by payor of tax erroneously collected from payee.

(a) * * * (1) * * *

(iv) The amount is withheld because a payor imposed backup withholding on a payment made to a person because the payee failed to furnish the documentation described in §1.1441–1(e)(1)(ii) of this chapter and the payee subsequently furnishes, completes, or corrects the documentation. The documentation must be furnished, completed, or corrected prior to the end of the calendar year in which the payment is made and prior to the time the payor furnishes a Form 1099 to the payee with respect to the payment for which the withholding erroneously occurred.

(2) For purposes of paragraph (a)(1) of this section (other than erroneous withholding occurring under the circumstances described in paragraph (a)(1)(iv) of this section), if a payor or broker withholds because the payor or broker has not received a taxpayer identifying number or required certification and the payee subsequently provides a taxpayer identifying number or a required certification to the payor, the payor or broker may not refund the amount to the payee.

(b) * * *

(2) *Adjustment after the deposit of the tax*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, if the amount erroneously withheld has been deposited prior to the time that the refund is made to the payee, the payor or broker may adjust any subsequent deposit of the tax collected under chapter 24 of the Internal Revenue Code that the payor or broker is required to make in the amount of the tax that has been refunded to the payee.

(ii) *Erroneous withholding from a payee that is a foreign person.* Where a payor withholds in error from a payee that is a nonresident alien or foreign person, as described in paragraph (a)(1)(iv) of this section, the payor may refund some or all of the amount subject to backup withholding under section 3406. A refund may be paid in accordance with the requirements of this paragraph (b)(2)(ii) where the documentation is furnished, completed, or corrected prior to the end of the calendar year in which the payment is made and prior to the time the payor furnishes a Form 1099 to the payee with respect to the payment for which the withholding erroneously occurred. The amount of the refund will be the amount erroneously withheld less the amount of tax required to be withheld, if any, under chapter 3 of the Internal Revenue Code and the regulations under that chapter. With respect to the amount of the payment to the foreign person and the amount of tax required to be withheld under chapter 3 of the Internal Revenue Code (and the regulations thereunder), returns must be made in accordance with the requirements of §1.1461–1(b) and (c) of this chapter.

Par. 58. Effective October 14, 1997, §31.9999–0 is added to read as follows:

§31.9999–0 Effective dates.

In general, the provisions of §§35a.9999–1, 35a.9999–2, 35a.9999–3, 35a.9999–3A, 35a.9999–4, and 35a.9999–5 of this chapter apply before January 1, 1997. The provisions of those sections remain applicable after December 31, 1996, and before January 1, 1999, however, for purposes of §301.6724–1 of this chapter, relating to due diligence safe harbor, and for international transactions, including transactions involving a foreign payee, a foreign payor, a foreign office of a U.S. bank or broker, or a payment from sources without the United States. See §§31.3406–0 through 31.3406(i)–1 of this chapter for rules that apply to other transactions after December 31, 1996.

§31.9999–0 [Removed]

Par. 59. Effective January 1, 1999, §31.9999–0 is removed.

PART 35a—TEMPORARY EMPLOYMENT TAX REGULATIONS UNDER THE INTEREST AND DIVIDEND TAX COMPLIANCE ACT OF 1983

Par. 60. The authority for part 35a is amended by removing the entries for §§35a.9999–1, 35a.9999–2, 35a.9999–3, 35a.9999–3A, 35a.9999–4T, and 35a.9999–5 to read in part as follows:

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

§35a.9999–0T [Removed]

Par. 60a. Effective October 14, 1997, §35a.9999–0T is removed.

Par. 61. Effective October 14, 1997, §35a.9999–0 is added to read as follows:

§35a.9999–0 Effective date.

See §31.9999–0 of this chapter for applicability dates for §§35a.9999–1 through 35a.9999–5.

Par. 62. Effective January 1, 1999, §§35a.9999–0, 35a.9999–1, 35a.9999–2, 35a.9999–3, 35a.9999–3A, 35a.9999–4T and 35a.9999–5 are removed.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 63. The authority citation for part 301 is amended by adding an entry in numerical order to read in part as follows:

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

Section 301.6402–3 also issued under 95 Stat. 357 amending 88 Stat. 2351. * * *

Par. 64. Section 301.6109–1 is amended as follows:

1. Paragraphs (b)(2)(iv) and (b)(2)(v) are revised.

2. Paragraph (b)(2)(vi) is added.

3. Paragraph (c) is revised.

The revisions and addition read as follows:

§301.6109–1 Identifying numbers.

* * * * *

(b) * * *

(2) * * *

(iv) A foreign person that makes a return of tax (including income, estate, and gift tax returns), an amended return, or a refund claim under this title but excluding information returns, statements, or documents;

(v) A foreign person that makes an election under §301.7701–3(c); and

(vi) A foreign person that furnishes a withholding certificate described in §1.1441–1(e)(2) or (3) of this chapter or §1.1441–5(c)(2)(iv) or (3)(iii) of this chapter to the extent required under §1.1441–1(e)(4)(vii) of this chapter.

(c) *Requirement to furnish another's number.* Every person required under this title to make a return, statement, or

other document must furnish such taxpayer identifying numbers of other U.S. persons and foreign persons that are described in paragraph (b)(2)(i), (ii), (iii), or (vi) of this section as required by the forms and the accompanying instructions. The taxpayer identifying number of any person furnishing a withholding certificate referred to in paragraph (b)(2)(vi) of this section shall also be furnished if it is actually known to the person making a return, statement, or other document described in this paragraph (c). If the person making the return, statement, or other document does not know the taxpayer identifying number of the other person, and such other person is one that is described in paragraph (b)(2)(i), (ii), (iii), or (vi) of this section, such person must request the other person's number. The request should state that the identifying number is required to be furnished under authority of law. When the person making the return, statement, or other document does not know the number of the other person, and has complied with the request provision of this paragraph (c), such person must sign an affidavit on the transmittal document forwarding such returns, statements, or other documents to the Internal Revenue Service, so stating. A person required to file a taxpayer identifying number shall correct any errors in such filing when such person's attention has been drawn to them.

* * * * *

Par. 65. Section 301.6114–1 is amended by:

1. Revising paragraph (a)(1)(ii).
2. Revising paragraph (b)(4)(ii) introductory text
3. Removing the period at the end of paragraph (b)(4)(ii)(B)(7) and adding "; or" in its place
4. Adding paragraphs (b)(4)(ii)(C) and (b)(4)(ii)(D).
5. Revising paragraph (c)(1)(i).
6. Adding paragraph (c)(6).

The revisions and addition read as follows:

§301.6114–1 Treaty-based return positions.

(a) * * * (1) * * *

(ii) If a return of tax would not otherwise be required to be filed, a return must nevertheless be filed for purposes of making the disclosure required by this section. For this purpose, such return need include only the taxpayer's name, address, taxpayer identifying number, and be signed under penalties of perjury (as well as the subject disclosure). Also, the taxpayer's taxable year shall be deemed to be the calendar year (unless the taxpayer has previously established, or timely chooses for this purpose to establish, a different taxable year). In the case of a disclosable return position relating solely to income subject to withholding (as defined in §1.1441–2(a) of this chapter), however, the statement required to be filed in paragraph (d) of this section must instead be filed at times and in accordance with procedures published by the Internal Revenue Service.

* * * * *

(b) * * *

(4) * * *

(ii) A treaty exempts from tax, or reduces the rate of tax on, fixed or determinable annual or periodical income subject to withholding under section 1441 or 1442 that a foreign person receives from a U.S. person, but only if described in paragraphs (b)(4)(ii)(A) and (B) of this section, or in paragraph (b)(4)(ii)(C) or (D) of this section as follows—

* * * * *

(C) For payments made after December 31, 1998, with respect to a treaty that contains a limitation on benefits article, that—

(*1*) The treaty exempts from tax, or reduces the rate of tax on income subject to withholding (as defined in §1.1441–2(a) of this chapter) that is received by a foreign person (other than a State, including a political subdivision or local authority) that is the beneficial owner of the income and the beneficial owner is related to the person obligated to pay the income within the meaning of sections 267(b) and 707(b), and the income exceeds $500,000; and

(*2*) A foreign person (other than an individual or a State, including a political subdivision or local authority) meets the requirements of the limitation on benefits article of the treaty; or

(D) For payments made after December 31, 1998, with respect to a treaty that imposes any other conditions for the entitlement of treaty benefits, for example as a part of the interest, dividends, or royalty article, that such conditions are met;

* * * * *

(c)* * *

(1) * * *

(i) Notwithstanding paragraph (b)(4) or (5) of this section, that a treaty has reduced the rate of withholding tax otherwise applicable to a particular type of fixed or determinable annual or periodical income subject to withholding under section 1441 or 1442, such as dividends, interest, rents, or royalties to the extent such income is beneficially owned by an individual or a State (including a political subdivision or local authority);

* * * * *

(6) This section does not apply to amounts required to be reported under section 6038A on a Form 5472 (or successor form) to the extent permitted under the form or accompanying instructions.

* * * * *

Par. 66. Section 301.6402–3 is amended by:

1. Revising paragraph (e).
2. Removing the authority citation at the end of the section.

The revision reads as follows:

§301.6402–3 Special rules applicable to income tax.

* * * * *

(e) In the case of a nonresident alien individual or foreign corporation, the appropriate income tax return on which the claim for refund or credit is made must contain the tax identification number of the taxpayer required pursuant to section 6109 and the entire amount of income of the taxpayer subject to tax, even if the tax liability for that income was fully satisfied at source through withholding under chapter 3 of the Internal Revenue Code (Code). Also, if the overpayment of tax resulted from the withholding of tax at source under chapter 3 of the Code, a copy of the Form 1042–S required to be provided to the beneficial owner pursuant to §1.1461–1(c)(1)(i) of this chapter must be attached to the return. For purposes of claiming a refund, the Form 1042-S must include the taxpayer identifying number of the beneficial owner even if not otherwise required. No claim of refund or

credit under chapter 65 of the Code may be made by the taxpayer for any amount that the payor has repaid to the taxpayer pursuant to §1.1461–2(a)(2) of this chapter, that was subject to a set-off pursuant to §1.1461–2(a)(3) of this chapter, or in accordance with the provisions of an agreement that a qualified intermediary described in §1.1441–1(e)(5)(ii) has in effect with the Internal Revenue Service. Upon request, a taxpayer must also submit such documentation as the Commissioner (or delegate), the District Director, or the Assistant Commissioner (International), may require establishing that the taxpayer is the beneficial owner of the income for which a claim of refund or credit is being made.

Par. 67. In §301.6721–0, the table is amended by adding entries for §3012.6724–1, paragraphs (g)(1), (g)(2), and (g)(3) to read as follows:

§301.6721–0 Table of Contents.

* * * * *

§301.6724–1 Reasonable cause.

* * * * *

(g) * * *
(1) In general.
(2) Special rules relating to TINs.
(3) Effective dates.

* * * * *

Par. 68. In §301.6724–1, paragraph (g) is revised to read as follows:

§301.6724–1 Reasonable cause.

* * * * *

(g) *Due diligence safe harbor*—(1) *In general.* A filer may establish reasonable cause with respect to a failure relating to an information reporting requirement as described in paragraph (j) of this section if the filer exercises due diligence as provided under section 6724(c)(1) with respect to failures described in sections 6721 through 6723.

(2) *Special rules relating to TINs.* The following questions and answers provide guidance on the exercise of due diligence for an exception to a penalty under sections 6721 through 6723 for a failure to provide a correct TIN on any information return (as defined in §301.6721–1(g)), payee statement (as defined in §301.6722–1(d)), document (as described in §301.6723–1(a)(4)), or the failure merely to provide a TIN as described in §301.6723–1(a)(4)(ii).

GENERAL RULE

Q–1. Is a payor subject to a penalty for a failure to provide a correct TIN on an information return with respect to a reportable interest or dividend payment if the payee has certified, under penalties of perjury, that the TIN furnished to the payor is the payee's correct number, the payor provided that number on an information return, and the number is later determined not to be the payee's correct number?

A–1. A payor is not subject to a penalty for failure to provide the payee's correct TIN on an information return, if the payee has certified, under penalties of perjury, that the TIN provided to the payor was his correct number, and the payor included such number on the information return before being notified by the Internal Revenue Service (IRS) (or a broker) that the number is incorrect.

DUE DILIGENCE DEFINED FOR ACCOUNTS OPENED AND INSTRUMENTS ACQUIRED AFTER DECEMBER 31, 1983

Q–2. In order for a payor of a reportable interest or dividend payment (other than in a window transaction) to be considered to have exercised due diligence in furnishing the correct TIN of a payee with respect to an account opened or an instrument acquired after December 31, 1983, what actions must the payor take?

A–2. (1) In general, the payor of an account or instrument that is not a pre-1984 account nor a window transaction must use a TIN provided by the payee under penalties of perjury on information returns filed with the IRS to satisfy the due diligence requirement. Therefore, if a payor permits a payee to open an account without obtaining the payee's TIN under penalties of perjury and files an information return with the IRS with a missing or an incorrect TIN, the payor will be liable for the $50 penalty for the year with respect to which such information return is filed. However, in its administrative discretion, the IRS will not enforce the penalty with respect to a calendar year if the certified TIN is obtained after the account is opened and before December 31 of such year, provided that the payor exercises due diligence in processing such number, i.e., the payor uses the same care in processing the TIN provided by the payee that a reasonably prudent payor would use in the course of the payor's business in handling account information such as account numbers and balances.

(2) Once notified by the IRS (or a broker) that a number is incorrect, a payor is liable for the penalty for all prior years in which an information return was filed with that particular incorrect number if the payor has not exercised due diligence with respect to such years. A pre-existing certified TIN does not constitute an exercise of due diligence after the IRS or a broker notifies the payor that the number is incorrect unless the payor undertakes the actions described in §31.3406–(d)–5–(d)(2)(i) of this chapter with respect to accounts receiving reportable payments described in section 3406(b)(1) and reported on information returns described in sections 6724(d)(1)(A)(i) through (iv).

Q–3. Is a payor as described in A–2 liable for the penalty if the payor obtained a certified TIN from a payee but inadvertently processed the name or number incorrectly on the information return?

A–3. Yes. The payor is liable for the penalty unless the payor exercised that degree of care in processing the TIN and name and in furnishing it on the information return that a reasonably prudent payor would use in the course of the payor's business in handling account information, such as account numbers and account balances.

SPECIAL RULES

Q–4. With respect to an instrument transferred without the assistance of a broker, is a payor liable for the penalty for filing an information return with a missing or an incorrect TIN if the payor records on its books a transfer of a readily tradable instrument in a transaction in which the payor was not a party?

A–4. Generally, a payor as described in Q-4 will be considered to have exercised due diligence with respect to a readily tradable instrument that is not part of a pre-1984 account with the payor if the payor records on its books a transfer in which the payor was not a party. This ex-

ception applies until the calendar year in which the payor receives a certified TIN from the payee.

Q–5. Is the payor described in A-4 required to solicit the TIN of a payee of an account with a missing TIN in order to be considered as having exercised due diligence in a subsequent calendar year?

A–5. There is no requirement on the payor to solicit the TIN in order to be considered to have exercised due diligence in a subsequent calendar year under the rule set forth in A–4.

Q–6. Is a payor as described in Q–4 considered to have exercised due diligence if the payee provides a TIN to the payor (whether or not certified), the payor uses that number on the information return filed for the payee, and the number is later determined to be incorrect?

A–6. A payor as described in Q–4 who records on its books a transfer in which it was not a party is considered to have exercised due diligence under the rule set forth in A–4 where the transfer is accompanied with a TIN provided that the payor uses the same care in processing the TIN provided by a payee that a reasonably prudent payor would use in the course of the payor's business in handling account information, such as account numbers and account balances. Thus, a payor will not be liable for the penalty if the payor uses the TIN provided by the payee on information returns that it files, even if the TIN provided by the payee is later determined to be incorrect. However, a payor will not be considered as having exercised due diligence under A–4 after the IRS or a broker notifies the payor that the number is incorrect unless the payor undertakes the required additional actions described in the second paragraph of A–2.

Q–7. Is a payor liable for a penalty for filing an information return with a missing or an incorrect TIN with respect to a post-1983 account or instrument if the payor could have met the due diligence requirements but for the fact that the payor incurred an undue hardship?

A–7. A payor of a post-1983 account or instrument is not liable for a penalty under section 6721(a) for filing an information return with a missing or an incorrect TIN if the IRS determines that the payor could have satisfied the due diligence requirements but for the fact that the payor incurred an undue hardship. An undue hardship is an extraordinary or unexpected event such as the destruction of records or place of business of the payor by fire or other casualty (or the place of business of the payor's agent who under a pre-existing written contract had agreed to fulfill the payor's due diligence obligations with respect to the account subject to the penalty and there was no means for the obligations to be performed by another agent or the payor). Undue hardship will also be found to exist if the payor could have met the due diligence requirements only by incurring an extraordinary cost.

Q–8. How does a payor obtain a determination from the IRS that the payor has met the undue hardship exception to the penalty under section 6721(a) for the failure to include the correct TIN on an information return for the year with respect to which the payor is subject to the penalty?

A–8. A determination of undue hardship may be established only by submitting a written statement to the IRS signed under penalties of perjury that sets forth all the facts and circumstances that make an affirmative showing that the payor could have satisfied the due diligence requirements but for the occurrence of an undue hardship. Thus, the statement must describe the undue hardship and make an affirmative showing that the payor either was in the process of exercising or stood ready to exercise due diligence when the undue hardship occurred. A payor may request an undue hardship determination from the district director or the director of the Internal Revenue Service Center where the payor is required to remit the penalty under section 6721(a).

Q–9. Is a pre-1984 account or instrument of a payor that is exchanged for an account or instrument of another payor as a result of a merger of the other payor or acquisition of the accounts or instruments of such payor transformed into a post-1983 account or instrument if the merger or acquisition occurs after December 31, 1983?

A–9. No. A pre-1984 account or instrument that is exchanged for another account or instrument pursuant to a statutory merger or the acquisition of accounts or instruments is not transformed into a post-1983 account or instrument because the exchange occurs without the participation of the payee.

Q–10. May the acquiring taxpayer described in A–9 rely upon the business records and past procedures of the merged payor or the payor whose accounts or instruments were acquired in order to establish that due diligence has been exercised on the acquired pre-1984 and post-1983 accounts or instruments?

A–10. Yes. The acquiring payor may rely upon the business records and past procedures of the merged payor or of the payor whose accounts or instruments were acquired in order to establish due diligence to avoid the penalty under section 6721(a) with respect to information returns that have been or will be filed.

Q–11. To what extent may a payor rely on the due diligence rules set forth in §§35a.9999–1, 35a.9999–2, and 35a.9999–3 of this chapter in effect prior to January 1, 1999 (see §§35a.9999–1, 35a.9999–2, and 35a.9999–3 as contained in 26 CFR part 35a, revised April 1, 1997).

A–11. A payor may rely on the due diligence rules set forth in §§35a.9999–1, 35a.9999–2, and 35a.9999–3 of this chapter in effect prior to January 1, 1999 (see §§35a.9999–1, 35a.9999–2, and 35a.9999–3 as contained in 26 CFR part 35a, revised April 1, 1997) solely for the definitions of terms or phrases used in this paragraph (g)(2).

(3) *Effective dates.* This paragraph (g) is effective for information returns (as defined in section 6724(d)(1)) required to be filed, payee statements (as defined in section 6724(d)(2)) required to be furnished, and specified information (as described in section 6724(d)(3)) required to be reported after December 31, 1998. See §301.6724–1(g) in effect prior to January 1, 1999 (see §301. 6724–1(g) as contained in 26 CFR part 301, revised April 1, 1997) for substantially similar rules applicable prior to January 1, 1999.

* * * * *

PART 502 [REMOVED]

Par. 70. Part 502 is removed.

PART 503 [REMOVED]

Par. 71. Part 503 is removed.

PART 509—SWITZERLAND

Par. 72. The authority citation for "Subpart—General Income Tax" is removed and a general authority citation for part 509 is added to read as follows:

Authority: 26 U.S.C. 62, 3791 and 7805.

Par. 73. Part 509 is amended as follows:

1. Subpart—Withholding of Tax consisting of §§509.1 through 509.10 is removed.

2. In §509.103, paragraph (e) is removed and reserved.

3. In §509.117, paragraph (a) is removed and reserved.

4. Sections 509.119 and 509.122 are removed.

PART 513—IRELAND

Par. 74. The authority citation for part 513 is revised to read as follows:

Authority: 26 U.S.C. 62.

Par. 75. Part 513 is amended as follows:

1. Section 513.1 is removed.

2. Sections 513.2, 513.3, 513.4 and 513.5 are revised to read as follows:

§513.2 Dividends.

The fact that the payee of the dividend is not required to pay Irish tax on such dividend because of the application of reliefs or exemptions under Irish revenue laws does not prevent the application of the reduction in rate of United States tax with respect to such dividend. If the dividend would have been subject to Irish tax had the payee thereof derived an income large enough to require payment of tax then liability to Irish tax exists for the purpose of the reduction in rate of United State tax. As to what constitutes a permanent establishment, see Article II(1)(i) of the convention.

§513.3 Interest.

The provisions of §513.2 relating to the degree of liability to Irish tax in the case of dividends are equally applicable with respect to the income falling within the scope of this section.

§513.4 Patent and copyright royalties and film rentals.

The provisions of §513.2 relating to the degree of liability to Irish tax in the case of dividends are equally applicable with respect to the income falling within the scope of this section.

§513.5 Natural resource royalties and real property rentals.

The provisions of §513.2 relating to the degree of liability to Irish tax in the case of dividends are equally applicable with respect to the income falling within the scope of this section.

PART 514 FRANCE

Par. 76. The authority citation for part 514 is added to read as set forth below and the authority citation preceding §514.1 is removed.

Authority: 26 U.S.C. 7805.

Par. 77. Part 514 is amended as follows:

1. The undesignated centerheading preceding §514.1 is removed.

§§514.20 and 514.21 [Removed]

2. Sections 514.20 and 514.21 are removed.

§514.22 [Amended]

3. In §514.22, paragraph (c) is removed.

§§514.23 through 514.32 [Removed]

4. Sections 514.23 through 514.32 are removed.

§§514.101 through 514.117 [Removed]

5. Subpart—General Income Tax consisting of sections 514.101 through 514.117 is removed.

PART 516 [REMOVED]

Par. 78. Part 516 is removed.

PART 517 [REMOVED]

Par. 79. Part 517 is removed.

PART 520 [REMOVED]

Par. 80. Part 520 is removed.

PART 521 [AMENDED]

Par. 81. The authority citation for part 521 is revised to read as follows:

Authority: 26 U.S.C. 62, 143, 144, 211, and 231.

Par. 82. Part 521 is amended as follows:

1. Subpart—Withholding of Tax consisting of §§521.1 through 521.8 is removed.

§521.103 [Amended]

2. In §521.103, paragraph (d) is removed and reserved.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 83. The authority for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 84. In §602.101, paragraph (c) is amended by:

1. Removing the following entries from the table:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1441–8T.	1545–1053
* * * * *	
1.1461–3	1545–0054
	1545–0055
	1545–0096
	1545–0795
1.1461–4	1545–0054
	1545–0055
	1545–0096
* * * * *	
35a.9999–3	1545–0112
* * * * *	
Part 502	1545–0844
Part 503	1545–0837
* * * * *	
Part 516	1545–0841
Part 517	1545–0849
Part 520	1545–0833
* * * * *	

2. Adding entries in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1441–1	1545–1484
1.1441–4	1545–1484
* * * * *	
1.1441–8	1545–1484 1545–1053
1.1441–9	1545–1484
* * * * *	

CFR part or section where identified and described	Current OMB control No.
31.3401(a)(6)	1545–1484
301.6114–1	1545–1484
* * * * *	

3. Revising entries in the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1441–5	1545–0096 1545–0795 1545–1484
1.1441–6	1545–0055 1545–0795 1545–1484
* * * * *	
1.1461–1	1545–0054 1545–0055 1545–0795 1545–1484
* * * * *	
301.6402–3	1545–0055 1545–0073 1545–0091 1545–0132 1545–1484
* * * * *	

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved August 28, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 14, 1997, 62 F.R. 53387)

Section 1442.—Withholding of Tax on Nonresident Corporations

26 CFR 1.1441–7: Requirement for the deduction and withholding of tax on payments to foreign persons.

Guidance is provided to payors of substitute interest and dividend concerning their obligations as withholding agents on payments made to foreign beneficial owners that are corporations. See Notice 97–66, page 328.

Chapter 6.—Consolidated Returns
Subchapter A.—Returns and Payment of Tax

Section 1502.—Regulations

26 CFR 1.1502–13: Intercompany transactions.

This revenue procedure provides guidance for requesting consent under §1.1502–13(e)(3) to treat certain intercompany transactions on a separate entity basis, to revoke such consent, or to change from the unauthorized use of separate entity reporting to single entity reporting. This revenue procedure cross-references Rev. Proc. 97–27 and modifies and supersedes Rev. Proc. 82–36. *See* Rev. Proc. 97–49, page 523.

Subtitle B—Estate and Gift Taxes
Chapter 11.—Estate Tax
Subchapter A.—Estates of Citizens or Residents
Part IV.—Taxable Estate

Section 2056.—Bequests, Etc., to Surviving Spouse

Ct.D. 2062

SUPREME COURT OF THE UNITED STATES

No. 95-1402

COMMISSIONER OF INTERNAL REVENUE v. ESTATE OF HUBERT, DECEASED, C & S SOVRAN TRUST CO. (GEORGIA) N.A., CO-EXECUTOR

520 U.S __

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

March 18, 1997
Syllabus

The executors of decedent Hubert's substantial estate filed a federal estate tax return about a year after his death. Subsequently, petitioner Commissioner of Internal Revenue issued a notice of deficiency, claiming underreporting of federal estate tax liability caused by the estate's asserted entitlement to marital and charitable deductions. While the estate's redetermination petition was pending in the Tax Court, interested parties settled much of the litigation surrounding the estate that had begun after Hubert's death. The agreement divided the estate's residue principal, assumed to be worth $26 million on the date of death, about equally between marital trusts and a charitable trust. It also provided that the estate would pay its administration expenses either from the principal or the income of the assets that would comprise the residue and the corpus of the trusts, preserving the executors' discretion to apportion such expenses. The estate paid about

$500,000 of its nearly $2 million of administration expenses from principal and the rest from income. It then recalculated its tax liability, reducing the marital and charitable deductions by the amount of principal, but not the amount of income, used to pay the expenses. The Commissioner concluded that using income for expenses required a dollar-for-dollar reduction of the deductions. The Tax Court disagreed, finding that no reduction was required by reason of the executors' power, or the exercise of their power, to pay administration expenses from income. The Court of Appeals affirmed.

Held: The judgment is affirmed.

63 F. 3d 1083, affirmed.

JUSTICE KENNEDY, joined by THE CHIEF JUSTICE, JUSTICE STEVENS, and JUSTICE GINSBURG, concluded that a taxpayer does not have to reduce the estate tax deduction for marital or charitable bequests by the amount of the administration expenses that were paid from income generated during administration by assets allocated to those bequests. Pp. 4–16.

(a) Hubert's executors used the standard date-of-death valuation to determine the value of property included in the gross estate for estate tax purposes. The parties agree that, for purposes of the question presented, the charitable, 26 U. S. C. §2055, and marital, §2056, deduction statutes should be read to require the same answer, notwithstanding differences in their language. Since the marital deduction statute and regulation speak in more specific terms on this question than the charitable deduction statute, this plurality concentrates on the marital provisions, but the holding here applies to both deductions. Pp. 4–5.

(b) The marital deduction statute allows deduction for qualifying property only to the extent of the property's "value." So when the executors use date of death valuation for gross estate purposes, the deduction's value will be limited by that value. Marital deduction "value" is "net value," determined by the same principles as if the bequest were a gift to the spouse, 26 CFR §20.2056(b)–4(a), *i.e.*, present value as of the controlling valuation date, §25.2523(a)–1(e); see also §§20.2056(b)–4(d), 20.2055–2(f)(1). Although the question presented is not controlled by these provisions' exact terms, it is natural to apply the present-value principle here. Thus, assuming it were necessary for valuation purposes to take into account that income, this would be done by subtracting from the value of the bequest, computed as if the income were not subject to administration expense charges, the present value (as of the controlling valuation date) of the income expected to be used to pay administration expenses. Cf. *Ithaca Trust Co.* v. *United States,* 279 U. S. 151. There is no dispute the entire interests transferred in trust here qualify for the marital and charitable deductions; the question before the Court is one of valuation. Pp. 5–9.

(c) Only material limitations on the right to receive income are taken into account when valuing the property interest passing to the surviving spouse. 26 CFR §20.2056(b)–4(a). A provision requiring or allowing administration expenses to be paid from income "may" be deemed a "marterial limitation" on the spouse's right to income. For example, where the amount of the corpus, and the expected income from it, are small, the amount of the estate's anticipated administration expenses chargeable to income may be material as compared with the anticipated income used to determine the assets' date-of-death value. Whether a limitation is material will also depend in part on the nature of the spouse's interest in the assets generating income. An obligation to pay administration expenses from income is more likely to be material where the value of the trust to the spouse is derived solely from income, but is less likely to be material where, as here, the marital property is valued as being equivalent to a transfer of the fee. Pp. 10–12.

(d) The Tax Court found that, on the facts presented, the trustee's discretion to pay administration expenses out of income was not a material limitation on the right to receive income. There is no reason to reverse for the Tax Court's failure to specify the facts it considered relevant to the materiality inquiry. The anticipated expenses could have been thought immaterial in light of the income the trust corpus could have been expected to generate. P. 12.

(e) This approach to the valuation question is consistent with the language of 26 U. S. C. §2056(b), as interpreted in *United States* v. *Stapf,* 375 U. S. 118, 126, in which the Court held that the marital deduction should not exceed the "net economic interest received by the surviving spouse." There is no basis here for the Commissioner's argument that the reduction she seeks is necessary to avoid a "double deduction" for administration expenses in violation of 26 U. S. C. §642(g). Moreover, assuming that the marital deduction statute's legislative history would have relevance here, it does not support the Commissioner's position. Pp. 13–16.

JUSTICE O'CONNOR, joined by JUSTICE SOUTER and JUSTICE THOMAS, concluded that the relevant sources point to a test of quantitative materiality to determine whether allocation of administrative expenses to postmortem income reduces marital and charitable deductions, and that test is not met by the unusual factual record in this case. Pp. 1–12.

(a) Neither the Tax Code itself nor its legislative history supplies guidance on the question whether allocation of administrative expenses to postmortem income reduces the marital deduction always, sometimes, or not at all. However, the Commissioner's regulations and revenue rulings can be relied on to decide this issue. Title 26 CFR §20.2056(b)–(4)(a) directs the reader to ask whether the executor's right to allocate administrative expenses to the marital bequest's postmortem income is a "material limitation" upon the spouse's "right to income from the property," such that "account must be taken of its effect." Because the executor's power is undeniably a "limitation" on the spouse's right to income, the case hinges on whether that limitation is "material." In Revenue Ruling 93–48, the Commissioner ruled that §20.2056(b)–4(a)'s marital deduction is not "ordinarily" reduced when an executor allocates interest payments on deferred federal estate taxes to the spousal bequest's postmortem income. Such interest and the administrative expenses at issue here are so similar that they should be treated the same under §20.2056(b)–4(a). The Commissioner's treatment of interest in the Revenue Ruling also indicates that some, but not all, financial obligations will reduce the marital deduction. Thus, by virtue of the Ruling, the Commissioner has created a quantitative materiality rule for §20.2056(b)–4(a). This rule is consistent

with the example set forth in §20.2056(b)–4(a), and the Commissioner's expressed preference for such a construction is entitled to deference. Pp. 2–10.

(b) The proper measure of materiality has yet to be decided by the Commissioner. In the absence of guidance from the Commissioner, the Tax Court's approach is as consistent with the Code as any other test, and provides no basis for reversal. Here, the Commissioner's litigation strategy effectively preempted the Tax Court from finding the $1.5 million diminution in postmortem income material under a quantitative materiality test, for she argued that *any* diversion of postmortem income was material and never presented any evidence or argued that this diminution was quantitatively material. Her failure to offer proof of materiality left the Tax Court with little choice but to reach its carefully crafted conclusion that the amount was not quantitatively material on the facts before it. Pp. 10-12.

KENNEDY, J., announced the judgment of the Court and delivered an opinion, in which REHNQUIST, C.J., and STEVENS and GINSBURG, J.J., joined. O'CONNOR, J., filed an opinion concurring in the judgment, in which SOUTER and THOMAS, JJ., joined. SCALIA, J., filed a dissenting opinion, in which BREYER, J., joined. BREYER, J., filed a dissenting opinion.

SUPREME COURT OF THE UNITED STATES

No. 95–1402

COMMISSIONER OF INTERNAL REVENUE, PETITIONER *v.* ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVRAN TRUST COMPANY (GEORGIA) N.A., CO-EXECUTOR

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

[March 18, 1997]

JUSTICE KENNEDY announced the judgment of the Court and delivered an opinion, in which the CHIEF JUSTICE, JUSTICE STEVENS, and JUSTICE GINSBURG join.

In consequence of life's two certainties a decedent's estate faced federal estate tax deficiencies, giving rise to this case. The issue is whether the amount of the estate tax deduction for marital or charitable bequests must be reduced to the extent administration expenses were paid from income generated during administration by assets allocated to those bequests.

I

The estate of Otis C. Hubert was substantial, valued at more than $30 million when he died. Considerable probate and civil litigation ensued soon after his death. The parties to the various proceedings included his wife and children; his nephew; one of the estate's coexecutors, Citizens and Southern Trust Company (Georgia), N. A., the predecessor of respondent C & S Sovran Trust Company (Georgia), N. A.; the district attorney for Cobb County, Georgia, on behalf of certain charitable beneficiaries; and the Georgia State Revenue Commission. Hubert had made various wills and codicils, and the legal disputes for the most part concerned the distribution of estate assets; but they were not confined to this. In addition to will contests alleging fraud and undue influence, there were satellite civil suits including claims of slander and abuse of process. The principal proceedings were in the Probate and the Superior Courts of Cobb County, Georgia.

The estate attracted the attention of petitioner, the Commissioner of Internal Revenue. The executors filed the federal estate tax return in 1987, about a year after Hubert died. In 1990, the Commissioner issued a notice of deficiency, claiming underreporting of federal estate tax liability by some $14 million. The Commissioner's major challenge then was to the estate's claimed entitlement to two deductions. One was the marital deduction, under 68A Stat. 392, as amended, 26 U. S. C. §2056, for qualifying property passing from a decedent to the surviving spouse. The other was the charitable deduction, under §2055, for qualifying property passing from a decedent to a charity. The Commissioner's notice of deficiency asserted, for reasons not relevant here, that the property passing to Hubert's surviving wife and to charity did not qualify for the marital and charitable deductions. The estate petitioned the United States Tax Court for a redetermination of the deficiency.

Within days of the estate's petition in the Tax Court, much of the other litigation surrounding the estate settled. The settlement agreement divided the estate's residue principal between a marital and a charitable share, which we can assume for purposes of our discussion were worth a total of $26 million on the day Hubert died. The settlement agreement divided the $26 million principal about half to trusts for the surviving spouse and half to a trust for the charities. The Commissioner stipulated that the nature of the trusts did not prevent them from qualifying for the marital and charitable deductions. The stipulation streamlined the Tax Court litigation but did not resolve it.

The settlement agreement provided that the estate would pay its administration expenses either from the principal or the income of the assets that would comprise the residue and the corpus of the trusts, preserving the discretion Hubert's most recent will had given his executors to apportion administration expenses. The apportionment provisions of the agreement and the will were consistent for all relevant purposes with the law of Georgia, the State where the decedent resided. The estate's administration expenses, including attorney's fees, were on the order of $2 million. The estate paid about $500,000 in expenses from principal and the rest from income.

The estate recalculated its estate tax liability based on the settlement agreement and the payments from principal. The estate did not include in its marital and charitable deductions the amount of residue principal used to pay administration expenses. The parties here have agreed throughout that the marital or charitable deductions could not include those amounts. The estate, however, did not reduce its marital or charitable deductions by the amount of the income used to pay the balance of the administration expenses. The Commissioner disagreed and contended that use of income for this purpose required a dollar-for-dollar reduction of the amounts of the marital and charitable deductions.

In a reviewed opinion, the Tax Court, with two judges concurring in part and dissenting in part, rejected the Commis-

sioner's position. 101 T. C. 314 (1993). The court noted it had resolved the same issue against the Commissioner in *Estate of Street* v. *Commissioner,* T. C. Mem. 1988–553, 1988 WL 128662 (T. C. 1988). The Court of Appeals for the Sixth Circuit had reversed this aspect of *Estate of Street,* see 974 F. 2d 723, 727–729 (1992), but in the instant case the Tax Court adhered to its view and said, given all the circumstances here, no reduction was required by reason of the executors' power, or the exercise of their power, to pay administration expenses from income. The Court of Appeals for the Eleventh Circuit affirmed the Tax Court, adopting the latter's opinion and noting the resulting conflict with the Sixth Circuit's decision in *Street* and with the Court of Appeals for the Federal Circuit's decision in *Burke* v. *United States*, 994 F. 2d 1576, cert. denied, 510 U. S. 990 (1993). See 63 F. 3d 1083, 1084–1085 (CA11 1995). We granted certiorari, 517 U. S.__(1996), and, in agreement with the Tax Court and the Court of Appeals for the Eleventh Circuit, we now affirm the judgment.

II

A necessary first step in calculating the taxable estate for federal estate tax purposes is to determine the property included in the gross estate, and its value. Though an alternative valuation date is authorized, the executors of the Hubert estate used the standard date-of death valuation. See 26 U. S. C. §§2031(a), 2051. A later step is to compute any claimed charitable or marital deductions. See §§2055 (charitable), 2056 (marital). Our inquiry here involves the relationship between valuation principles and those computations. The language of the charitable and marital deduction sections differs. For instance, §2056 requires consideration, in valuing a marital bequest, of obligations or encumbrances the decedent imposes on the bequest, "in the same manner as if the amount of a gift to such spouse of such interest were being determined." §2056(b)-(4). Section 2055 has no similar language. Treasury Regulation §20.2056(b)–4(a), 26 CFR §20.2056 (b)–4(a) (1996), moreover, has amplified aspects of the marital deduction statute, as we discuss. There is no similar regulation for the charitable deduction statute. These differences notwithstanding, the Commissioner and respondents agree that, for purposes of the question presented, the two deduction statutes should be read to require the same answer. We adopt this approach. For the issue we decide, the marital deduction statute and regulation speak in more specific terms than the charitable deduction statute, so we concentrate on the marital provisions. Our holding in the case applies to both deductions.

We begin with the language of the marital deduction statute. It allows an estate to deduct for federal estate tax purposes "an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate." 26 U. S. C. §2056(a).

The statute allows deduction for qualifying property only to the extent of the property's "value." So when the executors value the property for gross estate purposes as of the date of death, the value of the marital deduction will be limited by its date-of-death value. This is directed by the statutory language capping the deduction at "the value of any interest . . . included in determining the value of the gross estate." It is made explicit by Treas. Reg. §20.2056(b)–4(a), 26 CFR §20.2056(b)–4(a) (1996), which says "value, for the purpose of the marital deduction . . . is to be determined as of the date of the decedent's death [unless the estate uses the alternative valuation date]."

Regulation §20.2056(b)–4(a) provides that "value" for marital deduction purposes is "net value," determined by applying "the same principles . . . as if the amount of a gift to the spouse were being determined." Regulation §25.2523(a)–1, entitled "Gift to spouse; in general," includes a subsection (e), entitled "Valuation," which parallels §20.2056(b)–4(d); see also §20.2055–2(f)(1). It provides:

> "If the income from property is made payable to the donor or another individual for life or for a term of years, with remainder to the donor's spouse . . . the marital deduction is computed . . . with respect to the present value of the remainder, determined under [26 U. S. C. §] 7520. The present value of the remainder (that is, its value as of the date of gift) is to be determined in accordance with the rules stated in §25.2512–5 or, for certain prior periods, §25.2512–5A."

Section 7520, in turn, refers to present-value tables located in regulation §20.2031–7. The question presented here, involving date-of-death valuation of property or a principal amount, some of the income from which may be used to pay administration expenses, is not controlled by the exact terms of these provisions. For that reason, we do not attempt to force it into their detailed mold. It is natural, however, to apply the present-value principle to the question at hand, as we are directed to do by §20.2056(b)–4(a). In other words, assuming it were necessary for valuation purposes to take into account that income, see *infra,* at 10–12 (discussing materiality), this would be done by subtracting from the value of the bequest, computed as if the income were not subject to administration expense charges, the present value (as of the controlling valuation date) of the income expected to be used to pay administration expenses.

Our application of the present-value principle to the issue here is further supported by Justice Holmes' explanation of valuation theory in his opinion for the Court in *Ithaca Trust Co.* v. *United States,* 279 U. S. 151 (1929). The decedent there bequeathed the residue of his estate in trust to charity, subject to a particular life interest in his wife. After holding that the charitable bequest qualified for the charitable deduction under the law as it stood in 1929, the Court considered how to value the bequest. The Government argued the value should be reduced to reflect the wife's probable life expectancy as of the date the decedent died. The estate argued for a smaller reduction than the Government, because by the time of the litigation it was known that the wife had, in fact, lived for only six months after the decedent died. Justice Holmes wrote:

> "The first impression is that it is absurd to resort to statistical probabilities when you know the fact. But this is due to inaccurate thinking. . . . [Value] depends largely on more or less certain prophecies of the future; and the value is no less real at that time if later the prophecy turns out false than when it comes out true. . . . Tempting as it is to

correct uncertain probabilities by the now certain fact, we are of opinion that it cannot be done. . . . Our opinion is not changed by the necessary exceptions to the general rule specifically made by the Act." *Id.*, at 155.

So the charitable deduction had to be valued based on the wife's probable life expectancy as of the date of death rather than the known fact that she died only six months after her husband.

It is suggested that regulation §20.2056(b)–4(a)'s direction to value the marital deduction as a spousal gift refers to a gift-tax qualification regulation, §25.2523(e)– 1(f), and a revenue ruling interpreting it, Rev. Rul. 69–56, 1969–1 Cum. Bul. 224. *Post,* at 5–6 (O'CONNOR, J., concurring in judgment). The suggestion misunderstands the regulations and the revenue ruling. Regulation §20.2056(b)–4(a) concerns how to determine the "value, for the purpose of the marital deduction, of any deductible interest." Before determining an interest's value under §20.2056(b)–4(a), one must decide the extent to which the interest qualifies as deductible.

There is a structural problem with interpreting §20.2056(b)–4(a) as directing reference to §25.2523(e)–1(f) for valuation purposes. Qualification and valuation are different steps. Regulation §25.2523(e)–1(f) prescribes conditions under which an interest transferred in trust qualifies for a marital deduction under the gift tax. It tracks the language of regulation §20.2056(b)–5(f), which prescribes the same conditions for determining whether an interest transferred in trust qualifies for a marital deduction under the estate tax. Any interest to which §25.2523(e)–1(f) would apply, were its principles understood to be incorporated into §20.2056(b)–4(a), would, of necessity, already have been analyzed under the same principles at the earlier, qualification stage of the estate-tax marital-deduction inquiry under §20.2056(b)–5(f). So under the suggested interpretation, whether or not an interest passed the qualification test, there would never be a need to value it. If it failed, there would be nothing to value; if it passed, its value would never be reduced at the valuation stage. The qualification step of the estate-tax marital-deduction inquiry would render the valuation step superfluous.

We do not think the Commissioner adopted this view of the regulations in Revenue Ruling 69–56. The revenue ruling held that a trustee's power to:

> "charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses . . . [does] not result in the disallowance or diminution of the marital deduction for estate and gift tax purposes unless the execution of such directions would, or the exercise of such powers could, cause the spouse to have less than substantially full beneficial enjoyment of the particular interest transferred." Rev. Rul. 69–56, 1969–1 Cum. Bul. 224.

The revenue ruling cites for this proposition §20.2056(b)–5(f)(1) and §25.2523(e)–1(f)(1), parts of the estate- and gift-tax qualification regulations discussed above. The qualification regulations provide that an interest may qualify as deductible only in part. Where that happens, the deduction need not be disallowed but it must be diminished. See, *e.g.,* §20.2056(b)–5(b); §25.2523(e)–1(b); see also 26 U. S. C. §§2056(b)(5), 2523(e). It is in this qualification context that the revenue ruling speaks of "diminution" of the marital deduction. There is no dispute the entire interests transferred in trust here qualify for the estate-tax marital and charitable deductions, respectively. The question before us is one of valuation. Regulations 25.2523(e)–1(f) and 20.2056(b)–5(f) and Revenue Ruling 69–56 do not bear on our inquiry.

The parties here agree that the marital and charitable deductions had to be reduced by the amount of marital and charitable residue principal used to pay administration expenses. The Commissioner contends that the estate must reduce its marital and charitable deductions by the amount of administration expenses paid not only from principal but also, and in all events, from income and by a dollar-for-dollar amount. The Commissioner cites the controlling regulation in support of her position. The regulation says:

> "The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse is to be determined as of the date of the decedent's death [unless the estate uses the alternative valuation date]. The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate." 26 CFR §20.2056(b)–4(a) (1996).

The regulation does not help the Commissioner. It says a limitation providing that income "is to be used" throughout the administration period to pay administration expenses "may" be material in a given case and, if it is, account must be taken of it for valuation purposes as if it were a gift to the spouse, as we have discussed, see *supra,* at 5–6. The Tax Court was quite accurate in its description of the regulation when it said:

> "That section is merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse. The fact that income from property is to be used to pay expenses during the administration of the estate is not necessarily a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate." 101 T. C., at 324–325.

There is no indication in the case before us that the executor's power to charge administration expenses to income is equivalent to an express postponement of the spouse's right to income beyond a reasonable period of administration. Cf. 26 CFR §20.2056(b)–5(f)(9) (1996) (requiring valuation of express postponements of the spouse's right to income beyond a reasonable period of administration). By contrast,

we have no difficulty conceiving of situations where a provision requiring or allowing administration expenses to be paid from income could be deemed a "material limitation" on the spouse's right to income. Suppose the decedent's other bequests account for most of the estate's property or that most of its assets are nonincome producing, so that the corpus of the surviving spouse's bequest, and the income she could expect to receive from it, would be quite small. In these circumstances, the amount of the estate's anticipated administration expenses chargeable to income may be material as compared with the anticipated income used to determine the assets' date-of-death value. If so, a provision requiring or allowing administration expenses to be charged to income would be a material limitation on the spouse's right to income, reducing the marital bequest's date-of-death value and the allowable marital deduction.

Whether a limitation is "material" will also depend in part on the nature of the spouse's interest in the assets generating income. This analysis finds strong support in the text of regulation 20.2056(b)–4(a). The regulation gives an example of where a limitation on the right to income "may" be material—bequests "in trust" for the benefit of a decedent's spouse. The example suggests a significant difference between a bequest of income and an outright gift of the fee interest in the income-producing property. A fee in the same interest will almost always be worth much more. Where the value of the trust to the beneficiaries is derived solely from income, an obligation to pay administration expenses from that income is more likely to be "material." In the case of a specific bequest of income, for example, valued only for its future income stream, a diversion of that income would be more significant. The marital property in this case, however, comprising trusts involving either a general power of appointment (the GPA trust) or an irrevocable election (the QTIP trust), was valued as being equivalent to a transfer of the fee. See Brief for Petitioner 8–9, n. 1 ("[T]he corpus of both trusts is includable in the estate of the surviving spouse"). As a result, the limitation on the right to income here is less likely to be material. The inquiry into the value of the estate's anticipated administration expenses should be just as administrable, if not more so, than valuing property interests like going-concern businesses, see, *e.g.*, §20.2031–3, involving much greater complexity and uncertainty.

The Tax Court concluded here: "On the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income." 101 T. C., at 325. The Tax Court did not specify the facts it considered relevant to the materiality inquiry. As we have explained, however, the Commissioner does not contend the estate failed to give adequate consideration to expected future administration expenses as of the date-of-death in determining the amount of the marital deduction. We have no basis to reverse for the Tax Court's failure to elaborate. Here, given the size and complexity of the estate, one might have expected it to incur substantial litigation costs. But the anticipated expenses could nonetheless have been thought immaterial in light of the income the trust corpus could have been expected to generate.

The major disagreement in principle between the Tax Court majority and dissenters involved the distinction between expected and actual income and expenses. Judge Halpern's opinion, joined by Judge Beghe, explained:

> "I believe the majority is undone by its view that income earned on estate property is not included in the gross estate. Once it is accepted that income earned on estate property (as anticipated at the appropriate valuation date) *is* included in the gross estate, the next question is whether, but for the use of such income to pay administration expenses, it would be received by the surviving spouse or charitable beneficiary. If the answer is yes, then it follows easily that, when such income is used for administration expenses, rather than received by the surviving spouse or charitable beneficiary, the value of the interest passing from the decedent to the surviving spouse or charitable beneficiary is decreased." *Id.*, at 342–343 (opinion concurring in part and dissenting in part).

The Tax Court dissenters recognized that only anticipated, not actual, income is included in the gross estate, as the gross estate is based on date-of-death value. See also *id.*, at 342, n. 5 (opinion of Halpern, J.) ("It is true, of course, that income actually earned on . . . property [included in valuing the gross estate] during the period of administration is not included in the gross estate. The gross estate, however, does include the discounted value of post-mortem income expected to be earned during estate administration") (emphasis deleted). The dissenters failed to recognize that following their own logic, as a general rule, assuming compliance with regulation §20.2056(b)–4(a)'s limitation to relevant facts on the controlling valuation date, only anticipated administration expenses payable from income, not the actual ones, affect the date-of-death value of the marital or charitable bequests. The dissenters were, in a sense, a step closer to §25.2523(a)–1(e)'s present-value approach than the Commissioner, for they would have required the estate to reduce the marital or charitable deduction by only the discounted value of the actual administration expenses, whereas the Commissioner insists on a dollar-for-dollar reduction. The dissenters' wait-and-see approach to the valuation inquiry, however, is still at odds with the valuation inquiry required by the regulations: What is the net value of the marital or charitable bequest on the controlling valuation date, determined as if it were a gift to the spouse?

The Commissioner directs us to the language of §2056(b)(4), which says:

> "In determining . . . the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—
>
> . . . . .
>
> "(B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined."

We interpreted this language in *United States* v. *Stapf*, 375 U. S. 118 (1963). The husband's will there gave property to his wife, conditioned on her relinquishing other property she owned to the couple's children. We held that the husband's es-

tate was entitled to a marital deduction only to the extent the value of the property the husband gave his wife exceeded the value of the property she relinquished to receive it. The marital deduction, we explained, should not exceed the "net economic interest received by the surviving spouse." *Id.,* at 126. The statutory language, as we interpreted it in *Stapf,* is consistent with our analysis here. Where the will requires or allows the estate to pay administration expenses from income that would otherwise go to the surviving spouse, our analysis requires that the marital deduction reflect the date-of-death value of the expected future administration expenses chargeable to income if they are material as compared with the date-of-death value of the expected future income. Using this approach to valuation, the estate will arrive at the "net economic interest received by the surviving spouse." *Ibid.*

For the first time at oral argument, the Commissioner suggested that the reduction she seeks is necessary to avoid a "double deduction" in violation of 26 U. S. C. §642(g). Under §642(g), an estate may take an estate tax deduction for administration expenses under §2053(a)-(2), or it may take them, if deductible, off its taxable income, but it may not do both. The so-called double deduction argument is rhetorical, not statutory. As our colleagues in dissent recognize, "nothing in §642(g) *compels* the conclusion that the marital (or charitable) deduction must be reduced whenever an estate elects to deduct expenses from income." *Post,* at 12–13 (Scalia, J., dissenting) (emphasis in original). The Commissioner nevertheless suggests that, unless we reduce the estate's marital deduction by the amount of administration expenses paid from income and deducted on its income tax, the estate will receive a deduction for them on its income tax as well as a deduction for them on its estate tax in the form of inflated marital and charitable deductions. See Tr. of Oral Arg. 12, 15. The marital and charitable estate tax deductions do not include income, however. When income is used, consistent with state law and the will, to pay administration expenses, this does not require that the estate tax deductions be diminished. The deductions include asset values determined with reference to expected income, but under our analysis the values must also be reduced to reflect material expected administration expense charges to which that income may be subjected. As noted above, the Commissioner has not contended the estate's marital and charitable deductions fail to reflect such expected payments. So there is no basis for the double deduction argument. Our analysis is consistent with the design of the statute.

The Commissioner also invites our attention to the legislative history of the marital deduction statute. Assuming for the sake of argument it would have relevance here, it does not support her position. The Senate Report accompanying the statute says:

> "The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction." S. Rep. No. 1013, 80th Cong., 2d Sess., pt. 2, p. 6 (1948).

The Report supports our analysis. It underscores that valuation for marital deduction purposes occurs on the date of death.

The Commissioner's position is inconsistent with the controlling regulations. The Tax Court and the Court of Appeals were correct in finding for the taxpayer on these facts, and we affirm the judgment.

It is so ordered.

JUSTICE O'CONNOR, with whom JUSTICE SOUTER and JUSTICE THOMAS join, concurring in the judgment.

"Logic and taxation are not always the best of friends." *Sonneborn Brothers* v. *Cureton,* 262 U. S. 506, 522 (1923) (McReynolds, J., concurring). In cases like the one before us today, they can be complete strangers. That our tax laws can at times be in such disarray is a discomforting thought. I can understand why the plurality attempts to extrapolate a generalized estate tax valuation theory from one regulation and then to apply that theory to resolve this case, perhaps with the hope of making sense out of the applicable law. But where the applicability—not to mention the validity—of that theory is far from clear, the temptation to make order out of chaos at any cost should be resisted, especially when the question presented can be resolved—albeit imperfectly—by reference to more directly applicable sources. While JUSTICE SCALIA, JUSTICE BREYER, and I agree on this point, we disagree on the result ultimately dictated by these sources. I therefore write separately to explain why in my view the plurality's result, though not its reasoning, is correct.

I

When a citizen or resident of the United States dies, the Federal Government imposes a tax on "all [of his] property, real or personal, tangible or intangible, wherever situated." 26 U. S. C. §§2001(a), 2031(a). Specifically excluded from taxation, however, is certain property devised to the decedent's spouse or to charity. Such testamentary gifts may qualify for the marital deduction, §2056(a), or the charitable deduction, §2055(a). If they do, they are removed from the decedent's "gross estate" and exempted from the estate tax. §2051. Calculating the estate tax, however, takes time, as does marshaling the decedent's property and distributing it to the ultimate beneficiaries. During this process, the assets in the estate often earn income and the estate itself incurs administrative expenses. To deal with this eventuality, the Tax Code permits an estate administrator to choose between allocating these expenses to the assets in the estate at the time of death (the estate principal), or to the postmortem income earned by those assets. §642(g). Everyone agrees that when these expenses are charged against a portion of estate's principal devised to the spouse or charity, that portion of the principal is diverted from the spouse or charity and the marital and charitable deductions are accordingly "reduced" by the actual amount of expenses incurred. See *ante,* at 9 (plurality opinion); *post,* at 2 (SCALIA, J., dissenting); Brief for Petitioner 19; Brief for Respondent 6. The question presented here is what becomes of these deductions when the estate chooses the second option

under §642(g) and allocates administrative expenses to the postmortem income generated by the property in the spousal or charitable devise.

The Tax Code itself supplies no guidance. Accord, *post,* at 6 (SCALIA, J., dissenting). The statute most relevant to this case, 26 U. S. C. §2056(b)(4)(B), provides:

> "where [any interest in property otherwise qualifying for the marital deduction] is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined."

Although an executor's power to burden the postmortem income of the marital bequest with the estate's administrative expenses is arguably an "encumbrance" or an "obligation imposed by the decedent with respect to the passing of such interest," the statute itself says only that the "encumbrance or obligation shall be taken into account." It does not explain how this should be done, however. In my view, it is not possible to tell from §2056(b)(4)(B) whether allocation of administrative expenses to postmortem income reduces the marital deduction always, sometimes, or not at all.

Nor does the Code's legislative history give shape to its otherwise ambiguous language. The discussion in the Senate Report of §2056(b)(4)(B)'s predecessor statute reads:

> "The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or *if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction.*" S. Rep. No. 1013, 80th Cong., 2d Sess., pt. 2, p. 6 (1948) (emphasis added).

This italicized passage might be helpful if it explicitly referred to "administrative expenses" instead of"claims against the estate." But it is not at all clear from the Senate Report whether the latter term includes the former: The Report nowhere defines the term "claims against the estate," and the immediately preceding paragraph discusses §2056(b)(4)(B)'s language with reference to mortgages. *Ibid.* Because mortgages differ from administrative expenses in many ways (*e.g.*, mortgages pre-exist the decedent's death and are fixed in amount at that time), there is a reasonable argument that administrative expenses are not "claims against the estate." In sum, the Code's legislative history is not illuminating.

II

All that remains in this statutory vacuum are the Commissioner's regulations and revenue rulings, and it is on these sources that I would decide this issue. The key regulation is 26 CFR §20.2056(b)–4(a) (1996):

> "The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse is to be determined as of the date of the decedent's death.... The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property."

The text of the regulation leaves no doubt that, only the "net value" of the spousal gift may be deducted. There is also little doubt that, in assessing this "net value," one should examine how the spousal devise would have been treated if it were instead an *inter vivos* gift. See also 26 U. S. C. §2056(b)(4)(A) (also referring to treatment of gifts).

The plurality latches onto 26 CFR §25.2523(a)–1(e) (1996), and to the statutes and regulations to which it refers. *Ante,* at 5–6 (referring to 26 U. S. C. §7520; 26 CFR §20.2031–7 (1996)). In the plurality's view, these regulations define how to "tak[e] [account] of the effect of any material limitations upon [a spouse's] right to income from the property." 26 CFR §20.2056(b)–4(a) (1996). The plurality frankly admits that these regulations do not speak directly to the antecedent inquiry—when an executor's right to allocate administrative expenses to income constitutes a "material limitation." *Ante,* at 6. The plurality nevertheless believes that these regulations bear *indirectly* on this inquiry by implying an underlying estate tax valuation theory that, in the plurality's view, dovetails nicely with our decision in *Ithaca Trust Co.* v. *United States,* 279 U. S. 151 (1929). *Ante,* at 6–7, 13. It is on the basis of this valuation theory that the plurality is able to conclude that the Tax Court's analysis was wrong because that analysis did not, consistent with the plurality's theory, focus solely on *anticipated* administrative expenses and *anticipated* income. *Ante,* at 12–13. But, as JUSTICE SCALIA points out, the plurality's valuation theory is not universally applicable and, in fact, conflicts with the Commissioner's treatment of some other expenses. See 26 CFR §20.2056(b)–4(c) (1996); *post,* at 13–15. Because §25.2523(a)–1(e) and its accompanying provisions do no more than suggest an estate tax valuation theory that itself has questionable value in this context, these provisions do not in my view provide any meaningful guidance in this case.

The Tax Court, on the other hand, zeroed in on 26 CFR §§25.2523(e)–1(f)(3) and (4) (1996), the gift tax regulations which, read together, provide that a trustee's power to allocate the "trustees' commissions . . . and other charges" to the trust's income will not disqualify the trust from gift tax spousal deduction as long as the donee spouse receives "substantial beneficial enjoyment" of the trust property. 101 T. C. 314, 325 (1993); see also 26 CFR §20.2056(b)–5(f) (1996) (tracking language of §25.2523(e)–1(f)). The Commissioner interpreted this language in Revenue Ruling 69–56, and held that a trustee's power to

> "charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses . . . [does] not result in the disallowance or *diminution of the marital deduction for estate* and gift *tax purposes* unless the

execution of such directions would or the exercise of such powers could, cause the spouse to have less than substantially full beneficial enjoyment of the particular interest transferred." Rev. Rul. 69–56, 1969–1 Cum. Bul. 224 (emphasis added).

Both the plurality and JUSTICE SCALIA argue that these gift regulations and rulings are inapposite because they address how the power to allocate expenses affects a trust's *qualification* for the marital deduction, and not how it affects the *trust's value. Ante,* at 7–9; *post,* at 4–5, 11–12. They further contend that the "material limitation" language in 26 CFR §20.2056(b)–4(a) (1996) would be rendered superfluous if a "material limitation" on the spouse's right to receive income existed only when that spouse lacked "substantial beneficial enjoyment" of the income. 101 T. C., at 325–326 (adopting this argument). Under this reading, there could be no such thing as a trust that qualified for the marital deduction but imposed a material limitation on the right to income because any trust failing the "substantial beneficial enjoyment" test would not qualify for the deduction at all. *Ante,* at 8; *post,* at 11. These are potent criticisms. But no matter how poorly drafted or ill conceived the Revenue Ruling might be, the fact remains that the Commissioner issued it and its plain language is hard to ignore. In the end, the conclusion one draws regarding how the marital and charitable trusts would be treated if they were *inter vivos* gifts depends on whether one takes the Commissioner at her word: If one does, the gift tax provisions, Revenue Ruling 69–56 in particular, favor respondents' position; if one does not, one is left with no guidance at all. Neither result is wholly satisfying.

Fortunately, §20.2056(b)–4(a) further directs the reader to consider a second method of determining the amount of the marital deduction:

> "In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property."

From this we ask whether the executor's right to allocate administrative expenses to the postmortem income of the marital bequest is a material limitation upon the spouse's "right to income from the property," such that "account must be taken of the effect." Because the executor's power is undeniably a "limitation" on the spouse's right to income, the case hinges on whether that limitation is "material." Accord, *post,* at 7 (SCALIA, J., dissenting) ("The beginning of analysis . . . is to determine what, in the context of §20.2056(b)–4(a), the word 'material' means").

We can quibble over which definition of "material"—"substantial" or "relevant"—precedes the other in the dictionary, see *ibid.*; The American Heritage Dictionary 772 (2d ed. 1985) ("substantial" precedes "relevant"), but this debate is beside the point. The Commissioner has already interpreted the language in §20.2056(b)–4(a). In Revenue Ruling 93–48, the Commissioner ruled that the marital deduction is not "ordinarily" reduced when an executor allocates interest payments on deferred federal estate taxes to the postmortem income of the spousal bequest. Rev. Rul. 93–48, 1993–2 Cum. Bul. 270 ("[T]he value of a residuary charitable [or marital] bequest is [not] reduced by the amount of [interest] expenses payable from the income of the residuary property"). JUSTICE SCALIA contends that Revenue Ruling 93–48 should be disregarded because it was promulgated by the Commissioner only after her attempts to prevail on the contrary position in federal court repeatedly failed. *Post,* at 9. To be sure, the Commissioner may not have whole-heartedly embraced Revenue Ruling 93–48, but the Ruling nevertheless issued and we may not totally ignore the plain language of a regulation or ruling because the entity promulgating it did not *really* want to have to adopt it. See *Connecticut Nat. Bank* v. *Germain,* 503 U. S. 249, 253–254 (1992) ("We have stated time and time again that courts must presume that a legislature says in a statute what it means and means in a statute what it says there"); *West Virginia Univ. Hospitals, Inc.* v. *Casey,* 499 U. S. 83, 98 (1991) (rejecting argument that "the congressional purpose in enacting [a statute] must prevail over the ordinary meaning of statutory terms").

It is, as an initial matter, difficult to reconcile the Commissioner's treatment of interest under Revenue Ruling 93–48 with her position in this case. For all intents and purposes, interest accruing on estate taxes is functionally indistinguishable from the administrative expenses at issue here. By definition, neither of these expenses can exist prior to the decedent's death; before that time, there is no estate to administer and no estate tax liability to defer. Yet both types of expenses are inevitable once the estate is open because it is virtually impossible to close an estate in a day so as to avoid the deferral of estate tax payments or the incursion of some administration expenses. Although both can theoretically be avoided if an executor donates his time or pays up front what he estimates the estate tax to be, this will not often occur. Both types of expenses are, moreover, of uncertain amount on the date of death. Because these two types of expenses are so similar in relevant ways, in my view they should be treated the same under §20.2056(b)–4(a) and Ruling 93–48, despite the Commissioner's limitation on the applicability of Revenue Ruling 93–48 to interest on deferred estate taxes.

But more important, the Commissioner's treatment of interest on deferred estate taxes in Revenue Ruling 93–48 indicates her rejection of the notion that *every* financial burden on a marital bequest's postmortem income is a material limitation warranting a reduction in the marital deduction. That the Ruling purports to apply not only to *income* but also to *principal,* and may therefore deviate from the accepted rule regarding payment of expenses from principal, see, *supra,* at 2, does not undercut the relevance of the Ruling's implications as to *income. Post,* at 10 (SCALIA, J., dissenting). Thus, some financial burdens on the spouse's right to postmortem income will reduce the marital deduction; others will not. The line between the two does not, as JUSTICE SCALIA contends, depend upon the relevance of the limitation on the spouse's right to income to the value of the marital bequest, *post,* at 7–8, since interest on deferred estate taxes surely reduces, and is therefore relevant to, "the value of what passes." *Ibid.* (emphasis deleted). By virtue of Revenue Ruling 93–48, the Commissioner has instead created a quantitative rule for §20.2056(b)–4(a). That a limita-

tion affects the marital deduction only upon reaching a certain quantum of substantiality is not a concept alien to the law of taxation; such rules are quite common. See, *e.g.*, Rev. Rul. 75–298, 1975–2 Cum. Bul. 290 (exempting from income tax the income of qualifying banks owned by foreign governments, as long as their participation in domestic commercial activity is *de minimis*); Rev. Rul. 90–60, 1990–2 Cum. Bul. 3 (establishing *de minimis* rule so that taxpayers who give up less than 33.3% of their partnership interest need not post a bond to enable them to defer payment of credit recapture taxes for low-income housing).

The Commissioner's quantitative materiality rule is consistent with the example set forth in 26 CFR §20.2056(b)–4(a) (1996):

> "An example of a case in which [the material limitation] rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate."

Even assuming that JUSTICE SCALIA is correct that the word "may" connotes "possibility rather than permissibility," *post,* at 10, the example still does not specify whether it applies when all the income, some of the income, or any of the income "from the property . . . is to be used to pay expenses incurred in the administration of the estate." Any of these constructions of the example's language is plausible, and the Commissioner's expressed preference for the second one is worthy of deference. *National Muffler Dealers Assn., Inc.* v. *United States,* 440 U. S. 472, 476 (1979).

That said, the proper measure of materiality has yet to be decided by the Commissioner. The Tax Court below compared the actual amount spent on administration expenses to its estimate of the income to be generated by the marital bequest during the spouse's lifetime. 101 T. C., at 325. One *amicus* suggests a comparison of the discounted present value of the projected income stream from the marital bequest when the actual administrative expenses are allocated to income with the projected income stream when the expenses are allocated to principal. App. to Brief American College of Trust and Estate Counsel as *Amicus Curiae* 1–2. The plurality, drawing upon its valuation theory, *supra,* at 5, looks to whether the "date-of-death value of the expected future administration expenses chargeable to income . . . [is] material as compared with the date-of-death value of the expected future income." *Ante,* at 14. None of these tests specifies with any particularity when the threshold of materiality is crossed. Cf. 26 U. S. C. §2503(b) (setting $10,000 annual minimum before gift tax liability attaches). The proliferation of possible tests only underscores the need for the Commissioner's guidance. In its absence, the Tax Court's approach is as consistent with the Code as any of the others, and provides no basis for reversal.

I share JUSTICE SCALIA's reluctance to find a $1.5 million diminution in postmortem income immaterial under any standard. *Post,* at 8. Were this Court considering the question of quantitative materiality in the first instance, I would be hard pressed not to find this amount "material" given the size of Mr. Hubert's estate. But the Tax Court in this case was effectively preempted from making such a finding by the Commissioner's litigation strategy. It appears from the record that the Commissioner elected to marshal all her resources behind the proposition that *any* diversion of postmortem income was material, and never presented any evidence or argued that $1.5 million was quantitatively material. See App. 58 (Stipulation of Agreed Issues) (setting forth Commissioner's argument); Brief for Respondent 47. Because she bore the burden of proving materiality (since her challenge to administrative expenses was omitted from the original Notice of Deficiency), Tax Court Rule 142(a), her failure of proof left the Tax Court with little choice but to reach its carefully crafted conclusion that $1.5 million was not quantitatively material on "the facts before [it]." 101 T. C., at 325. I would resist the temptation to correct the seemingly counterintuitive result in this case by protecting the Commissioner from her own litigation strategy, especially when she continues to adhere to that strategy and does not, even now, ask us to reconsider the Tax Court's finding on this issue.

This complex case has spawned four separate opinions from this Court. The question presented is simple and its answer should have been equally straightforward. Yet we are confronted with a maze of regulations and rulings that lead at times in opposite directions. There is no reason why this labyrinth should exist, especially when the Commissioner is empowered to promulgate new regulations and make the answer clear. Indeed, nothing prevents the Commissioner from announcing by regulation the very position she advances in this litigation. Until that time, however, the relevant sources point to a test of quantitative materiality, one that is not met by the unusual factual record in this case. I would, accordingly, affirm the judgment of the Tax Court.

JUSTICE SCALIA with whom JUSTICE BREYER joins, dissenting.

The statute and regulation most applicable to the question presented in this case are discussed in today's opinion almost as an afterthought. Instead of relying on the text of 26 U. S. C. §2056(b)(4)(B) and its interpretive regulation, 26 CFR §20.2056(b)–4(a) (1996), the plurality hinges its analysis on general principles of valuation which it mistakenly believes to inhere in the estate tax. It thereby creates a tax boondoggle never contemplated by Congress, and announces a test of deductibility virtually impossible for taxpayers and the IRS to apply. In my view, §2056(b)(4)(B) and §20.2056(b)–4(a) provide a straightforward disposition, namely that the marital (and charitable) deductions must be reduced whenever income from property comprising the residuary bequest to the spouse (or charity) is used to satisfy administration expenses. I therefore respectfully dissent.

I

Section 2056 of the Internal Revenue Code provides for a deduction from gross estate for marital bequests.[1] The Code places two limitations on the marital deduction which are relevant to this case.

[1]This case involves both the marital and the charitable deductions. I agree with the plurality's determination that the provisions governing the two should be read in *pari materia, ante,* at 4–5, and, like the plurality, I focus my attention on the marital deduction.

First, as would be expected, the marital deduction is limited to "an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate." 26 U. S. C. §2056(a). Thus, as the plurality correctly recognizes, and as both parties agree, if any portion of marital bequest principal is used to pay estate administration expenses, then the marital deduction must be reduced commensurately. Second, and more to the point, "where such interest or property [bequeathed to the spouse] is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined." §2056(b)(4)(B). Section 2056(b)(4)(B) controls this case and leads to the conclusion that the marital deduction must be reduced when estate income which would otherwise pass to the spouse is used to pay administration expenses of the estate.

A

As the plurality implicitly recognizes, Mrs. Hubert's interest in the estate was burdened with the obligation of paying administration expenses. The settlement agreement resolving the will contest, like Mr. Hubert's most recent will, provided that the estate's administration expenses would be paid from the residuary trusts, with the discretion given to the executor to apportion expenses between the income and principal of the residue. The marital bequest, which makes up some 52% of the residue, was thus plainly burdened with the obligation of paying 52% of the administration expenses of the estate. (The charitable bequest accounted for the remaining 48% of the residue.)

Our task under §2056(b)(4)(B) is to determine how this obligation would affect the value of the marital bequest were the bequest an *inter vivos* gift. This seemingly rudimentary question proves difficult to answer. Both parties point to various provisions of the Internal Revenue Code and the Treasury Regulations, but these concern the quite different question whether a gift *qualifies* for the gift tax marital deduction; none discusses how the actual payment of administration expenses from income will affect the *value* of the gift tax marital deduction. See, *e.g.*, 26 CFR §25.2523(e)–1(f)(3) and (4) (1996) (inclusion of the power to a trustee to allocate expenses of a trust between income and corpus will not *disqualify* the gift from the marital deduction so long as the spouse maintains substantial beneficial enjoyment of the income). The plurality seeks to derive some support from Treasury Regulation §25.2523(a)–1(e), see *ante,* at 5–6, though it must acknowledge that "[t]he question presented here . . . is not controlled by the exact terms of [that regulation or the provisions to which it refers]," *ante,* at 6. Even going beyond its "exact terms," however, the regulation has no relevance. Like its counterparts in the estate tax provisions, see §§20.2031–1(b), 20.2031–7, it simply provides instruction on how to value the *assets* comprising the gift. It says nothing about how to take account of administration expenses. Indeed, the gross estate does not include anticipated administration expenses. As I discuss below, *infra,* at 13–14, the estate tax provisions provide for a deduction from the gross estate for administration expenses actually incurred. See 26 U.S.C. §2053(a)(2) and 26 CFR §20.2053–3(a) (1996). Were expected administration expenses taken into account in valuing the assets of the gross estate, as the plurality incorrectly suggests, then the estate tax deduction for actual administration expenses would in effect be a second deduction for the same charge.

Respondent's strongest argument is based on Rev. Rul. 69–56, 1969–1 Cum. Bul. 224, which held that inclusion in a marital trust of the power to charge administration expenses to either income or principal does not run afoul of that provision of the regulations which requires, in order for a life-estate trust to *qualify* for the gift and estate tax marital deductions, that settlor intend the spouse to enjoy "substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trust accord to a person who is unqualifiedly designated as the life beneficiary of a trust." 26 CFR §§2523(e)–1(f)(1), 2056(b)–5(f)(1) (1996). Although the Revenue Ruling was an interpretation of qualification regulations, it also purported to "h[o]ld" that inclusion of the "powe[r]" to allocate expenses between income and principal "does not result in the disallowance or *diminution* of the marital deduction" (emphasis added). I agree with the Commissioner that this Revenue Ruling is inapposite because it deals with the effect of the mere *existence* of the power to allocate expenses against income; it speaks not at all to the question of how the actual *exercise* of that power will affect the valuation of the estate tax marital deduction. If the ruling is construed to mean that *exercise* of the power does not reduce the marital deduction, then actually using principal to pay the expenses should not reduce the marital deduction, a result which everyone agrees is incorrect, see, *e.g., ante,* at 9 (plurality opinion); *ante,* at 2 (O'CONNOR, J., concurring in the judgment), *supra,* at 2, and which plainly conflicts with §2056(a). It seems to me obvious that the Commissioner was simply not addressing the issue before us today when she issued Revenue Ruling 69–56, a conclusion confirmed by the fact that the Commissioner's longstanding view—which antedates Revenue Ruling 69–56—is that use of marital bequest income to pay administration expenses requires that the marital deduction be reduced, see, *e.g.,* Brief for Government Appellee, in *Ballantine* v. *Tomlinson,* No. 18,736 (CA5 1961), p. 18; Brief for Government Appellee, in *Alston* v. *United States,* No. 21,402 (CA5 1965), p. 15.

B

The Commissioner contends that Treasury Regulation §20.2056(b)–4(a), which interprets §2056(b)(4)(B), mandates the conclusion that payment of administration expenses from marital bequest income reduces the marital deduction. Section 20.2056(b)–4(a) provides:

> "The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse is to be determined as of the date of the decedent's death, [unless the executor elects the alternate valuation date]. The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles

being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any *material* limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate." (Emphasis added.)

This text was issued pursuant to explicit authority given the Secretary of the Treasury to promulgate the rules and regulations necessary to enforce the Internal Revenue Code. See 26 U. S. C. §7805(a). As this Court has repeatedly acknowledged, judicial deference to the Secretary's handiwork "helps guarantee that the rules will be written by 'masters of the subject.' " *National Muffler Dealers Assn., Inc.* v. *United States,* 440 U. S. 472, 477 (1979), quoting *United States* v. *Moore*, 95 U. S. 760, 763 (1878). Thus, when a provision of the Internal Revenue Code is ambiguous, as §2056(b)(4)(B) plainly is, this Court has consistently deferred to the Treasury Department's interpretive regulations so long as they " '"implement the congressional mandate in some reasonable manner." ' " *National Muffler Dealers Assn., Inc., supra,* at 477, quoting *United States* v. *Cartwright,* 411 U. S. 546, 550 (1973), in turn quoting *United States* v. *Correll,* 389 U. S. 299, 307 (1967). See also *Cottage Savings Assn.* v. *Commissioner,* 499 U. S. 554, 560–561 (1991).

As the courts below recognized, the crucial term of the regulation for present purposes is "material limitations." Curiously enough, however, neither the Commissioner nor the respondents come forward with a definition of this term, the former simply contending that "it is the burden of paying administration expenses *itself* that constitutes the 'material' limitation," Brief for Petitioner 31, and the latter simply contending that that burden is for various reasons not substantial enough to qualify. Today's plurality opinion also takes the latter approach, never defining the term but displaying by its examples that "material" must mean "relatively substantial." If, it says, a spouse's bequest represents a small portion of the overall estate and could be expected to generate little income, the estate's anticipated administration expenses "'may' be material" when compared to the anticipated income. *Ante,* at 10–11. But, it says, the mere fact that an estate incurs (or as I discuss below, under the plurality's approach, expects to incur) "substantial litigation costs" is insufficient to make a limitation material. *Ante,* at 12.

The beginning of analysis, it seems to me, is to determine what, in the context of §20.2056(b)–4(a), the word "material" means. In common parlance, the word sometimes bears the meaning evidently assumed by respondents: "substantial," or "serious" or "important." See 1 The New Shorter Oxford English Dictionary 1714 (1993) (def. 3); Webster's New International Dictionary 1514 (2d ed. 1950) (def. 2a). It would surely bear that meaning in a regulation that referred to a "material diminution of the value of the spouse's estate." Relatively small diminutions would not count. But where, as here, the regulation refers to "material limitations upon [the spouse's] right to receive income," it seems to me that the more expansive meaning of "material" is naturally suggested—the meaning that lawyers use when they move that testimony be excluded as "immaterial": Not "insubstantial" or "unimportant," but "*irrelevant*" or "*inconsequential.*" See American Heritage Dictionary 1109 (3d ed. 1992) (def. 4: defining "material" as "[b]eing both relevant and consequential," and listing "relevant" as a synonym). In the context of §20.2056(b)–4(a), which deals, as its first sentence recites, with "[t]he *value,* for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse" (emphasis added), a "*material* limitation" is a limitation that is relevant or consequential *to the value* of what passes. Many limitations are not—for example, a requirement that the spouse not spend the income for five years, or that the spouse be present at the reading of the will, or that the spouse reconcile with an alienated relative.

That this is the more natural reading of the provision is amply demonstrated by the consequences of the alternative reading, which would leave it to the taxpayer, the Commissioner, and ultimately the courts, to guess whether a particular decrease in value is "material" enough to qualify—without any hint as to what might be a "ballpark" figure, or indeed any hint as to whether there is such a thing as "absolute materiality" (the two million dollars at issue here, for instance) or whether it is all relative to the size of the estate. One should not needlessly impute such a confusing meaning to a regulation which readily bears another interpretation that is more precise. Moreover, the Commissioner's interpretation of her own regulation, so long as it is consistent with the text, is entitled to considerable deference, see *National Muffler Dealers Assn., Inc., supra,* at 488–489; *Cottage Savings Assn., supra,* at 560–561.

The concurrence contends that the other (more unnatural) reading of "material" must be adopted—and that no deference is to be accorded the Commissioner's longstanding approach of reducing the marital deduction for *any* payment of administrative expenses out of marital-bequest income—because of a recent Revenue Ruling in which the Commissioner acquiesced in lower court holdings that the marital deduction is not reduced by the payment from the marital bequest of interest on deferred estate taxes. *Ante,* at 8–9 (discussing Rev. Rul. 93–48). The concurrence asserts that interest accruing on estate taxes "is functionally indistinguishable" from administrative expenses, so that Revenue Ruling 93–48 "created a quantitative rule" shielding some financial burdens from affecting the calculation of the marital deduction. *Ante,* at 8–9. I think not. The Commissioner issued Revenue Ruling 93–48 only after her contention, that §20.2056(b)–4(a) required the marital deduction to be reduced by payment of estate-tax interest from the marital bequest, was repeatedly rejected by the Tax Court and the Courts of Appeals. See, *e.g., Estate of Street* v. *Commissioner,* 974 F. 2d 723 (CA6 1992); *Estate of Whittle* v. *Commissioner,* 994 F. 2d 379 (CA7 1993); *Estate of Richardson* v. *Commissioner,* 89 T. C. 1193 (1987). Rather than continuing to expend resources in litigation that seemed likely to bring little or no income to the Treasury, the Commissioner chose, in Revenue Ruling 93–48,

to "adopt the result" of thenrecent court decisions regarding interest on taxes. It is impossible to think that this suggested her view on the proper treatment of administrative expenses had changed. Indeed, the Ruling itself expressly indicates continued adherence to the Commissioner's longstanding position by reaffirming Revenue Ruling 73–98, which held that the charitable deduction must be reduced by the amount of charitable bequest income and principal consumed to pay administrative expenses, modifying it only insofar as it applies to payment of interest on taxes. Moreover, the Courts of Appeals whose results the Commissioner adopted *themselves distinguished* administrative expenses. In *Estate of Street,* for example, the court reasoned that while administrative expenses accrue at death interest on taxes accrues after death, and noted that the example in Treasury Regulation §2056(b)–4(a) specifically required a reduction of the marital deduction for payment of administrative expenses, but was silent as to interest on taxes. 974 F. 2d, at 727, 729. While the concurrence may be correct that the distinctions advanced by the Courts of Appeals are not wholly persuasive (the Commissioner herself argued that to no avail), I hardly think they are so irrational that it was arbitrary or capricious for the Commissioner to maintain her longstanding prior position on administrative expenses once Revenue Ruling 93–48 was issued; and it is utterly impossible to think that Revenue Ruling 93–48 was, or was understood to be, an indication that the Commissioner had *changed* her prior position on administrative expenses. That eliminates the only two grounds on which Revenue Ruling 93–48 could be relevant.

The concurrence's reading of Revenue Ruling 93–48 suffers from an additional flaw. Revenue Ruling 93–48 is not limited to payment from marital bequest *income,* but rather extends to payment from marital bequest *principal* as well. Thus, under the concurrence's view of that Ruling, even substantial administrative expenses paid out of marital bequest principal may not require a reduction of the marital deduction. This result, is, of course, inconsistent with the statute, see 26 U. S. C. §2056(a), and with what appears to be (as I noted earlier, *supra,* at 4–5) the concurrence's view, *ante,* at 2.

Respondents assert that some inquiry into "substantiality" is necessarily implied by the fact that the last sentence of the regulation describes an income-to-pay-administration-expenses limitation as "[a]n example of a case in which this rule [of taking account of material limitations] *may* be applied," 26 CFR §20.2056(b)–4(a) (1996) (emphasis added). The word "may" implies, the argument goes, that in some circumstances under those same facts the rule would *not* be applied—namely (the argument posits) when the administration expenses are not "substantial." But the latter is not the only explanation for the "may." Assuming it connotes possibility rather than permissibility (as in, "My boss said that I may go to New York"), the contingency referred to could simply be the contingency that there be some income which is used to pay administration expenses.

The Tax Court (in analysis adopted verbatim by the Eleventh Circuit and seemingly adopted by the concurrence, *ante,* at 10–11) took yet a third approach to "material limitation," which I must pause to consider. The Tax Court relied on Treas. Reg. §25.2523(e)–1(f)(3), 26 CFR §25.2523(e)–1(f)(3) (1996), which, it stated, provides that so long as the spouse has substantial beneficial enjoyment of the income of a trust, the bequest will not be disqualified from the marital gift deduction by virtue of a provision allowing the trustee to allocate expenses to income, and the spouse will be deemed to have received all the income from the trust. The Tax Court concluded that: "If Mrs. Hubert is treated as having received all of the income from the trust, there can be no material limitation on her right to receive income." 101 T. C. 314, 325–326 (1993). This reasoning fails for a number of reasons. First, §25.2523(e)–1(f)(3) is a *qualification* provision; it does not purport to instruct on how to value the bequest. Second, and more fundamentally, the Tax Court's approach renders the "material limitation" phrase in §20.2056(b)–4(a) superfluous. Under that view, a limitation is material only if it deprives the spouse of substantial beneficial enjoyment of the income. However, if the spouse does not have substantial beneficial enjoyment of the income, the trust does not qualify for the marital deduction and whether the limitation is material is irrelevant. That "material limitation" is not synonymous with "substantial beneficial enjoyment" is further suggested by the regulations governing the qualification of trusts for the marital estate tax deduction, which are virtually identical to the gift tax provisions relied upon by the Tax Court. See 26 C.F.R. §20.2056(b)–5(f) (1996). Section 20.2056(b)–5(f)(9) provides that a spouse will not be deemed to lack substantial beneficial enjoyment of the income merely because the spouse is not entitled to the income from the estate assets for the period reasonably required for administration of the estate. However, that section expressly provides: "As to the *valuation* of the property interest passing to the spouse in trust where the right to income is expressly postponed, see *§20.2056(b)–4.*" *Ibid.* (emphasis added).

C

My understanding of §20.2056(b)–4(a) is the only approach consistent with the statutory requirement that the marital deduction be limited to the value of property which passes to the spouse. See 26 U. S. C. §2056(a). As the plurality and the concurrence acknowledge, one component of an asset's value is its discounted future income. See, *e.g., Maass* v. *Higgins,* 312 U. S. 443, 448 (1941); 26 CFR §20.2031–1(b) (1996). (This explains why post-mortem income earned by the estate is not added to the date-of-death value in computing the gross estate: projected income was already included in the date-of-death value.) The plurality and the concurrence also properly acknowledge that if residuary principal is used to pay administration expenses, then the marital deduction must be reduced commensurately because the property does not pass to the spouse. See *ante,* at 9 (plurality opinion); *ante,* at 2 (O'CONNOR, J., concurring in the judgment); 26 U. S. C. §2056(a). The plurality and the concurrence decline, however, to follow this reasoning to its logical conclusion. Since the future stream of income is one part of the value of the assets at the date of death, use of the income to pay administration expenses (which were not included in calculating the assets' values) in effect reduces the value of the interest that passes to the spouse. As succinctly explained by a respected tax commentator:

"Beneficiaries are compensated for the delay in receiving possession by giving them the right to the income that is earned during administration. . . . [I]t is only the combination of the two rights—that to the income and that to possess the property in the future—that gives the beneficiary rights at death that are equal to value of the property at death. If the beneficiary does not get the income, what the beneficiary gets is less than the deathtime value of the property." Davenport, A *Street* Through *Hubert*'s Fog, Tax Notes, 1107, 1110 (1996).

If the beneficiary does not receive the income generated by the marital bequest principal, she in effect receives at the date of death less than the value of the property in the estate, in much the same way as she receives less than the value of the property in the estate when principal is used to pay expenses.

II

Besides giving the word "material" the erroneous meaning of something in excess of "substantial," the plurality's opinion adopts a unique methodology for determining materiality. Consistent with its apparent view that the estate tax provisions prohibit examination of any events following the date of death, the plurality concludes that whether a limitation is material, and the extent of any reduction in the marital deduction, are determined solely on the basis of the information available at the date of death—a position espoused by neither litigant, none of the *amici*, and none of the courts to have considered this issue since it arose some 35 years ago. The plurality appears to have been misled by its view that the estate tax demands symmetry: Since only anticipated income is included in the gross estate, only anticipated administration expenses can reduce the marital deduction. See *ante*, at 6–7, 11–13. The provisions of the estate tax clearly reject such a notion of symmetry and do not sharply discriminate between date-of-death and postmortem events insofar as the allowance of deductions for claims against and obligations of the estate are concerned. In this very case, for example, in calculating the taxable estate the executors deducted $506,989 of actual administration expenses pursuant to 26 U. S. C. §2053(a)-(2). App. to Pet. for Cert. 3a. The regulations governing such deductions provide that "[t]he amounts deductible . . . as 'administration expenses' . . . are limited to such expenses as are *actually* and *necessarily*, incurred in the administration of the decedent's estate," §20.2053–3(a) (emphasis added), and expressly prohibit taking a deduction "upon the basis of a vague or uncertain estimate," 26 CFR §20.2053–1(b)(3) (1996). Since such common administration expenses as litigation costs will be impossible to ascertain with any exactitude as of the date of death, the plurality's approach flatly contradicts the provisions of these regulations.[2]

The marital deduction itself is calculated on the basis of actual rather than anticipated expenditures from the marital bequest. The regulations governing 26 U. S. C. §2056(b)(4)(A), the provision requiring the marital deduction to be reduced to take account of the effect of estate and inheritance taxes, make it clear that the *actual* amounts of those taxes control. See 26 CFR §20.2056(b)–4(c) (1996). (With respect to the charitable deduction, the requirement that actual amounts be used is apparent on the face of the statute itself, see 26 U. S. C. §2055(c).) Moreover, the language of §2056(b) (4)(A) is quite similar to the language of the regulation at issue here, §20.2056(b)–4(a), suggesting that the latter, like the former, should be interpreted to require consideration of *actual*, rather than merely expected, administration expenses. Compare 26 U. S. C. §2056(b) (4)(A) ("[T]here shall be taken into account the *effect* which the tax imposed by section 2001, or any estate [tax], has on the *net* value to the surviving spouse of such interest" (emphasis added)) with 26 CFR §20.2056(b)–4(a) (1996) ("The marital deduction may be taken only with respect to the *net* value of any deductible interest which passed from the decedent to his surviving spouse . . . . In determining the value of the interest in property passing to the spouse account must be taken of *the effect of* any material limitations upon [the spouse's] right to income" (emphasis added)).

[2]The plurality's reference to *Ithaca Trust Co.* v. *United States*, 279 U. S. 151 (1929), is unhelpful. That case holds that date-of-death valuation is applicable to bequeathed assets, not that it is applicable to claims and obligations that are to be satisfied out of those assets.

In short, the plurality's general theory concerning valuation is contradicted by provisions of both the Code and regulations. It is also plagued by a number of practical problems. Most prominently, the plurality's rule is simply unadministrable. It requires the Internal Revenue Service and courts to engage in a peculiar, *nunc pro tunc*, three-stage investigation into what would have been believed on the date of death of the decedent. This highly speculative inquiry begins, I presume, with an examination of the various possible administration expenditures multiplied by the likelihood that they would actually come into being (for example, estimating the chances that a will contest would develop). Next, one must calculate the expected future income from the bequest. Finally, one must determine if, in light of the expected income, the anticipated expenses are such that a willing buyer would deem them to be a "material [*i.e.*, substantial] limitation" on the right to receive income.

Just how a court, presiding over a tax controversy many years after the decedent's death, is supposed to blind itself to later-developed facts, and gauge the expected administration expenses and anticipated income just as they would have been gauged on the date of death, is a mystery to me. In most cases, it is nearly impossible to estimate administration expenses as of the date of death; much less is it feasible to reconstruct such an estimation five or six years later. The plurality's test creates tremendous uncertainty and will undoubtedly produce extensive litigation. We should be very reluctant to attribute to the Code or the Secretary's regulations the intention to require this sort of inherently difficult inquiry, especially when the key regulation is best read to require that account be taken of *actual* expenses.

The plurality's test also leads to rather peculiar results. One example should suffice: Assume a decedent leaves his entire $30 million estate in trust to his wife and that as of the date of death a hypothetical buyer estimates that the estate will generate administration expenses on the order of $5 million because the decedent's estranged son has publicly stated that he is going to wage a fight over the will. Further, assume that the will provides that either income or principal may be used to

satisfy the estate's expenses. Finally, assume that a week after the decedent's death, mother and son put aside their differences and that the money passes to the spouse almost immediately with virtually no administration expenses. Under the plurality's test, since "only anticipated administration expenses payable from income, not the actual ones, affect the date-of-death value of the marital or charitable bequests," *ante,* at 13, the marital deduction will be limited to approximately $25 million, and, despite generating almost no income and having very few administration expenses, the estate will be required to pay an estate tax on some five million dollars even though the entire estate passed to the spouse. The plurality's test creates taxable estates where none exist. The proper result under §2056(b)(4)(B) and §20.2056 (b)–4(a) is that the marital deduction is thirty million dollars and the estate pays no estate tax.

I have one final concern with the plurality's approach: It effectively permits an estate to obtain a double deduction from tax for administration expenses, a tax windfall which Congress could never have intended. Title 26 U. S. C. §642(g) provides that administration expenses, which are allowed as a deduction in computing the taxable estate of a decedent, see §2053, may be deducted from income (provided they fall within an income tax deduction) if the estate files a statement with the Secretary stating that such amounts have not been taken as deductions from the gross estate. Here, respondent elected to deduct some $1.5 million of its administration expenses on its fiduciary income tax returns and was prohibited from taking these expenses as a deduction from the gross estate. Notwithstanding §642(g), however, the plurality's holding effectively permits the respondent to deduct the $1.5 million of administration expenses on the estate tax return under the guise of a marital or charitable deduction. Of course, the estate could have avoided the estate tax by electing to deduct its administration expenses on its estate tax return, but then it would have had no income-tax deduction; Congress gave estates a choice, not a road map to a double deduction. I recognize that nothing in §642(g) *compels* the conclusion that the marital (or charitable) deduction must be reduced whenever an estate elects to deduct expenses from income. However, by enacting §642 to prohibit a double deduction, Congress seemingly anticipated that if an estate elected to deduct administration expenses against income, its potential estate tax liability would increase commensurately. The plurality's holding today defeats this expectation.

III

The plurality today virtually ignores the controlling authority and instead decides this case based on a novel vision of the estate tax system. Because 26 CFR §20.2056(b)–4(a) (1996), which is a reasonable interpretation of 26 U. S. C. §2056(b)(4)(B), squarely controls this case and requires that the marital (and charitable) deductions be reduced whenever marital (or charitable) bequest income is used to pay administration expenses, I would reverse the judgment of the Eleventh Circuit. There is some dispute as to how exactly to calculate the reduction in the marital and charitable deductions. The dissenting judges in the Tax Court, on the one hand, contended that the marital and charitable deductions should be reduced by the date-of-death value of an annuity charged against the residuary interest which would be sufficient to pay the actual administration expenses charged to income. See 101 T. C., at 348–349 (Beghe, J., dissenting). The Commissioner, on the other hand, contends that the marital and charitable deductions must be reduced on a dollar-for-dollar basis, reasoning that this is the same way that all claims and obligations of the estate are treated. Since this dispute was not adequately briefed by the parties, nor passed upon by the Eleventh Circuit or the majority of judges in the Tax Court, I would remand the case to allow the lower courts to consider this issue in the first instance.

* * * * *

JUSTICE BREYER, dissenting.

I join JUSTICE SCALIA's dissent. This case turns on whether a payment of administration expenses out of income generated by estate assets constitutes a "material limitation" on the right to receive income from those assets. 26 CFR §20.2056(b)–4(a) (1996). The Commissioner has long, and consistently, argued that such a payment does reduce the value of the marital deduction. See, *e.g., Ballantine* v. *Tomlinson,* 293 F. 2d 311 (CA5 1961); *Alston* v. *United States,* 349 F. 2d 87 (CA5 1965); *Estate of Street* v. *Commissioner of Internal Revenue,* 974 F. 2d 723 (CA6 1992); *Estate of Roney,* 33 T. C. 801 (1960), aff'd *per curiam,* 294 F. 2d 774 (CA5 1961); Reply Brief for United States 15. JUSTICE SCALIA explains why the Commissioner's interpretation is consistent with the regulation's language and the statute it interprets. I add a brief explanation as to why I believe that it is consistent with basic statutory and regulatory tax law objectives as well.

The regulation, which speaks of the "net value" of what passes to the spouse, requires a realistic valuation of the interest left to the spouse as of the date of the decedent's death. Assume, for example, that a decedent leaves his entire estate to his wife in trust, with the proviso that the administrator pay 25% of the income earned by the estate assets during the period of administration to the decedent's son. Assume that the period of administration lasts several years and that the estate generates several million dollars in income during that time. On these assumptions, the son will have received an important asset (included in the estate's date-of-death value) that the surviving spouse did not receive, namely, the right to a portion of the estate's income over a period of several years. Were estate tax law to fail to take account of this fact (that the son, not the wife, received that asset), it would permit a valuable asset (the right to that income) to pass to the son without estate tax. But estate tax law does seem realistically to appraise the "net value" of what passes to the wife in such circumstances. See 26 CFR §§20.2056(b)–5(f)(9), 20.2056(b)–4(a) (1996); 4 A. Casner & J. Pennell, Estate Planning §13.11, pp. 138–139, and §13.14.6, n. 18 (5th ed. 1988); cf. *Estate of Friedberg,* 63 TCM 3080 (1992), ¶92, 310 P–H Memo TC (delay in payment of a specific bequest to a surviving spouse reduces its marital deduction value). And that being so, why would it not take account of the similar limitation on the right to income at issue here? The fact that the administrator uses estate income to pay administration expenses, rather than to make a bequest to the son, makes no difference from a marital deduction perspective, for, as the regu-

lations state, the marital deduction focuses upon the "net value" of the "interest which passed from the decedent to his surviving spouse." §20.2056(b)–4(a) (1996); see *United States* v. *Stapf,* 375 U. S. 118, 125 (1963).

The Commissioner's position also treats economic equals as equal. The time when the administrator writes the relevant checks, and not the account to which he debits them, determines economic impact. Thus $100,000 in administration expenses incurred by a $1 million estate open for one year, paid by check on the year's last day will (assuming 10% simple interest and assuming away here-irrelevant complexities) leave $1 million for the spouse at year's end, whether the administrator pays the expenses out of estate principal or from income. On these same assumptions, a commitment to pay, say, $100,000 in administration expenses out of income will reduce the value of principal by an amount identical to the reduction in value that would flow from a commitment to pay a similar amount out of principal. This economic similarity argues for similar estate tax treatment.

I recognize that the statute permits estates to deduct administration and certain other expenses either from the estate tax or from the estate's income tax. 26 U. S. C. 642(g); cf. *ante,* at 2 (O'CONNOR, J., concurring in judgment). But I do not read that statute as allowing a spouse to escape payment both of the estate tax (through a greater marital deduction) and also of income tax (through the deduction of the administration expenses from income). One can easily read the provision's language as simply granting the estate the advantage of whichever of the two tax rates is the more favorable, while continuing to require the estate to pay at least one of the two potential taxes. To read the "election" provision in this way makes of it a less dramatic departure from a Tax Code that otherwise sees what passes to heirs not as the full value of what the testator left, but, rather, as that value minus a set of permitted deductions. 26 U. S. C. §2053(a) (specifying deductions).

Although respondents argue that the Commissioner's interpretation will sometimes produce an unjustified "shrinking" of the marital deduction, I do not see how that is so. I concede that unfairness could occur were the Commissioner to readjust the marital deduction *every time* the administrator deducted from the estate's income tax *every* expense necessary to produce that income. But regulations guard against her doing so. Those regulations distinguish between (a) "expenditures . . . essential to the proper settlement of the estate," and (b) expenses "incurred for the individual benefit of the heirs, legatees, or devisees." 26 CFR §20.2053–3(a) (1996). The former are "administration expenses;" the latter are not. Deducting expenses in the latter category from the estate's income tax should not affect the marital deduction; and, as long as that is so, the Commissioner's interpretation will simply permit estates to use their administration expense deductions to best tax advantage. It will not lead to a marital deduction that to the spouse's overall disadvantage somehow shrinks, or disappears.

The Commissioner's insistence upon reducing the date of death value of the trust dollar-for-dollar poses a more serious problem. Payment of $100,000 in administration expenses from future income should reduce the date of death value of assets left to a wife in trust not by $100,000, but by $100,000 discounted to reflect the fact that the $100,000 will be paid in the future, earning interest in the meantime. (Assuming a 10% interest rate and payment one year after death, the reduction in value would be about $91,000, not $100,000.) Nonetheless, the Commissioner's practice of reducing the marital deduction dollar-for-dollar might reflect the simplifying assumption that discount calculations do not make a sufficiently large difference sufficiently often to warrant the administrative burden of authorizing them. Or it might reflect the fact that when administration expenses are taken as a deduction against the estate tax, their value is not discounted. Were the Commissioner to defend the dollar-for-dollar position in some such way, her approach might prove reasonable. And this Court will defer to longstanding interpretations of the Code and Treasury Regulations, see *supra,* at 1, that reasonably "implement the congressional mandate." *United States* v. *Correll,* 389 U. S. 299, 307 (1967); see *National Muffler Dealers Assn., Inc.* v. *United States,* 440 U. S. 472, 488 (1979). Regardless, I would not decide this matter now, for it has not been argued to us.

Finally, although I agree with much that JUSTICE O'CONNOR has written, I cannot agree that the amount at issue—almost $1.5 million of administration expenses deducted from income—is insignificant hence immaterial; and I can find no concession to that effect in the courts below.

For these reasons and those set forth by JUSTICE SCALIA, I would reverse the Court of Appeals.

Subtitle C—Employment Taxes and Collection of Income Tax
Chapter 22.—Railroad Retirement Tax Act
Subchapter C.—Tax on Employers

Section 3221.—Rate of Tax

Determination of Quarterly Rate of Excise Tax for Railroad Retirement Supplemental Annuity Program

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C., Section 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning July 1, 1997, shall be at the rate of 35 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning July 1, 1997, 31.0 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 69.0 percent of the taxes collected under such Sections 3211 (b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

By Authority of the Board.
Dated: May 28, 1997.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on June 4, 1997, 8:45 a.m., and published in the issue of the Federal Register for June 5, 1997, 62 F.R. 30901)

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C., Section 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning October 1, 1997, shall be at the rate of 35 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning October 1, 1997, 31.4 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 68.6 percent of the taxes collected under such Sections 3211 (b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: August 25, 1997.

By Authority of the Board.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on September 2, 1997, 8:45 a.m., and published in the issue of the Federal Register for September 3, 1997, 62 F.R. 46526)

In accordance with directions in Section 3221(c) of the Railroad Retirement Tax Act (26 U.S.C., Section 3221(c)), the Railroad Retirement Board has determined that the excise tax imposed by such Section 3221(c) on every employer, with respect to having individuals in his employ, for each work-hour for which compensation is paid by such employer for services rendered to him during the quarter beginning January 1, 1998, shall be at the rate of 35 cents.

In accordance with directions in Section 15(a) of the Railroad Retirement Act of 1974, the Railroad Retirement Board has determined that for the quarter beginning January 1, 1998, 31.6 percent of the taxes collected under Sections 3211(b) and 3221(c) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Account and 68.4 percent of the taxes collected under such Sections 3211 (b) and 3221(c) plus 100 percent of the taxes collected under Section 3221(d) of the Railroad Retirement Tax Act shall be credited to the Railroad Retirement Supplemental Account.

Dated: December 2, 1997.

By Authority of the Board.

Beatrice Ezerski,
Secretary to the Board.

(Filed by the Office of the Federal Register on December 9, 1997, 8:45 a.m., and published in the issue of the Federal Register for December 10, 1997, 62 F.R. 65108)

Chapter 25.—General Provisions Relating to Employment Taxes and Collection of Income Taxes at Source

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Section 3504.—Acts To Be Performed by Agents

26 CFR 31.3504–1: Acts to be performed by agents.

Requirements of the Form 941 Electronic Filing (ELF) Program are provided. See Rev. Proc. 97–47, page 510.

Subtitle D—Miscellaneous Excise Taxes
Chapter 31.—Retail Excise Taxes
Subchapter A.—Luxury Passenger Vehicles

Section 4001.—Imposition of Tax

The Service provides an inflation adjustment to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 1998. See Rev. Proc. 97–57, page 584.

Section 4003.—Special Rules

The Service provides an inflation adjustment to the price above which a passenger vehicle becomes subject to an excise tax for transactions occurring in calendar year 1998. (Price includes the price of installation of parts or accessories on a passenger vehicle within six months of the date after the vehicle was first placed in service.) See Rev. Proc. 97–57, page 584.

Chapter 33.—Facilities and Services
Subchapter C.—Transportation By Air
Part I.—Persons

Section 4261.—Imposition of Tax

26 CFR 49.4261–1: Imposition of Tax; in general.

This revenue procedure provides a list of "rural airports" as that term is defined in § 4261(e)(1)(B) of the Internal Revenue Code, for purposes of computing the tax on air transportation. The revenue procedure also provides guidance on how to calculate the tax where at least one segment of multiple segment domestic transportation does not begin or end at a rural airport. See Rev. Proc. 97–46, page 500.

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26 CFR 49.4261–1: Imposition of tax; in general.

This announcement corrects Rev. Proc. 97–46, which provides a list of "rural airports" as that term is defined in § 4261(e)(1)(B) of the Internal Revenue Code, for purposes of computing the tax on air transportation. See Announcement 97–107, 1997–43 I.R.B. 25.

Subtitle F—Procedure and Administration
Chapter 61.—Information and Returns
Subchapter A.—Returns and Records
Part II.—Tax Returns or Statements
Subpart A.—General Requirement

Section 6011.—General Requirement of Return, Statement, or List

26 CFR 31.6011(a)–7: Execution of returns.

Requirements of the Form 941 Electronic Filing (ELF) Program are provided. See Rev. Proc. 97–47, page 510.

Subpart B.—Income Tax Returns

Section 6012.—Persons Required To Make Returns of Income

26 CFR 1.6012–1: Individuals required to make returns of income.

The Service provides adjusted tax tables for individuals and trusts and estates for taxable years beginning in 1998 to reflect changes in the cost of living. See Rev. Proc. 97–57, page 584.

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26 CFR 1.6012–5: Composite return in lieu of specified form.

For the requirements for participation in the 1998 Electronic Filing Program for the Form 1040 Series, see Rev. Proc. 97–60, page 602.

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26 CFR 1.6012–5: Composite return in lieu of specified form.

For the requirements for participation in the 1998 On-Line Filing Program for the Form 1040 Series, see Rev. Proc. 97–61, page 614.

Section 6013.—Joint Returns of Income Tax by Husband and Wife

26 CFR 1.6013–1: Joint returns.

The Service provides adjusted tax tables for individuals for taxable years beginning in 1998 to reflect changes in the cost of living. See Rev. Proc. 97–57, page 584.

Part III.—Information Returns
Subpart A.—Information Concerning Persons Subject To Special Provisions

Section 6033.—Returns by Exempt Organizations

The Service provides an inflation adjustment to the amount of dues certain exempt organizations can charge and still be excepted from the reporting requirements for exempt organizations with nondeductible lobbying expenditures for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Section 6039F.—Notice of Large Gifts Received From Foreign Persons

The Service provides an inflation adjustment to the amount of gifts in a taxable year from certain foreign person(s) that may trigger a reporting requirement for a United States person for taxable years beginning in 1998. See Rev. Proc. 97–57, page 584.

Subpart B.—Information Concerning Transactions With Other Persons

Section 6041.—Information at Source

26 CFR 1.6041–1: Return of information as to payments of $600 or more.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 7.6041–1: Return of information as to payments of winnings from bingo, keno, and slot machines (Temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6041A.—Returns Regarding Payments of Remuneration for Services and Direct Sales

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6042.—Returns Regarding Payments of Dividends, and Corporate Earnings and Profits

26 CFR 1.6042–2: Returns of information as to dividends paid in calendar years after 1962.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6042–4: Statements to recipients of dividend payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6043.—Liquidating, Etc., Transactions

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6044.—Returns Regarding Payments of Patronage Dividends

26 CFR 1.6044–2: Returns of information as to payments of patronage dividends with respect to patronage occurring in taxable years beginning after 1962.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6044–5: Statements to recipients of patronage dividends.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6045.—Returns of Brokers

26 CFR 1.6045–1: Returns of information of brokers and barter exchanges.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6045–1: Returns of information for brokers and barter exchanges (Temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6045–2: Furnishing statement required with respect to certain substitute payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6045–4: Information reporting on real estate transactions with dates of closing on or after January 1, 1991.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6047.—Information Relating to Certain Trusts and Annuity Plans

26 CFR 1.6047–1: Information to be furnished with regard to employee retirement plan covering an owner-employee.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6049.—Returns Regarding Payments of Interest

26 CFR 1.6049–4: Return of information as to interest paid and original issue discount includible in gross income after December 31, 1982.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6049–6: Statements to recipients of interest payments and holders of obligations for attributed original issue discount.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

29 CFR 1.6049–7: Returns of information with respect to REMIC regular interests and collateralized debt obligations.

Specifications for paper substitutes for Forms

1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050A.—Reporting Requirements of Certain Fishing Boat Operators

26 CFR 1.6050A–1: Reporting requirements of certain fishing boat operators.

Specifications for paper substitutes for Form 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050B.—Returns Relating to Unemployment Compensation

26 CFR 1.6050B–1: Information returns by person making unemployment compensation payments.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050D.—Returns Relating to Energy Grants and Financing

26 CFR 1.6050D–1: Information returns relating to energy grants and financing.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev Proc. 97–32, page 342.

Section 6050E.—State and Local Income Tax Refunds

26 CFR 1.6050E–1: Reporting of State and local income tax refunds.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498 and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050H.—Returns Relating to Mortgage Interest Received in Trade or Business From Individuals

26 CFR 1.6050H–1: Information reporting of mortgage interest received in a trade or business from an individual.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

26 CFR 1.6050H-2: Time, form, and manner of reporting interest received on qualified mortgage.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050J.—Returns Relating to Foreclosures and Abandonments of Security

26 CFR 1.6050J–1T: Questions and answers concerning information returns relating to foreclosures and abandonments of security (Temporary).

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050N.—Returns Regarding Payments of Royalties

26 CFR 1.6050N–1: Statements to recipients of royalties.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050P.—Returns Relating to the Cancellation of Indebtedness by Certain Entities

26 CFR 1.6050P–1: Information reporting for discharges of indebtedness by certain financial entities.

Specifications for paper substitutes for Forms 1096, 1098, 1099, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Section 6050Q.—Certain Long-Term Care Benefits

Specifications for paper substitutes for Forms 1096, 1098, 5498, and W–2G. See Rev. Proc. 97–32, page 342.

Part IV.—Signing and Verifying of Returns and Other Documents

Section 6061.—Signing of Returns and Other Documents

26 CFR 31.6061–1: Signing of returns.

Requirements of the Form 941 Electronic Filing (ELF) Program are provided. See Rev. Proc. 97–47, page 510.

26 CFR 301.6061–1: Signing of returns and other documents.

Requirements of the Form 941 Electronic Filing (ELF) Program are provided. See Rev. Proc. 97–47, page 510.

26 CFR 1.6061–1: Signing of returns and other documents by individuals.

For the requirements for participation in the 1998 Electronic Filing Program for the Form 1040 Series, see Rev. Proc. 97–60, page 602.

26 CFR 1.6061–1: Signing of returns and other documents by individuals.

For the requirements for participation in the 1998 On-Line Filing Program for the Form 1040 Series, see Rev. Proc. 97–61, page 614.

Part V.—Time For Filing Returns and Other Documents

Section 6071.—Time for Filing Returns and Other Documents

26 CFR 31.6071(a)–1: Time for filing returns and other documents.

Requirements of the Form 941 Electronic Filing (ELF) Program are provided. See Rev. Proc. 97–47, page 510.

26 CFR 53.6071–1: Time for filing returns.

T.D. 8736

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 53

Time for Filing Form 4720 Return

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains a regulation that specifies the filing date by which Form 4720 returns must be filed by disqualified persons and organization managers liable for Internal Revenue Code section 4958 excise taxes. These excise taxes are imposed on excess benefit transactions between disqualified persons and section 501(c)(3) organizations (except for private foundations) or section 501(c)(4) organizations.

DATES: This regulation is effective October 7, 1997.

For dates of applicability, see § 53.6071–1(f).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Foundation and Similar Excise Taxes regulations (26 CFR part 53) under Internal Revenue Code (Code) section 6071. Those amendments provide guidance on the time for filing the return that is required to accompany payment of section 4958 excise taxes. This rule was first published in Notice 96–46 (1996–39 I.R.B. 7) (September 23, 1996). A notice of proposed rulemaking (NPRM) of that rule was published at 62 Fed. Reg. 84, by cross reference to a temporary regulation, (T.D. 8705, 62 FR 25), on January 2, 1997. The deadline for comments on the NPRM was April 2, 1997; no comments were received.

Taxpayer Bill of Rights 2, Public Law 104-168, 110 Stat. 1452 (TBOR2), enacted July 30, 1996, added section 4958 to the Code, which imposes excise taxes on excess benefit transactions. Section 4958 taxes apply retroactively to excess benefit transactions occurring on or after September 14, 1995. The taxes do not, however, apply to any benefit arising from a transaction pursuant to any written contract which was binding on September 13, 1995, and at all times thereafter before such transaction occurred.

An "excess benefit transaction" subject to tax under section 4958 is any transaction in which an economic benefit is provided by an organization described in Code section 501(c)(3) (except for a private foundation) or 501(c)(4) directly or indirectly to, or for the use of, any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing the benefit. A "disqualified person" is any person who was, at any time during the 5-year period ending on the date of the excess benefit transaction, in a position to exercise substantial influence over the affairs of the organization. Disqualified persons also include family members and certain entities in which at least 35 percent of the control or beneficial interest are held by persons described in the preceding sentence.

Code section 4958 imposes three taxes. The first tax is equal to 25 percent of the excess benefit amount, and is to be paid by any disqualified person who engages in an excess benefit transaction. The second tax is equal to 200 percent of the excess benefit amount, and is to be paid by any disqualified person if the excess benefit transaction is not corrected within the taxable period. The third tax is equal to 10 percent of the excess benefit amount, and is to be paid generally by any organization manager who knowingly participates in an excess benefit transaction. The maximum amount of this third tax with respect to any one excess benefit transaction may not exceed $10,000. An "organization manager" is any officer, director, trustee, or any individual having powers or responsibilities similar to those of any officer, director, or trustee. Final regulations under Code section 6011 were published on January 2, 1997, at T.D. 8705 (62 FR 25), prescribing Form 4720 for calculating and paying the first and third taxes described above.

TBOR2 also amended Code section 6033(b) to require section 501(c)(3) organizations to report the amounts of the taxes paid under section 4958 with respect to excess benefit transactions involving the organization, as well as any other information the Secretary may require concerning those transactions. Section 6033(f) also was amended to impose the same reporting requirements on section 501(c)(4) organizations. Those amendments to section 6033 only apply to organizations' returns for taxable years beginning after July 30, 1996. These and other TBOR2 amendments to the reporting requirements for section 501(c)(3) and section 501(c)(4) organizations are reflected on IRS Forms 990 and 990–EZ beginning with the 1996 versions.

Explanation of Provisions

This regulation provides the general rule that Form 4720 returns will be due on or before the 15th day of the fifth month following the close of the taxable year of any disqualified person or organization manager who is liable for section 4958 excise taxes on excess benefit transactions. The regulations also provide that returns on Form 4720 for taxable years ending after September 13, 1995, and on or before July 30, 1996, will be due on or before December 15, 1996. See also Notice 96–46 (1996–39 I.R.B. 7) (September 23, 1996), and 62 FR 25, 84 (January 2, 1997).

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 53 is amended as follows:

PART 53—FOUNDATION AND SIMILAR EXCISE TAXES

Paragraph 1. The authority citation for part 53 continues to read as follows:

Authority: 26 U.S.C. 7805.

§53.6071–1T [Amended]

§53.6071–1 [Amended]

Par 2. In §53.6071–1T, paragraph (f) is redesignated as paragraph (f) of §53.6071–1.

§53.6071-1T [Removed]

Par 3. §53.6071–1T is removed.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 7, 1997, 62 F.R. 52256)

Part VI.—Extension of Time for Filing Returns

Section 6081.—Extension of Time for Filing Returns

26 CFR 301.6081–1: Extension of time for filing returns.

Up to a 6-month extension of time to file federal tax returns is provided to taxpayers located in Grand Forks County, North Dakota, and Polk County, Minnesota. See Notice 97–62, page 320.

Subchapter B.—Miscellaneous Provisions

Section 6109.—Identifying Numbers

26 CFR 301.6109–1: Identifying numbers.

T.D. 8739

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 301 and 602

IRS Adoption Taxpayer Identification Numbers

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations under section 6109 relating to taxpayer identifying numbers. The final regulations include a cross reference to the temporary regulations, which provide rules for obtaining and using IRS adoption taxpayer identification numbers. The temporary regulations assist individuals who are in the process of adopting children and wish to claim certain tax benefits with respect to those children. The text of these temporary regulations also serves as the text of REG–103330–97, page 645.

DATES: These regulations are effective November 24, 1997.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These final and temporary regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in these regulations has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1564. Responses to this collection of information are required to obtain a taxpayer identification number.

For further information concerning this collection of information, and where to submit comments on the collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of REG–103330–97.

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

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

Background

This document contains amendments to the Regulations on Procedure and Administration (26 CFR Part 301) relating to identifying numbers under section 6109. Section 6109(a)(1) provides that any person required to make a return, statement, or other document must include in the document such identifying number as may be prescribed for securing proper identification of the person. Section 6109(a)(2) provides that any person with respect to whom a return, statement, or other document is required to be made by another person or whose identifying number must be shown on a return of another person, must furnish to the other person such identifying number as may be prescribed for securing the person's proper identification. Section 6109(d) provides that an individual must use a social security number as the individual's taxpayer identification number unless the Secretary prescribes otherwise by regulations.

Currently, there are three types of taxpayer identification numbers (TINs) assigned to individuals: (1) a social security number (SSN), (2) an IRS individual taxpayer identification number (ITIN) assigned to an alien individual who is ineligible to obtain an SSN, and (3) an employer identification number (EIN) assigned to an individual who is engaged in a trade or business as a sole proprietor. An SSN is assigned by the Social Security Administration. An ITIN or an EIN is assigned by the IRS.

Section 1615 of the Small Business Job Protection Act of 1996 (Public Law 104–188, 110 Stat. 1755, 1853 (1996)) added sections 21(e)(10) and 151(e) to deny the dependent care credit and the deduction for the dependency exemption if the TIN (as defined by section 6109 and the regulations thereunder) of the dependent is not included on the return claiming the credit or deduction. Sections 21(e)(10) and 151(e) generally are effective for tax returns due (without regard to extensions) after September 18, 1996.

In addition, section 101 of the Taxpayer Relief Act of 1997 (Public Law 105–34, 111 Stat. 788, 796 (1997)) added section 24 to the Code to provide a child tax credit for each qualifying child, effective for taxable years beginning after December 31, 1997. Pursuant to section 24(e), the taxpayer will be denied the credit if the qualifying child's TIN is not included on the return claiming the credit.

In most cases, taxpayers can meet the TIN requirements of sections 21, 24, and 151 by including a child's SSN on the return claiming the credit or deduction. In the case of adoption, however, a child may not have an SSN or, if the child does have an SSN, the taxpayer adopting the child (the prospective adoptive parent) may be unable to obtain the SSN because of confidentiality laws. See H.R. Rep. No. 542, 104th Cong., 2d Sess. 20 (1996); S. Rep. No. 412, 103d Cong., 2d Sess. 163 (1994).

Explanation of Provisions

These temporary regulations authorize the IRS to assign a new form of taxpayer identification number, the IRS adoption taxpayer identification number (ATIN), to a child who is in the process of being adopted (a prospective adoptive child). The regulations are effective for income tax returns due (without regard to extension) on or after April 15, 1998.

The temporary regulations provide that an ATIN is a temporary taxpayer identification number that expires two years after the date of issuance. However, upon application, the IRS may grant an extension of the ATIN. A prospective adoptive parent may apply for an ATIN for a child if: (1) the prospective adoptive parent is eligible to claim a personal exemption under section 151 with respect to the child; (2) the child is placed with the prospective adoptive parent for legal adoption by an authorized placement agency (as defined in §1.152–2(c)); (3) the Social Security Administration will not assign the prospective adoptive parent an SSN for the child (for example, because the adoption is not final); and (4) the prospective adoptive parent has used all reasonable means to obtain the child's assigned SSN, if any, but has been unsuccessful in obtaining this number (for example, because the birth parent who obtained the number is not legally required to disclose the number to the prospective adoptive parent).

The temporary regulations provide that an application for an ATIN must be made on the Form W–7A, *Application for Taxpayer Identification Number for Pending Adoptions,* or such other form prescribed by the IRS. The ATIN application must be accompanied by documentary evidence to establish that an authorized placement agency placed the child in the prospective adoptive parent's household for legal adoption by the parent. Such documentary evidence may include: a copy of a placement agreement entered into between the prospective adoptive parent and an authorized placement agency; an affidavit signed by the adoption attorney or government official who placed the child for legal adoption pursuant to state law; a document authorizing the release of a newborn child from a hospital to a prospective adoptive parent for adoption; or a court document ordering or approving the placement of a child for adoption.

When an adoption becomes final, the adoptive parent must apply for an SSN for the child. Once obtained, the SSN, rather than the ATIN, must be used as the child's TIN on all future returns, statements, or other documents required by the Code.

An ATIN may be used by the prospective adoptive parents to meet the TIN requirements of sections 21(e)(10), 24(e), and 151(e), relating to the dependent care credit, the child tax credit, and the dependency exemption, respectively. Also, as may be prescribed by forms, instructions, or otherwise, an ATIN may be used to meet the TIN requirements under sections 23(f) and 137(e), relating to qualified adoption expenses. The ATIN may not be used to meet the TIN requirement of section 32. See section 32(l).

The ATIN procedures do not apply to adoptions involving alien children. Generally, the Social Security Administration will assign an SSN to an alien child if all the requirements for assigning a number are met. When the Social Security Administration cannot assign an SSN, the child generally will be eligible for an ITIN.

In addition to adoptions involving alien children, there are two other types of adoptions to which the ATIN procedures may not apply. If the child placed for adoption is a foster child or is otherwise in the custody of a government agency or court (because, for example, the birth parents' rights were previously terminated for abuse or neglect), the government agency or court will generally obtain an SSN for the child and can make the SSN available to the prospective adoptive parent. Also, the prospective adoptive parent may be able to obtain the child's SSN from the birth parents (or other person) in the case of an adoption by the child's relatives or an adoption in which the adoptive parent and birth parent share information about the child and themselves.

Taxpayers are invited to comment on two issues partially addressed by the temporary regulations. First, comments are requested regarding what types of documents are available to establish that a child has been placed in the prospective adoptive parent's household for legal adoption. Also, comments are requested as to whether certain types of adoptions (in addition to foreign adoptions) should be completely excluded from the ATIN process. In particular, comments are requested regarding whether a prospective adoptive parent is always able to obtain a prospective adoptive child's SSN if the child is a foster child or is otherwise in the custody of a government agency or court.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Only individuals may receive ATINs under this Treasury decision, and an individual is not a small entity as defined in the Regulatory Flexibility Act. See 5 U.S.C. 601(6).

Pursuant to section 7805(f) of the Internal Revenue Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are amended as follows:

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.6109–1T also issued under 26 U.S.C. 6109;

Section 301.6109–3T also issued under 26 U.S.C. 6109; * * *

Par. 2 Section 301.6109–1 is amended by adding paragraph (h)(2)(iii) to read as follows:

§301.6109–1 Identifying numbers.

* * * * *

(h) * * *

(2) * * *

(iii) Paragraphs (a)(1)(i), (a)(1)(ii)(A), and (a)(1)(ii)(B) of this section do not apply after November 24, 1997. For further guidance after November 24,1997, see §301.6109–1T(a)(1)(i), (a)(1)(ii) introductory text, and (a)(1)(ii)(A) and (B).

Par. 3. Sections 301.6109–1T is added to read as follows:

§301.6109–1T Identifying numbers (temporary).

(a) *In general*—(1) *Taxpayer identifying numbers*—(i) *Principal types.* There are four principal types of taxpayer identifying numbers: social security numbers, Internal Revenue Service (IRS) individual taxpayer identification numbers, employer identification numbers, and IRS adoption taxpayer identification numbers. Social security numbers take the form 000-00-0000. IRS individual taxpayer identification numbers and IRS adoption taxpayer identification numbers also take the form 000-00-0000 but include a specific number or specific numbers designated by the IRS. Employer identification numbers take the form 00-0000000.

(ii) *Uses.* Social security numbers, IRS individual taxpayer identification numbers, and IRS adoption taxpayer identification numbers are used to identify individual persons. For the definition of social security number and employer identification number, see §§301.7701–11 and 301.7701–12, respectively. For the definition of IRS individual taxpayer identification number, see §301.6109–1 (d)(3). For the definition of IRS adoption taxpayer identification number, see §301.6109–3T. Except as otherwise provided in applicable regulations under this title or on a return, statement, or other document, and related instructions, taxpayer identifying numbers must be used as follows—

(A) Except as otherwise provided in §301.6109–1(a)(1)(ii)(D), paragraph (a)(1)(ii)(B) of this section, and §301.6109–3T, an individual required to furnish a taxpayer identifying number must use a social security number.

(B) Except as otherwise provided in §301.6109–1(a)(1)(ii)(D) and §301.6109–3T, an individual required to furnish a taxpayer identifying number but who is not eligible to obtain a social security number must use an IRS individual taxpayer identification number.

(a)(1)(ii)(C) through (g) [**Reserved**]. For further guidance, see §301.6109–1(a)(1)(ii)(C) through (g).

(h) *Effective date.* Paragraphs (a)(1)(i), (a)(1)(ii) introductory text, (a)(1)(ii)(A), and (a)(1)(ii)(B) of this section are applicable after November 24, 1997. For further guidance, prior to November 24, 1997, see §301.6109–1(a)(1)(i), (a)(1)(ii)-(A) and (a)(1)(ii)(B).

Par. 4. Section 301.6109–3T is added to read as follows:

§301.6109–3T IRS adoption taxpayer identification numbers (temporary).

(a) *In general*—(1) *Definition.* An *IRS Adoption Taxpayer Identification Number* (ATIN) is a temporary taxpayer identifying number assigned by the Internal Revenue Service (IRS) to a child (other than an alien individual as defined in §301.6109–1(d)(3)(i)) who has been placed, by an authorized placement agency, in the household of a prospective adoptive parent for legal adoption. An ATIN is assigned to the child upon application for use in connection with filing requirements under this title. When an adoption becomes final, the adoptive parent must apply for a social security number for the child. After the social security number is assigned, that number, rather than the ATIN, must be used as the child's taxpayer identification number on all returns, statements, or other documents required under this title.

(2) *Expiration and extension.* An ATIN automatically expires two years after the number is assigned. However, upon request, the IRS may grant an extension if the IRS determines the extension is warranted.

(b) *Definitions.* The following definitions apply for purposes of this section—

(1) *Authorized placement agency* has the same meaning as in §1.152–2(c) of this chapter;

(2) *Prospective adoptive child* or *child* refers to a child who has not been adopted, but who has been placed in the household of a prospective adoptive parent for legal adoption by an authorized placement agency; and

(3) *Prospective adoptive parent* or *parent* refers to an individual in whose household a prospective adoptive child is placed by an authorized placement agency for legal adoption.

(c) *General rule for obtaining a number*—(1) *Who may apply.* A prospective adoptive parent may apply for an ATIN for a child if—

(i) The prospective adoptive parent is eligible to claim a personal exemption under section 151 with respect to the child;

(ii) An authorized placement agency places the child with the prospective adoptive parent for legal adoption;

(iii) The Social Security Administration will not process an application for an SSN by the prospective adoptive parent on behalf of the child (for example, because the adoption is not final); and

(iv) The prospective adoptive parent has used all reasonable means to obtain the child's assigned social security number, if any, but has been unsuccessful in obtaining this number (for example, because the birth parent who obtained the number is not legally required to disclose the number to the prospective adoptive parent).

(2) *Procedure for obtaining an ATIN.* If the requirements of paragraph (c)(1) of this section are satisfied, the prospective adoptive parent may apply for an ATIN for a child on Form W–7A, *Application for Taxpayer Identification Number for Pending Adoptions* (or such other form as may be prescribed by the IRS). An application for an ATIN should be made far enough in advance of the first intended use of the ATIN to permit issuance of the ATIN in time for such use. An application for an ATIN must include the information required by the form and accompanying instructions, including the name and address of each prospective adoptive parent and the child's name and date of birth. In addition, the application must include such documentary evidence as the IRS may prescribe to establish that a child was placed in the prospective adoptive parent's household by an authorized placement agency for legal adoption. Examples of acceptable documentary evidence establishing placement for legal adoption by an authorized placement agency may include—

(i) A copy of a placement agreement entered into between the prospective adoptive parent and an authorized placement agency;

(ii) An affidavit signed by the adoption attorney or government official who

placed the child for legal adoption pursuant to state law;

(iii) A document authorizing the release of a newborn child from a hospital to a prospective adoptive parent for adoption; and

(iv) A court document ordering or approving the placement of a child for adoption.

(d) *Effective date.* The provisions of this section apply to income tax returns due (without regard to extension) on or after April 15, 1998.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 5. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 6. Section 602.101(c) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control Number
* * * * *	
301.6109–3T	1545–1564
* * * * *	

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved October 24, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 21, 1997, 8:45 a.m., and published in the issue of the Federal Register for November 24, 1997, 62 F.R. 62518)

Section 6114.—Treaty-Based Return Positions

26 CFR 301.6114–1: Treaty-based return positions.

T.D. 8733

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 301 and 602

Treaty-Based Return Positions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations under section 6114 of the Internal Revenue Code of 1986 providing that reporting is specifically required if the residency of an individual is determined under a treaty and apart from the Code. The IRS concluded, in the process of completing the regulations under section 7701(b), that the rules of section 6114 should apply to individuals determining their residency under a treaty. These final regulations are necessary to implement the section 6114 rules to individuals determining their residency under a treaty. Also contained in this document are final regulations relating to section 7701(b) and conforming changes to regulations under sections 6038 and 6046.

EFFECTIVE DATE: These regulations are effective December 15, 1997.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1126. Responses to these collections of information are mandatory.

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

The estimated annual burden per respondent varies from 1/2 hour to 3 hours, depending on individual circumstances, with an estimated average of 1 hour.

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

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

Background

On April 27, 1992, a notice of proposed rulemaking was published in the **Federal Register** (57 F.R. 15272) proposing amendments to the final Regulations on Procedure and Administration (26 CFR 301.6114–1), published in the **Federal Register** on March 14, 1990 (55 F.R. 9438) and on July 12, 1990 (55 F.R. 28608). The proposed amendments related to §301.6114–1(b) and (c) and §301.7701(b)–7(c)(2). No written comments responding to the notice were received. No public hearing was requested or held. The proposed amendments are adopted without change by this Treasury decision. This Treasury decision also includes modifications to §§1.6038–2(j), 1.6046–1(g), 301.6114–1(d), 301.7701(b)–3(b)(3) and (4), 301.7701(b)–7(c)(1) and 301.7701(b)–8(b)(1) and (2).

Explanation of Provisions

Section 301.6114–1(b) is amended by adding paragraph (b)(8) to provide that reporting is required under section 6114 where residency of an individual is determined under a treaty and apart from the Internal Revenue Code (Code). The regulations provide, however, that reporting is waived for an individual if payments or income items reportable by reason of paragraph (b)(8) do not exceed $100,000 in the aggregate. Section 301.6114–1(d) currently provides that when reporting is required under section 6114, a taxpayer must furnish as an attachment to his or her return a written statement with the information as set forth in paragraph (d). Section 301.7701(b)–7(b) currently provides that a dual resident taxpayer who claims a treaty benefit as a nonresident of the United States must file a statement in the form required by paragraph (c) of that

section. Section 301.6114–1(d) is now amended to provide that, when reporting is required under section 6114, a taxpayer must furnish, as an attachment to his or her return, a fully completed Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) or appropriate successor form. Section 301.7701(b)–7(c)(1) is amended to provide that the written statement required to be furnished under paragraph (b) of that section, as an attachment to a dual resident taxpayer's return, must be in the form of a fully completed Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) or appropriate successor form. Form 8833 was developed to provide standardized reporting of the information currently required by §§301.6114–1(d) and 301.7701(b)–7(c).

In an effort to provide standardized reporting of the information currently required to be reported, under §301.7701(b)–8(b), by taxpayers claiming the closer connection exception and exempt individuals and individuals with a medical condition, the Service has developed Form 8840 (Closer Connection Exception Statement) and Form 8843 (Statement for Exempt Individuals and Individuals with a Medical Condition). Accordingly, §301.7701(b)–8(b)(1) is amended to provide that the statement filed by alien individuals claiming the closer connection exception, described in §301.7701(b)–2, must be in the form of a fully completed Form 8840 or appropriate successor form. Section 301.7701(b)–8(b)(2) is amended to provide that the statement filed by exempt individuals and individuals with a medical condition, described in §301.7701(b)–3, must be in the form of a fully completed Form 8843 or appropriate successor form.

Sections 3121(b)(19), 3306(c)(19) and 3231(e)(1) of the Code provide that "J" class visa holders (teachers and trainees) are exempt from FICA, FUTA and Railroad Retirement Act taxes, respectively. Section 320 of the Social Security Independence and Program Improvements Act of 1994, Public Law 103–296 (108 Stat. 1464), extends the FICA, FUTA and Railroad Retirement Act tax exemptions and certain other tax rules to "Q" class visa holders (participants in international cultural exchange programs). Accordingly, conforming changes have been made to §301.7701(b)–3(b)(3) and (4) to reflect the revisions in the Code to the definitions of a *teacher or trainee* and *student* contained in section 7701(b)(5).

Section 301.7701(b)–7(c)(2), adopted as proposed, provides that, for purposes of stating the approximate amount of subpart F income to be included in the statement required to be furnished under paragraph (b) of that section by a dual resident taxpayer who is a shareholder in a *controlled foreign corporation* (as defined in section 957 or section 953(c)), the approximate amount of income may be based on the audited foreign financial statements of the CFC if there are no other United States shareholders in that CFC. Parallel rules with respect to information reporting under sections 6038 and 6046 are added in §§1.6038–2(j)(2)(ii) and 1.6046–1(g). Under these rules, a taxpayer who claims a treaty benefit as a nonresident of the United States, but who is a United States person for purposes of the information reporting requirements of sections 6038 or 6046, may satisfy certain information reporting requirements by filing the audited foreign financial statements of the foreign corporation with respect to which the information reporting is required. However, these rules apply only if the taxpayer is the sole United States person for purposes of the information reporting requirements with respect to the foreign corporation. If there are other United States persons for those purposes, then the taxpayer must report the information required by the regulations in the form and manner generally prescribed.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the notice of proposed rulemaking preceding the regulations was issued prior to March 29, 1996, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 301 and 602 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6038-2 is amended by:

1. Redesignating paragraph (j)(2)(ii) as paragraph (j)(2)(iii).

2. Adding new paragraph (j)(2)(ii) to read as follows:

§1.6038–2 Information returns required of United States persons with respect to annual accounting periods of certain foreign corporations beginning after December 31, 1962.

* * * * *

(j) * * *

(2) * * *

(ii) If an individual who is a United States person required to furnish information with respect to a foreign corporation under section 6038 is entitled under a treaty to be treated as a nonresident of the United States, and if the individual claims this treaty benefit, and if there are no other United States persons that are required to furnish information under section 6038 with respect to the foreign corporation, then the individual may satisfy the requirements of paragraphs (f)(10), (f)(11), (g), and (h) of this section by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6038.

* * * * *

Par. 3. In §1.6046–1, paragraph (g) is amended by adding a sentence at the end to read as follows:

§1.6046–1 Returns as to organization or reorganization of foreign corporations and as to acquisitions of their stock, on or after January 1, 1963.

* * * * *

(g) * * * If an individual who is a United States person required to make a return with respect to a foreign corpora-

tion under section 6046 is entitled under a treaty to be treated as a nonresident of the United States, and if the individual claims this treaty benefit, and if there are no other United States persons that are required to furnish information under section 6046 with respect to the foreign corporation, then the individual may satisfy the requirements of paragraphs (b)(10), (11) and (12), (c)(3)(ii)(d), and (g) of this section by filing the audited foreign financial statements of the foreign corporation with the individual's return required under section 6046.

* * * * *

PART 301—PROCEDURE AND ADMINISTRATION

Par. 4. The authority citation for part 301 continues to read in part as follows:

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

Section 301.6114–1 also issued under 26 U.S.C. 6114; * * *

Par. 5. Section 301.6114–1 is amended by:

1. Removing the language "(c)(1)" in paragraph (b)(4) introductory text and adding "(c)(1)(i)" in its place.

2. Removing the language "(c)(1)" in paragraph (b)(5) introductory text and adding "(c)(1)(i)" in its place.

3. Removing the language"(c)(4)" in paragraph (b)(6) and adding "(c)(1)(iv)" in its place.

4. Removing the language "or" at the end of paragraph (b)(6).

5. Removing the period at the end of paragraph (b)(7) and adding "; or" in its place.

6. Adding a paragraph (b)(8).

7. Paragraphs (c)(1) through (c)(6) are redesignated as paragraphs (c)(1)(i) through (c)(1)(vi), respectively.

8. Paragraphs (c)(7) introductory text, (c)(7)(i), (c)(7)(ii), and (c)(7)(iii) are redesignated as paragraphs (c)(1)(vii) introductory text, (c)(1)(vii)(A), (c)(1)(vii)(B) and (c)(1)(vii)(C), respectively.

9. The introductory text of paragraph (c) is redesignated as the introductory text of paragraph (c)(1).

10. Revising newly designated paragraph (c)(1)(ii).

11. Removing the concluding text immediately following newly designated paragraph (c)(1)(vii)(C).

12. Adding paragraphs (c)(2), (c)(3), (c)(4) and (c)(5).

13. Revising paragraph (d).

The additions and revisions read as follows:

§301.6114–1 Treaty-based return positions.

* * * * *

(b) * * *

(8) For returns relating to taxable years for which the due date for filing returns (without extensions) is after December 15, 1997, that residency of an individual is determined under a treaty and apart from the Internal Revenue Code.

(c) *Reporting requirement waived.* (1) * * *

(ii) For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, that residency of an individual is determined under a treaty and apart from the Internal Revenue Code.

* * * * *

(2) Reporting is waived for an individual if payments or income items otherwise reportable under this section (other than by reason of paragraph (b)(8) of this section), received by the individual during the course of the taxable year do not exceed $10,000 in the aggregate or, in the case of payments or income items reportable only by reason of paragraph (b)(8) of this section, do not exceed $100,000 in the aggregate.

(3) Reporting with respect to payments or income items the treatment of which is mandated by the terms of a closing agreement with the Internal Revenue Service, and that would otherwise be subject to the reporting requirements of this section, is also waived.

(4) If a partnership, trust, or estate that has the taxpayer as a partner or beneficiary discloses on its information return a position for which reporting is otherwise required by the taxpayer, the taxpayer (partner or beneficiary) is then excused from disclosing that position on a return.

(5) This section does not apply to a withholding agent with respect to the performance of its withholding functions.

(d) *Information to be reported*—(1) *Returns due after December 15, 1997.* When reporting is required under this section for a return relating to a taxable year for which the due date (without extensions) is after December 15 1997, the taxpayer must furnish, in accordance with paragraph (a) of this section, as an attachment to the return, a fully completed Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) or appropriate successor form.

(2) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the taxpayer must furnish information in accordance with paragraph (d) of this section in effect prior to December 15, 1997 (see §301.6114–1(d) as contained in 26 CFR part 301, revised April 1, 1997).

(3) *In general*—(i) *Permanent establishment.* For purposes of determining the nature and amount (or reasonable estimate thereof) of gross receipts, if a taxpayer takes a position that it does not have a permanent establishment or a fixed base in the United States and properly discloses that position, it need not separately report its payment of actual or deemed dividends or interest exempt from tax by reason of a treaty (or any liability for tax imposed by reason of section 884).

(ii) *Single income item.* For purposes of the statement of facts relied upon to support each separate Treaty-Based Return Position taken, a taxpayer may treat payments or income items of the same type (e.g., interest items) received from the same ultimate payor (e.g., the obligor on a note) as a single separate payment or income item.

(iii) *Foreign source effectively connected income.* If a taxpayer takes the return position that, under the treaty, income that would be income effectively connected with a U.S. trade or business is not subject to U.S. taxation because it is income treated as derived from sources outside the United States, the taxpayer may treat payments or income items of the same type (e.g., interest items) as a single separate payment or income item.

(iv) *Sales or services income.* Income from separate sales or services, whether or not made or preformed by an agent (independent or dependent), to different U.S. customers on behalf of a foreign corporation not having a permanent establishment in the United States may be treated as a single payment or income item.

(v) *Foreign insurers or reinsurers.* For purposes of reporting by foreign insurers

or reinsurers, as described in paragraph (c)(1)(vii)(B) of this section, such reporting must separately set forth premiums paid with respect to casualty insurance and indemnity bonds (subject to section 4371(1)); life insurance, sickness and accident policies, and annuity contracts (subject to section 4371(2)); and reinsurance (subject to section 4371(3)). All premiums paid with respect to each of these three categories may be treated as a single payment or income item within that category. For reports first due before May 1, 1991, the report may disclose, for each of the three categories, the total amount of premiums derived by the foreign insurer or reinsurer in U.S. dollars (even if a portion of these premiums relate to risks that are not U.S. situs). Reasonable estimates of the amounts required to be disclosed will satisfy these reporting requirements.

* * * * *

Par. 6. Section 301.7701(b)–0 is amended in the contents listing by:

1. Adding entries for §301.7701(b)–7, paragraphs (c)(1)(i) and (c)(1)(ii).

2. Removing the language "[Reserved]" in the entry for §301.7701(b)–7, paragraph (c)(2).

3. Adding entries for §301.7701(b)–8, paragraphs (b)(1)(i), (b)(1)(ii), (b)(2)(i) and (b)(2)(ii).

The additions read as follows:

§301.7701(b)–0 Outline of regulation provision for section 7701(b)–1 through (b)–9.

* * * * *

§301.7701(b)–7 Coordination with income tax treaties.

* * * * *

(c) * * *

(1) * * *

(i) *Returns due after December 15, 1997.*

(ii) *Earlier returns.*

* * * * *

§301.7701(b)–8 Procedural rules.

* * * * *

(b) * * *

(1) * * *

(i) *Returns due after December 15, 1997.*

(ii) *Earlier returns.*

(2) * * *

(i) *Returns due after December 15, 1997.*

(ii) *Earlier returns.*

* * * * *

Par. 7. Section 301.7701(b)3 is amended by revising paragraphs (b)(3) and (b)(4) to read as follows:

§301.7701(b)–3 Days of presence in the United States that are excluded for purposes of section 7701(b).

* * * * *

(b) * * *

(3) *Teacher or trainee.* A teacher or trainee includes any individual (and that individual's immediate family), other than a student, who is admitted temporarily to the United States as a nonimmigrant under section 101(a)(15)(J) (relating to the admission of teachers and trainees into the United States) or section 101(a)(15)(Q) (relating to the admission of participants in international cultural exchange programs) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15)(J), (Q)) and who substantially complies with the requirements of being admitted.

(4) *Student.* A student is any individual (and that individual's immediate family) who is admitted temporarily to the United States as a nonimmigrant under section 101(a)(15)(F) or (M) (relating to the admission of students into the United States) or as a student under section 101(a)(15)(J) (relating to the admission of teachers and trainees into the United States) or section 101(a)(15)(Q) (relating to the admission of participants in international cultural exchange programs) of the Immigration and Nationality Act (8 U.S.C. 1101(a)(15)(F), (J), (M), (Q)) who substantially complies with the requirements of being admitted. For rules concerning taxation of certain nonresident students or trainees, see section 871 (c) and §1.871–9(a) of this chapter.

* * * * *

Par. 8. Section 301.7701(b)–7 is amended by:

1. Revising paragraph (c)(1).

2. Adding text for paragraph (c)(2).

The revision and addition read as follows:

§301.7701(b)–7 Coordination with income tax treaties.

* * * * *

(c) * * * (1) *In general*—(i) *Returns due after December 15, 1997.* The statement filed by an individual described in paragraph (a)(1) of this section, for a return relating to a taxable year for which the due date (without extensions) is after December 15, 1997, must be in the form of a fully completed Form 8833 (Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)) or appropriate successor form. See section 6114 and §301.6114–1 for rules relating to other treaty-based return positions taken by the same taxpayer.

(ii) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the statement filed by the individual described in paragraph (a)(1) of this section must contain the information in accordance with paragraph (c)(1) of this section in effect prior to December 15, 1997 (see §301.7701(b)–7(c)(1) as contained in 26 CFR part 301, revised April 1, 1997).

(2) *Controlled foreign corporation shareholders.* If the taxpayer who claims a treaty benefit as a nonresident of the United States is a United States shareholder in a controlled foreign corporation (CFC), as defined in section 957 or section 953(c), and there are no other United States shareholders in that CFC, then for purposes of paragraph (c)(1) of this section, the approximate amount of subpart F income (as defined in section 952) that would have been included in the taxpayer's income may be determined based on the audited foreign financial statements of the CFC.

* * * * *

Par. 9. Section 301.7701(b)–8 is amended by revising paragraphs (b)(1) and (b)(2) to read as follows:

§301.7701(b)–8 Procedural rules.

* * * * *

(b) * * *

(1) *Closer connection exception*—(i) *Returns due after December 15, 1997.* The statement filed by an individual de-

scribed in paragraph (a)(1) of this section, for a return relating to a taxable year for which the due date (without extensions) is after December 15, 1997, must be in the form of a fully completed Form 8840 (Closer Connection Exception Statement) or appropriate successor form.

(ii) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the statement filed by the individual described in paragraph (a)(1) of this section must contain the information in accordance with paragraph (b)(1) of this section in effect prior to December 15, 1997 (see §301.7701(b)–8(b)(1) as contained in 26 CFR Part 301, revised April 1, 1997).

(2) *Exempt individuals and individuals with a medical condition*—(i) *Returns due after December 15, 1997.* The statement filed by an individual described in paragraph (a)(2) of this section, for a return relating to a taxable year for which the due date (without extensions) is after December 15, 1997, must be in the form of a fully completed Form 8843 (Statement for Exempt Individuals and Individuals with a Medical Condition) or appropriate successor form.

(ii) *Earlier returns.* For returns relating to taxable years for which the due date for filing returns (without extensions) is on or before December 15, 1997, the statement filed by the individual described in paragraph (a)(2) of this section must contain the information in accordance with paragraph (b)(2) of this section in effect prior to December 15, 1997 (see §301.7701(b)–8(b)(2) as contained in 26 CFR Part 301, revised April 1, 1997).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In §602.101, paragraph (c) is amended by adding an entry in numerical order to the table and revising the entry for 301.7701(b)–7 to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
301.6114–1	1545–1126
* * * * *	
301.7701(b)–7	1545–0089 1545–1126
* * * * *	

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved August 28, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 14, 1997, 62 F.R. 53384)

Chapter 62.—Time and Place for Paying Tax
Subchapter B.—Extensions of Time for Payment

Section 6161.—Extension of Time for Paying Tax

26 CFR 1.6161–1: Extension of time for paying tax or deficiency.

Up to a 6-month extension of time to pay federal tax is provided to taxpayers located in Grand Forks County, North Dakota, and Polk County, Minnesota. See Notice 97–62, page 320.

Chapter 64.—Collection
Subchapter A.—General Provisions

Section 6302.—Mode or Time of Collection

26 CFR 31.6302–1: Federal tax deposit rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA) attributable to payments made after December 31, 1992.

T.D. 8723

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1, 31, and 40

Federal Tax Deposits by Electronic Funds Transfer

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the deposit of Federal taxes by electronic funds transfer (EFT). The regulations provide rules regarding which taxpayers must make deposits by EFT, the types of Federal taxes that must be deposited by EFT, and when deposits by EFT must begin. The regulations affect taxpayers required to make deposits of Federal taxes by EFT. The final regulations reflect changes to the Internal Revenue Code of 1986 (Code) made by the North American Free Trade Agreement Implementation Act and the Small Business Job Protection Act of 1996.

DATES: The final regulations are effective July 14, 1997. For dates of applicability of these regulations, see §31.6302–1(h)(2).

SUPPLEMENTARY INFORMATION:

Background

Section 523 of the North American Free Trade Agreement Implementation Act, Public Law 103–182, 107 Stat. 2057 (December 8, 1993), amended section 6302 of the Code by enacting a new subsection (h) requiring the Secretary of the Treasury to prescribe such regulations as may be necessary for the development and implementation of an EFT system to be used for the collection of depository taxes.

On July 11, 1994, the IRS published temporary regulations (T.D. 8553 [1994–2 C.B. 261]) in the **Federal Register** (59 FR 35414) relating to the deposit of Federal taxes by EFT. A notice of proposed rulemaking (IA–03–94 [1994–2 C.B. 874]) cross-referencing the temporary regulations was also published in the **Federal Register** for the same day (59 FR 35418). Subsequently, on March 21, 1996, additional temporary regulations (T.D. 8661 [1996–1 C.B. 319]) were published in the **Federal Register** (61 FR 11548) as well as a notice of proposed rulemaking (IA–03–94, 61 FR 11595

[1996–1 C.B. 771]) that both cross-referenced the temporary regulations published that day and amended the notice of proposed rulemaking published July 11, 1994. Many written comments were received in response to these notices of proposed rulemaking. A public hearing on the 1994 notice was held on October 3, 1994. There were no requests for a public hearing on the 1996 notice and none was held.

Section 1809 of the Small Business Job Protection Act of 1996, Public Law 104–188, 110 Stat. 1755 (August 20, 1996), delayed the date by which certain taxpayers must begin EFT deposits.

After consideration of all comments, the regulations proposed by IA–03–94 are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below.

Explanation of Provisions

Under the temporary regulations, the requirement to deposit by EFT is based on the taxpayer's total deposits of certain taxes during certain "determination periods." If the taxpayer's deposits of the taxes during a determination period exceed a prescribed dollar threshold, the taxpayer must use EFT to make deposits on and after the date prescribed in the temporary regulations.

DELAY IN JANUARY 1, 1997, START-UP DATE

The Small Business Job Protection Act of 1996 provides that taxpayers first required by the temporary regulations to deposit by EFT for return periods beginning on and after January 1, 1997, need not begin to deposit by EFT until July 1, 1997. The final regulations provide that these taxpayers must use EFT to make deposits that are due on or after July 1, 1997, and relate to return periods beginning on or after January 1, 1997. For example, a corporation to which this rule applies, and which files its income tax returns on a calendar year basis, must use EFT to make corporate and estimated income tax deposits that are due on or after July 1, 1997. Thus, the corporation's September 15, 1997, and subsequent estimated tax payments must be made by EFT.

PENALTY RELIEF

Under Notice 97–43, (1997–30 I.R.B.), the IRS announced that no penalties for failure to deposit by EFT will be imposed through December 31, 1997, on any taxpayer first required to deposit by EFT on or after July 1, 1997. These taxpayers will remain liable for the failure-to-deposit penalty (absent reasonable cause) under section 6656 if they fail to make a required deposit (using either EFT or paper coupons) in a timely manner.

THRESHOLD FOR JANUARY 1, 1999 MANDATE

The temporary regulations provide that if a taxpayer's employment tax deposits during 1997 exceed $20,000, or, if no employment taxes are deposited, the other taxes deposited in 1997 exceed $20,000, the taxpayer must begin depositing by EFT for return periods beginning on and after January 1, 1999. Based on information available in 1994, the IRS and Treasury Department concluded that the $20,000 threshold was necessary to assure that 94% of employment taxes and 94% of other depository taxes would be collected by EFT in fiscal year 1999 and subsequent years as required by section 6302(h). Based on information currently available, the IRS and Treasury Department have concluded that the statutory requirement for 1999 and subsequent years will be satisfied without the need to reduce the threshold below $50,000. Accordingly, the final regulations raise the threshold for the January 1, 1997 through December 31, 1997 determination period from $20,000 to $50,000.

TECHNICAL CORRECTION—FIRST REQUIRED DEPOSIT

The final regulations revise the special rule requiring taxpayers with no employment tax deposits to use EFT if their deposits of other taxes exceed a specified threshold. As revised, the requirement to deposit by EFT "applies to all depository taxes due with respect to deposit obligations incurred for return periods beginning on and after the applicable effective date." The words "for return periods beginning" were inadvertently omitted in the temporary regulations.

MISCELLANEOUS

The definition of *time deemed deposited* has been revised solely for purposes of clarity.

Certain obsolete provisions in the temporary regulations relating to agreements entered into by the Commissioner with third party bulk data processors for the period prior to January 1, 1995, have been deleted.

Public Comment

Some commentators asked if the IRS intends to notify each affected taxpayer of the EFT requirement before the date on which the taxpayer must begin depositing by EFT. The IRS mailed several advance notices to each taxpayer that became subject to the EFT requirement in 1997, and plans to provide similar notices to taxpayers required to begin depositing by EFT in 1998.

Other commentators stated that it would be easier for taxpayers to determine whether they are subject to the rules if the thresholds were based on *deposit liabilities incurred* during the calendar year rather than *deposits made* during the calendar year. Although the specific suggestion was not adopted, the IRS is addressing the underlying concern in other ways. The IRS will make the threshold determination for affected taxpayers and, as indicated above, notify those taxpayers, in advance, of their obligation to begin depositing by EFT.

Some commentators suggested that the final regulations should clarify whether tax payments made with returns by check, money order, etc. are taken into account in threshold determinations. Payments submitted with a return are not "deposits" and are, therefore, not taken into account in determining if a threshold has been exceeded for EFT purposes.

Other commentators stated that the determination period for EFT should be the same as the lookback period used in determining a taxpayer's deposit status (semi-weekly or monthly) for employment tax deposit purposes. This suggestion was not adopted because the lookback periods for determining a taxpayer's deposit status with respect to employment

tax vary depending upon the type of employment tax being deposited (for example, Form 943 and 945 depositors have a calendar year lookback period whereas Form 941 depositors do not).

Several commentators suggested employers need a safe harbor more generous than the current 98 percent rule because deposits by EFT must be initiated earlier than current paper coupon deposits. The IRS and Treasury Department do not believe it is necessary to change the safe harbor. EFT depositors may use the Same Day Payment option (Electronic Tax Application (ETA)) and, when using this option, are not required to initiate deposits any earlier than paper coupon depositors. Thus, EFT depositors will have as much time as they have always had to determine the amount they are required to deposit.

One commentator indicated that following the ACH Holiday Schedule will cause problems for $100,000 next-day depositors. The IRS and Treasury Department believe that the availability of ETA will alleviate any problems caused by the ACH Holiday Schedule.

Another commentator noted that many securities firms that have next-day deposits will be unable to comply with the EFT deposit requirement because of the nature of the securities business. The commentator recommends either exempting nonpayroll related income tax deposits from the EFT deposit requirement or allowing the use of Fedwire on a regular basis. Since ETA includes Fedwire value transfers, Fedwire non-value transfers, and Direct Access transactions, and is available for taxpayers to use on a regular basis, securities firms should be able to comply with the next-day deposit rule.

Another commentator suggested that a deposit by EFT should be considered timely if initiated with the Automated Clearing House (ACH) in a timely and correct manner and that the taxpayer should not be responsible for possible ACH breakdowns. Rev. Rul. 94–46 (1994–2 C.B. 278), has been published to address this situation. The revenue ruling provides guidance on establishing reasonable cause for abatement of the failure-to-deposit penalty in certain situations involving deposits by EFT.

A commentator suggested that the regulations should allow taxpayers to make deposits by EFT from any institution that has the ability to make ACH credit or debit transfers and should not require the taxpayers to open accounts with a Treasury Financial Agent. A taxpayer is not required to open an account with a Treasury Financial Agent. The ACH debit and ACH credit options allow a taxpayer to make a deposit from any of the many institutions that have the ability to make ACH credit or debit transfers.

One commentator suggested that a $500 minimum threshold should be provided for EFT deposits. This change would unduly complicate administration of the rules and has not been adopted.

Some of the issues raised in comments on the notice of proposed rulemaking published on July 11, 1994, were addressed in changes made to the temporary regulations by T.D. 8661. These issues were discussed in the preamble to T.D. 8661 and will not be addressed again here. In addition, several other comments that were outside the scope of this regulations project have not been addressed here.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the notices of proposed rulemaking preceding the regulations were issued prior to March 29, 1996, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the two notices of proposed rulemaking preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR parts 1, 31, and 40 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the citations for "Section 1.6302–1(a)", and Sections 1.6302–1T, 1.6302–2T and 1.6302–3T", and "Section 1.6302–4T" and adding entries in numerical order to read as follows:

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

Section 1.6302–1 also issued under 26 U.S.C. 6302(c) and (h).

Section 1.6302–2 also issued under 26 U.S.C. 6302(h).

Section 1.6302–3 also issued under 26 U.S.C. 6302(h).

Section 1.6302–4 also issued under 26 U.S.C. 6302(a) and (c). * * *

Par. 2. Section 1.6302–1 is amended as follows:

1. The heading for paragraph (b) is revised.

2. The text of paragraph (b) is redesignated as paragraph (b)(1) and a heading for (b)(1) is added.

3. Paragraph (b)(2) is added.

4. The OMB parenthetical at the end of the section is removed.

The revised and added provisions read as follows:

§1.6302–1 Use of Government depositaries in connection with corporation income and estimated income taxes and certain taxes of tax-exempt organizations.

* * * * *

(b) *Manner of deposit*—(1) *Deposit by Federal tax deposit coupon.* * * *

(b)(2) *Deposits by electronic funds transfer.* For the requirement to deposit corporation income and estimated income taxes and certain taxes of tax-exempt organizations by electronic funds transfer, see §31.6302–1(h) of this chapter. A taxpayer not required to deposit by electronic funds transfer pursuant to §31.6302–1(h) of this chapter remains subject to the rules of paragraph (b)(1) of this section.

§1.6302–1T [Removed]

Par. 3. Section 1.6302–1T is removed.

Par. 4. Section 1.6302–2 is amended as follows:

1. The heading for paragraph (b) is revised.

2. Paragraph (c) is redesignated as paragraph (b)(6).

3. A new paragraph (c) is added.

4. The OMB parenthetical at the end of the section is removed.

The revised and added provisions read as follows:

§1.6302–2 Use of Government depositaries for payment of tax withheld on nonresident aliens and foreign corporations.

* * * * *

(b) *Deposits by Federal tax deposit coupon.* * * *

(c) *Deposits by electronic funds transfer.* For the requirement to deposit taxes withheld on nonresident aliens and foreign corporations by electronic funds transfer, see §31.6302–1(h) of this chapter. A taxpayer not required to deposit by electronic funds transfer pursuant to §31.6302–1(h) of this chapter remains subject to the rules of paragraph (b) of this section.

* * * * *

§1.6302–2T [Removed]

Par. 5. Section 1.6302–2T is removed.

Par. 6. In §1.6302–3, paragraph (c) is revised to read as follows:

§1.6302–3 Use of Government depositaries in connection with estimated taxes of certain trusts.

* * * * *

(c) *Cross-references.* For further guidance and instructions for certain banks and financial institutions acting as fiduciaries with respect to taxable trusts, see Rev. Proc. 89–49 (1989–2 C.B. 615), (see §601.601(d)(2) of this chapter) or any successor revenue procedure. For the requirement to deposit estimated tax payments of taxable trusts by electronic funds transfer, see §31.6302–1(h) of this chapter.

§1.6302–3T [Removed]

Par. 7. Section 1.6302–3T is removed.

Par. 8. Section 1.6302–4 is added to read as follows:

§1.6302–4 Use of financial institutions in connection with individual income taxes.

Voluntary payments by electronic funds transfer. An individual may voluntarily remit by electronic funds transfer all payments of tax imposed by subtitle A of the Code, including any payments of estimated tax. Such payments must be made in accordance with procedures to be prescribed by the Commissioner.

§1.6302–4T [Removed]

Par. 9. Section 1.6302–4T is removed.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Par. 10. The authority citation for Part 31 is amended by removing the entries for "Section 31.6302–1T", and "Section 31.6302(c)–3T" and revising the entry "Sections 31.6302–1 through 31.6302–3" and by adding an entry for "Section 31.6302(c)–3" to read as follows:

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

Sections 31.6302–1 through 31.6302–3 also issued under 26 U.S.C. 6302(a), (c), and (h). * * *

Section 31.6302(c)–3 also issued under 26 U.S.C. 6302(h).

Par. 11. In §31.0–1, paragraph (a) is amended by adding a sentence at the end of the paragraph to read as follows:

§31.0–1 Introduction.

(a) * * * The regulations in this part also provide rules relating to the deposit of other taxes by electronic funds transfer.

* * * * *

Par. 12. In §31.0–3, paragraph (f) is amended by adding a sentence at the end of the paragraph to read as follows:

§31.0–3 Scope of regulations.

* * * * *

(f) * * * Subpart G of this part also provides rules relating to the deposit of other taxes by electronic funds transfer.

Par. 13. In §31.6302–1, paragraph (h) is redesignated as paragraph (i), and new paragraph (h) is added to read as follows:

§31.6302–1 Federal tax deposit rules for withheld income taxes and taxes under the Federal Insurance Contributions Act (FICA) attributable to payments made after December 31, 1992.

* * * * *

(h) *Time and manner of deposit—deposits required to be made by electronic funds transfer*—(1) *In general.* Section 6302(h) requires the Secretary to prescribe such regulations as may be necessary for the development and implementation of an electronic funds transfer system to be used for the collection of the depository taxes as described in paragraph (h)(3) of this section. Section 6302(h)(2) provides a phase-in schedule that sets forth escalating minimum percentages of those depository taxes to be deposited by electronic funds transfer. This paragraph (h) prescribes the rules necessary for implementing an electronic funds transfer system for collection of depository taxes and for effecting an orderly and expeditious phase-in of that system.

(2) *Threshold amounts, determination periods, and effective dates.* (i)(A) Taxpayers whose aggregate deposits of the taxes imposed by Chapters 21 (Federal Insurance Contributions Act), 22 (Railroad Retirement Tax Act), and 24 (Collection of Income Tax at Source on Wages) of the Internal Revenue Code during a 12-month determination period exceed the applicable threshold amount are required to deposit all depository taxes described in paragraph (h)(3) of this section by electronic funds transfer (as defined in paragraph (h)(4) of this section) unless exempted under paragraph (h)(5) of this section. If the applicable effective date is January 1, 1995, or January 1, 1996, the requirement to deposit by electronic funds transfer applies to all deposits required to be made on or after the applicable effective date. If the applicable effective date is July 1, 1997, the requirement to deposit by electronic funds transfer applies to all deposits required to be made on or after July 1, 1997 with respect to deposit obligations incurred for return periods beginning on or after January 1, 1997. If the applicable effective date is January 1, 1998, or thereafter, the requirement to deposit by electronic funds transfer applies to all deposits required to be made with respect to deposit obligations incurred for return periods beginning on or after the applicable effective date. In general, each applicable effective date has one 12-month determination period. However, for the applicable effective date January 1, 1996, there are two determination periods. If the applicable threshold amount is exceeded in either of those determination periods, the taxpayer becomes subject to the requirement to deposit by electronic funds transfer, effective January 1, 1996. The threshold amounts, determination periods and applicable effective dates for

Threshold Amount	*Determination Period*	*Applicable Effective Date*
$78 million	1–1–93 to 12–31–93	January 1, 1995
$47 million	1–1–93 to 12–31–93	January 1, 1996
$47 million	1–1–94 to 12–31–94	January 1, 1996
$50 thousand	1–1–95 to 12–31–95	July 1, 1997
$50 thousand	1–1–96 to 12–31–96	January 1, 1998
$50 thousand	1–1–97 to 12–31–97	January 1, 1999

purposes of this paragraph (h)(2)(i)(A) are as follows:

(B) Unless exempted under paragraph (h)(5) of this section, a taxpayer that does not deposit any of the taxes imposed by chapters 21, 22, and 24 during the applicable determination periods set forth in paragraph (h)(2)(i)(A) of this section, but that does make deposits of other depository taxes (as described in paragraph (h)(3) of this section), is nevertheless subject to the requirement to deposit by electronic funds transfer if the taxpayer's aggregate deposits of all depository taxes exceed the threshold amount set forth in this paragraph (h)(2)(i)(B) during an applicable 12-month determination period. This requirement to deposit by electronic funds transfer applies to all depository taxes due with respect to deposit obligations incurred for return periods beginning on or after the applicable effective date. The threshold amount, determination periods, and applicable effective dates for purposes of this paragraph (h)(2)(i)(B) are as follows:

(ii) Once a taxpayer is required to deposit by electronic funds transfer pursuant to this paragraph (h)(2), the taxpayer must continue to deposit by electronic funds transfer. Until such time as a taxpayer is required by this section to deposit by electronic funds transfer, the taxpayer may voluntarily make deposits by electronic funds transfer, but remains subject to the rules of paragraph (i) of this section, pertaining to deposits by Federal tax deposit (FTD) coupon, in making deposits other than by electronic funds transfer.

(3) *Taxes required to be deposited by electronic funds transfer.* The requirement to deposit by electronic funds transfer under paragraph (h)(2) of this section applies to all the taxes required to be deposited under §§1.6302–1, 1.6302–2, and 1.6302–3 of this chapter; §§31.6302–1, 31.6302–2, 31.6302–3, 31.6302–4, and 31.6302(c)–3; and §40.6302(c)–1 of this chapter.

(4) *Definitions*—(i) *Electronic funds transfer.* An *electronic funds transfer* is any transfer of depository taxes made in accordance with Revenue Procedure 97–33, (1997–30 I.R.B.), (see §601.601(d)(2) of this chapter), or in accordance with procedures subsequently prescribed by the Commissioner.

(ii) *Taxpayer.* For purposes of this section, a *taxpayer* is any person required to deposit federal taxes, including not only individuals, but also any trust, estate, partnership, association, company or corporation.

(5) *Exemptions.* If any categories of taxpayers are to be exempted from the requirement to deposit by electronic funds transfer, the Commissioner will identify those taxpayers by guidance published in the Internal Revenue Bulletin. (See §601.601(d)(2)(ii)(*b*) of this chapter.)

Threshold Amount	*Determination Period*	*Applicable Effective Date*
$50 thousand	1–1–95 to 12–31–95	January 1, 1998
$50 thousand	1–1–96 to 12–31–96	January 1, 1998
$50 thousand	1–1–97 to 12–31–97	January 1, 1999

Subchapter D.—Seizure of Property for Collection of Taxes

Section 6334.—Property Exempt From Levy

The Service provides inflation adjustments to the value of certain property exempt from levy; for example, fuel, provisions, and personal effects as well as books and tools of a trade, business, or profession for calendar year 1998. See Rev. Proc. 97–57, page 584.

26 CFR 301.6334–1: Property exempt from levy.

T.D. 8725

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 301

Miscellaneous Sections Affected by the Taxpayer Bill of Rights 2 and the Personal Responsibility and Work Opportunity Reconciliation Act of 1996

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to joint returns, property exempt from levy, interest, penalties, offers in compromise, and the awarding of costs and certain fees. The regulations reflect changes to the law made by the Taxpayer Bill of Rights 2 and a conforming amendment made by the Personal Responsibility and Work Opportunity Reconciliation Act of 1996. The regulations affect taxpayers with respect to filing of returns, interest, penalties, court costs, and payment, deposit, and collection of taxes.

DATES: These regulations are effective July 22, 1997.

For dates of applicability of these regu-

lations, see §§301.6334–1(e) and (f), 301.6601–1(f)(3) and (4), 301.6651–1(a)(3) and (g)(2), 301.6656–3(c), 301.7122–1(e)(2), 301.7430–2(c)(3)-(i)(B), 301.7430–4(b)(3)(ii), 301.7430–5(a) and (c)(3), and 301.7430–6.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1356. Responses to this collection of information are required to obtain an award of reasonable administrative costs.

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

The estimated annual burden per respondent varies from 10 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes.

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

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

Background

This document contains amendments to the Income Tax Regulations and the Regulations on Procedure and Administration (26 CFR parts 1 and 301, respectively) relating to joint returns under section 6013, levy under section 6334, interest under section 6601, the failure to file penalty under section 6651, the failure to deposit penalty under section 6656, compromise under section 7122, and awards of costs and certain fees under section 7430. These sections were amended by the Taxpayer Bill of Rights 2 (TBOR2) (Public Law 104–168, 110 Stat. 1452 (1996)) and section 110(l)(6) of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (Public Law 104–193, 110 Stat. 2105, 2173 (1996)). The changes made by TBOR2 and the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 are reflected in the final regulations.

A notice of proposed rulemaking was published in the **Federal Register** for January 2, 1997 (62 FR 77). One written comment was received in response to the notice of proposed rulemaking. No public hearing was requested or held. The proposed regulations under sections 6013, 6334, 6601, 6651, 6656, 7122, and 7430 are adopted by this Treasury decision with minor revisions, which are discussed below.

Explanation of Revisions and Summary of Comments

The IRS received one comment regarding the proposed regulations. The commentator remarked that §301.6601– 1(f)(3) of the proposed regulations is unclear because, as drafted, the regulation implies that interest on all additions to tax, including those covered by section 6601(e)-(2)(B), runs from the date of the notice and demand. Therefore, the final regulations clarify that interest on any addition to tax, except additions to tax described in section 6601(e)(2)(B), begins to run from the date of the notice and demand.

The commentator also requested clarification for purposes of computing the $100,000 threshold in §§301.6601–1(f)(3) and (4) and 301.6651–1(a)(3). Sections 303(a) and (b) of TBOR2 extend the interest-free period to 21 calendar days or 10 business days if the amount for which the notice and demand is made equals or exceeds $100,000. The commentator suggested that the $100,000 threshold should include tax, interest, and penalties. The language in the statute supports this interpretation. Under section 303(b)(1) of TBOR2, the 10 day period specifically applies to a notice and demand for interest and penalties. Therefore, the final regulations clarify that 10 business days is the applicable interest-free period if the total amount assessed, including tax, penalties, and interest, and shown on the notice and demand equals or exceeds $100,000.

In addition, §301.6651–1(a)(3), regarding the failure to pay penalty, has been clarified by cross-referencing the definitions of calendar day and business day in §301.6601–1(f)(5).

Effective Dates

These regulations are applicable on July 31, 1996, except that §301.7122–1(e) is applicable on July 30, 1996, and §301.6334–1(a)(2), (a)(3), (a)(11)(i), and (e), §301.6601–1(f)(3), (f)(4), and (f)(5), §301.6651–1(a)(3), and §301.7430–4(b)(3)(ii) are applicable on January 1, 1997.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Moreover, it is hereby certified that the regulations in this document will not have a significant economic impact on a substantial number of small entities. This certification is based on a determination that in the past only an average of 38 taxpayers per year, the majority of whom were individuals, have filed a request to recover administrative costs. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on the impact of the proposed regulations on small business.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.6013–2(b)(1) is amended by removing the language "Unless" and adding "Beginning on or before July 30, 1996, unless" in its place.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. Section 301.6334–1 is amended by:

1. Revising paragraph (a)(2).
2. Removing the language "$1,100 ($1,050 for levies issued prior to January 1, 1990)" from paragraph (a)(3) and adding "$1,250" in its place.
3. Removing the language "(relating to aid to families with dependent children)" from paragraph (a)(11)(i).
4. Revising paragraph (e).
5. Adding paragraph (f).

The additions and revisions read as follows:

§301.6334–1 Property exempt from levy.

(a) * * *

(2) *Fuel, provisions, furniture, and personal effects.* So much of the fuel, provisions, furniture, and personal effects in the taxpayer's household, and of the arms for personal use, livestock, and poultry of the taxpayer, that does not exceed $2,500 in value.

* * * * *

(e) *Inflation adjustment.* For any calendar year beginning after December 31, 1997, each dollar amount referred to in paragraphs (a)(2) and (3) of this section will be increased by an amount equal to the dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for the calendar year (substituting "calendar year 1996" for "calendar year 1992" in section 1(f)(3)(B)). If any dollar amount as adjusted is not a multiple of $10, the dollar amount will be rounded to the nearest multiple of $10 (rounding up if the amount is a multiple of $5).

(f) *Effective date.* Generally, these provisions are applicable with respect to levies made on or after July 1, 1989. However, any reasonable attempt by a taxpayer to comply with the statutory amendments addressed by the regulations in this section prior to February 21, 1995, will be considered as meeting the requirements of the regulations in this section. In addition, paragraphs (a)(2), (3), (11)(i) and (e) of this section are applicable with respect to levies issued after December 31, 1996.

Par. 5. Section 301.6601–1 is amended by:

1. Revising paragraphs (f)(3) and (f)(4).
2. Redesignating paragraph (f)(5) as paragraph (f)(6) and adding new paragraph (f)(5).

The additions and revisions read as follows:

§301.6601–1 Interest on underpayments.

* * * * *

(f) * * *

(3) Interest will not be imposed on any assessable penalty, addition to the tax (other than an addition to tax described in section 6601(e)(2)(B)), or additional amount if the amount is paid within 21 calendar days (10 business days if the amount assessed and shown on the notice and demand equals or exceeds $100,000) from the date of the notice and demand. If interest is imposed, it will be imposed only for the period from the date of the notice and demand to the date on which payment is received. This paragraph (f)(3) is applicable with respect to any notice and demand made after December 31, 1996.

(4) If notice and demand is made after December 31, 1996, for any amount and the amount is paid within 21 calendar days (10 business days if the amount assessed and shown on the notice and demand equals or exceeds $100,000) from the date of the notice and demand, interest will not be imposed for the period after the date of the notice and demand.

(5) For purposes of paragraphs (f)(3) and (4) of this section—

(i) The term *business day* means any day other than a Saturday, Sunday, legal holiday in the District of Columbia, or a statewide legal holiday in the state where the taxpayer resides or where the taxpayer's principal place of business is located. With respect to the tenth business day (after taking into account the first sentence of this paragraph (f)(5)(i)), see section 7503 relating to time for performance of acts where the last day falls on a statewide legal holiday in the state where the act is required to be performed.

(ii) The term *calendar day* means any day. With respect to the twenty-first calendar day, see section 7503 relating to time for performance of acts where the last day falls on a Saturday, Sunday, or legal holiday.

* * * * *

Par. 6. Section 301.6651–1 is amended by:

1. Revising paragraph (a)(3).
2. Adding paragraph (g).

The addition and revision read as follows:

§301.6651–1 Failure to file tax return or to pay tax.

(a) * * *

(3) *Failure to pay tax not shown on return.* In the case of failure to pay any amount of any tax required to be shown on a return specified in paragraph (a)(1) of this section that is not so shown (including an assessment made pursuant to section 6213(b)) within 21 calendar days from the date of the notice and demand (10 business days if the amount assessed and shown on the notice and demand equals or exceeds $100,000) with respect to any notice and demand made after December 31, 1996, there will be added to the amount stated in the notice and demand the amount specified below unless the failure to pay the tax within the prescribed time is shown to the satisfaction of the district director or the director of the service center to be due to reasonable cause and not to willful neglect. The amount added to the tax is 0.5 percent of the amount stated in the notice and demand if the failure is for not more than 1 month, with an additional 0.5 percent for each additional month or fraction thereof during which the failure continues, but not to exceed 25 percent in the aggregate. For purposes of this paragraph (a)(3), see §301.6601–1(f)(5) for the definition of *calendar day* and *business day*.

* * * * *

(g) *Treatment of returns prepared by the Secretary*—(1) *In general.* A return prepared by the Secretary under section 6020(b) will be disregarded for purposes of determining the amount of the addition to tax for failure to file any return pursuant to paragraph (a)(1) of this section.

However, the return prepared by the Secretary will be treated as a return filed by the taxpayer for purposes of determining the amount of the addition to tax for failure to pay the tax shown on any return and for failure to pay the tax required to be shown on a return that is not so shown pursuant to paragraphs (a)(2) and (3) of this section, respectively.

(2) *Effective date.* This paragraph (g) applies to returns the due date for which (determined without regard to extensions) is after July 30, 1996.

Par. 7. Section 301.6656–3 is added to read as follows:

§301.6656–3 Abatement of penalty.

(a) *Exception for first time depositors of employment taxes*—(1) *Waiver.* The Secretary will generally waive the penalty imposed by section 6656(a) on a person's failure to deposit any employment tax under subtitle C of the Internal Revenue Code if—

(i) The failure is inadvertent;

(ii) The person meets the requirements referred to in section 7430(c)(4)(A)(ii) (relating to the net worth requirements applicable for awards of attorney's fees);

(iii) The failure occurs during the first quarter that the person is required to deposit any employment tax; and

(iv) The return of the tax is filed on or before the due date.

(2) *Inadvertent failure.* For purposes of paragraph (a)(1)(i) of this section, the Secretary will determine if a failure to deposit is inadvertent based on all the facts and circumstances.

(b) *Deposit sent to Secretary.* The Secretary may abate the penalty imposed by section 6656(a) if the first time a depositor is required to make a deposit, the amount required to be deposited is inadvertently sent to the Secretary instead of to the appropriate government depository.

(c) *Effective date.* This section applies to deposits required to be made after July 30, 1996.

Par. 8. n §301.7122–1, paragraph (e) is revised to read as follows:

§301.7122–1 Compromises.

* * * * *

(e) *Record*—(1) *In general.* If an offer in compromise is accepted, there will be placed on file the opinion of the Chief Counsel of the IRS with respect to the compromise, with the reasons for the opinion, and including a statement of—

(i) The amount of tax assessed;

(ii) The amount of interest, additional amount, addition to the tax, or assessable penalty, imposed by law on the person against whom the tax is assessed; and

(iii) The amount actually paid in accordance with the terms of the compromise.

(2) *Exception.* For compromises accepted on or after July 30, 1996, no opinion will be required with respect to the compromise of any civil case in which the unpaid amount of tax assessed (including any interest, additional amount, addition to the tax, or assessable penalty) is less than $50,000. However, the compromise will be subject to continuing quality review by the Secretary.

* * * * *

Par 9. Section 301.7430–0 is amended by adding entries for §§301.7430–1(b)(4) and 301.7430–5(c)(3) to read as follows:

§301.7430–0 Table of contents.

* * * * *

§301.7430–1 Exhaustion of administrative remedies.

* * * * *

(b) * * *

(4) Failure to agree to extension of time for assessments.".

* * * * *

§301.7430–5 Prevailing party.

* * * * *

(c) * * *

(3) Presumption.

* * * * *

Par. 10. Section 301.7430–1 is amended by adding paragraph (b)(4) to read as follows:

§301.7430–1 Exhaustion of administrative remedies.

* * * * *

(b) * * *

(4) Failure to agree to extension of time for assessments. Any failure by the prevailing party to agree to an extension of the time for the assessment of any tax will not be taken into account for purposes of determining whether the prevailing party has exhausted the administrative remedies available to the party within the Internal Rrevenue Service.

* * * * *

Par. 11. Section 301.7430–2 is amended by:

1. Removing the language "7430(c)-(4)(B)(ii)" from the third sentence of paragraph (b)(2) and adding "7430(c)(4)-(C)(ii)" in its place.

2. The introductory text of paragraph (c)(3) is amended by removing the colon and adding a dash in its place.

3. Revising paragraph (c)(3)(i)(B).

4. Removing the language "If more than $75" from paragraph (c)(3)(ii)(C) and adding "In the case of administrative proceedings commenced after July 30, 1996, if more than $110" in its place.

The revision reads as follows:

§301.7430–2 Requirements and procedures for recovery of reasonable administrative costs.

* * * * *

(c) * * *

(3) * * *

(i) * * *

(B) A clear and concise statement of the reasons why the taxpayer alleges that the position of the Internal Revenue Service in the administrative proceeding was not substantially justified. For administrative proceedings commenced after July 30, 1996, if the taxpayer alleges that the Internal Revenue Service did not follow any applicable published guidance, the statement must identify all applicable published guidance that the taxpayer alleges that the Internal Revenue Service did not follow. For purposes of this paragraph (c)(3)(i)(B), the term applicable published guidance means final or temporary regulations, revenue rulings, revenue procedures, information releases, notices, announcements, and, if issued to the taxpayer, private letter rulings, technical advice memoranda, and determination letters. Also, for purposes of this paragraph (c)(3)(i)(B), the term administrative proceeding includes only those administrative proceedings or portions of administrative proceedings occurring on or after

the administrative proceeding date as defined in §301.7430–3(c);

* * * * *

Par. 12. Section 301.7430–4 is amended by:

1. Removing the language "$75" from paragraph (b)(3)(i) and adding ", in the case of proceedings commenced after July 30, 1996, $110" in its place.

2. Revising paragraph (b)(3)(ii).

3. Removing the language "$75" from the first, second, and third sentences of paragraph (b)(3)(iii)(B) and adding "$110" in its place.

4. Removing the language "$75" from the first sentence of paragraph (b)(3)-(iii)(C) and adding "$110" in its place.

5. Removing the language "$75" from the third sentence of the example in paragraph (b)(3)(iii)(D) and adding "$110" in its place.

6. Removing the language "$75" from the second and third sentences of paragraph (c)(2)(ii) and adding "$110" in its place.

The revision reads as follows:

§301.7430–4 Reasonable administrative costs.

* * * * *

(b) * * *

(3) * * *

(ii) Cost of living adjustment. The Internal Revenue Service will make a cost of living adjustment to the $110 per hour limitation for fees incurred in any calendar year beginning after December 31, 1996. The cost of living adjustment will be an amount equal to $110 multiplied by the cost of living adjustment determined under section 1(f)(3) for the calendar year (substituting "calendar year 1995" for "calendar year 1992" in section 1(f)(3)(B)). If the dollar limitation as adjusted by this cost of living increase is not a multiple of $10, the dollar amount will be rounded to the nearest multiple of $10 (rounding up if the amount is a multiple of $5).

* * * * *

Par. 13. Section 301.7430–5 is amended by:

1. Revising paragraph (a).

2. Adding paragraph (c)(3).

The addition and revision read as follows:

§301.7430–5 Prevailing party.

(a) *In general.* For purposes of an award of reasonable administrative costs under section 7430 in the case of administrative proceedings commenced after July 30, 1996, a taxpayer is a prevailing party only if—

(1) The position of the Internal Revenue Service was not substantially justified;

(2) The taxpayer substantially prevails as to the amount in controversy or with respect to the most significant issue or set of issues presented; and

(3) The taxpayer satisfies the net worth and size limitations referenced in paragraph (f) of this section.

* * * * *

(c) * * *

(3) *Presumption.* If the Internal Revenue Service did not follow any applicable published guidance in an administrative proceeding commenced after July 30, 1996, the position of the IRS, on those issues to which the guidance applies and for all periods during which the guidance was not followed, will be presumed not to be substantially justified. This presumption may be rebutted. For purposes of this paragraph (c)(3), the term applicable published guidance means final or temporary regulations, revenue rulings, revenue procedures, information releases, notices, announcements, and, if issued to the taxpayer, private letter rulings, technical advice memoranda, and determination letters (see §601.601(d)(2) of this chapter). Also, for purposes of this paragraph (c)(3), the term administrative proceeding includes only those administrative proceedings or portions of administrative proceedings occurring on or after the administrative proceeding date as defined in §301.7430–3(c).

* * * * *

Par. 14. Section 301.7430–6 is revised to read as follows:

§301.7430–6 Effective dates.

Sections 301.7430–2 through 301.7430– 6, other than §§301.7430–2(b)(2), (c)(3)(i)(B), (c)(3)(ii)(C), and (c)(5); §§301.7430–4(b)(3)(i), (b)(3)(ii), (b)(3)(iii)(B), (b)(3)(iii)(C), (b)(3)(iii)(D), and (c)(2)(ii); and §§301.7430–5(a) and (c)(3), apply to claims for reasonable administrative costs filed with the Internal Revenue Service after December 23, 1992, with respect to costs incurred in administrative proceedings commenced after November 10, 1988. Section 301.7430–2(c)(5) is applicable March 23, 1993. Section 301.7430–2(b)(2), (c)(3)(i)(B), and (c)(3)(ii)(C); 301.7430–4(b)(3)(i), (b)(3)(ii), (b)(3)(iii)(B), (b)(3)(iii)(C), (b)(3)(iii)(D), and (c)(2)(ii); and 301.7430–5(a) and (c)(3) are applicable for administrative proceedings commenced after July 30, 1996.

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved June 27, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on July 21, 1997, 8:45 a.m., and published in the issue of the Federal Register for July 22, 1997, 62 F.R. 39115)

Chapter 67.—Interest
Subchapter A.—Interest on Underpayments

Section 6601.—Interest on Underpayment, Nonpayment, or Extensions of Time for Payment, of Tax

26 CFR 301.6601–1: Interest on underpayments.

Interest is abated with respect to federal individual income tax returns for certain taxpayers located in Grand Forks County, North Dakota, and Polk County, Minnesota. See Notice 97–62, page 320.

Subchapter C.—Determination of Interest Rate; Compounding of Interest

---

Section 6621.—Determination Rate of Interest

26 CFR 301.6621–1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning October 1, 1997, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interest paid on the portion of a corporate overpayment exceeding $10,000 is 6.5 percent.

Rev. Rul. 97–40

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable rate. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988–1 C.B. 546, announced that in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of July 1997 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning October 1, 1997. The overpayment rate for the portion of corporate overpayments exceeding $10,000 for the calendar quarter beginning October 1, 1997, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning October 1, 1997, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 18, 21, 23, and 27 of Rev. Proc. 95–17, 1995–1 C.B. 556, 572, 575, 577, and 581.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the accompanying tables.

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975 — PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS

PERIOD	RATE	DAILY RATE TABLE IN 1995–1 C.B.
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25, pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES
FROM JAN. 1, 1987—PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
	RATE	TABLE 1995–1 C.B.	PG	RATE	TABLE 1995–1 C.B.	PG
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577

TABLE OF INTEREST RATES FOR
LARGE CORPORATE UNDERPAYMENTS

FROM JANUARY 1, 1991—PRESENT

	RATE	TABLE 1995–1 C.B.	PG
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581

TABLE OF INTEREST RATES FOR CORPORATE
OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995 — PRESENT

	RATE	TABLE 1995–1 C.B	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572

26 CFR 301.6621–1: Interest rate.

Interest rates; underpayments and overpayments. The rate of interest determined under section 6621 of the Code for the calendar quarter beginning January 1, 1998, will be 8 percent for overpayments, 9 percent for underpayments, and 11 percent for large corporate underpayments. The rate of interst paid on the portion of a corporate overpayment exceeding $10,000 is 6.5 percent.

Rev. Rul. 97–53

Section 6621 of the Internal Revenue Code establishes different rates for interest on tax overpayments and interest on tax underpayments. Under § 6621(a)(1), the overpayment rate is the sum of the federal short-term rate plus 2 percentage points, except the rate for the portion of a corporate overpayment of tax exceeding $10,000 for a taxable period is the sum of the federal short-term rate plus 0.5 of a percentage point for interest computations made after December 31, 1994. Under § 6621(a)(2), the underpayment rate is the sum of the federal short-term rate plus 3 percentage points.

Section 6621(c) provides that for purposes of interest payable under § 6601 on any large corporate underpayment, the underpayment rate under § 6621(a)(2) is determined by substituting "5 percentage points" for "3 percentage points." See § 6621(c) and § 301.6621–3 of the Regulations on Procedure and Administration for the definition of a large corporate underpayment and for the rules for determining the applicable date. Section 6621(c) and § 301.6621–3 are generally effective for periods after December 31, 1990.

Section 6621(b)(1) provides that the Secretary will determine the federal short-term rate for the first month in each calendar quarter.

Section 6621(b)(2)(A) provides that the federal short-term rate determined under § 6621(b)(1) for any month applies during the first calendar quarter beginning after such month.

Section 6621(b)(2)(B) provides that in determining the addition to tax under § 6654 for failure to pay estimated tax for any taxable year, the federal short-term rate that applies during the third month following such taxable year also applies during the first 15 days of the fourth month following such taxable year.

Section 6621(b)(3) provides that the federal short-term rate for any month is the federal short-term rate determined during such month by the Secretary in accordance with § 1274(d), rounded to the nearest full percent (or, if a multiple of 1/2 of 1 percent, the rate is increased to the next highest full percent).

Notice 88–59, 1988-1 C.B. 546, announced that, in determining the quarterly interest rates to be used for overpayments and underpayments of tax under § 6621, the Internal Revenue Service will use the federal short-term rate based on daily compounding because that rate is most consistent with § 6621 which, pursuant to § 6622, is subject to daily compounding.

Rounded to the nearest full percent, the federal short-term rate based on daily compounding determined during the month of October 1997 is 6 percent. Accordingly, an overpayment rate of 8 percent and an underpayment rate of 9 percent are established for the calendar quarter beginning January 1, 1998. The overpayment rate for the portion of a corporate overpayment exceeding $10,000 for the calendar quarter beginning January 1, 1998, is 6.5 percent. The underpayment rate for large corporate underpayments for the calendar quarter beginning January 1, 1998, is 11 percent. These rates apply to amounts bearing interest during that calendar quarter.

The 9 percent rate also applies to estimated tax underpayments for the first calendar quarter in 1998 and for the first 15 days in April 1998.

Interest factors for daily compound interest for annual rates of 6.5 percent, 8 percent, 9 percent, and 11 percent are published in Tables 18, 21, 23, and 27 of Rev. Proc. 95–17, 1995–1 C.B. 556, 572, 575, 577, and 581.

Annual interest rates to be compounded daily pursuant to § 6622 that apply for prior periods are set forth in the tables accompanying this revenue ruling.

TABLE OF INTEREST RATES

PERIODS BEFORE JUL. 1, 1975 – PERIODS ENDING DEC. 31, 1986

OVERPAYMENTS AND UNDERPAYMENTS – PERIOD

	RATE	DAILY RATE TABLE IN 1995–1 C.B.
Before Jul. 1, 1975	6%	Table 2, pg. 557
Jul. 1, 1975—Jan. 31, 1976	9%	Table 4, pg. 559
Feb. 1, 1976—Jan. 31, 1978	7%	Table 3, pg. 558
Feb. 1, 1978—Jan. 31, 1980	6%	Table 2, pg. 557
Feb. 1, 1980—Jan. 31, 1982	12%	Table 5, pg. 560
Feb. 1, 1982—Dec. 31, 1982	20%	Table 6, pg. 560
Jan. 1, 1983—Jun. 30, 1983	16%	Table 37, pg. 591
Jul. 1, 1983—Dec. 31, 1983	11%	Table 27, pg. 581
Jan. 1, 1984—Jun. 30, 1984	11%	Table 75, pg. 629
Jul. 1, 1984—Dec. 31, 1984	11%	Table 75, pg. 629
Jan. 1, 1985—Jun. 30, 1985	13%	Table 31, pg. 585
Jul. 1, 1985—Dec. 31, 1985	11%	Table 27, pg. 581
Jan. 1, 1986—Jun. 30, 1986	10%	Table 25 pg. 579
Jul. 1, 1986—Dec. 31, 1986	9%	Table 23, pg. 577

TABLE OF INTEREST RATES

FROM JAN. 1, 1987 – PRESENT

	OVERPAYMENTS			UNDERPAYMENTS		
		RATE TABLE PG 1995–1 C.B.			RATE TABLE PG 1995–1 C.B.	
Jan. 1, 1987—Mar. 31, 1987	8%	21	575	9%	23	577
Apr. 1, 1987—Jun. 30, 1987	8%	21	575	9%	23	577
Jul. 1, 1987—Sep. 30, 1987	8%	21	575	9%	23	577
Oct. 1, 1987—Dec. 31, 1987	9%	23	577	10%	25	579
Jan. 1, 1988—Mar. 31, 1988	10%	73	627	11%	75	629
Apr. 1, 1988—Jun. 30, 1988	9%	71	625	10%	73	627
Jul. 1, 1988—Sep. 30, 1988	9%	71	625	10%	73	627
Oct. 1, 1988—Dec. 31, 1988	10%	73	627	11%	75	629
Jan. 1, 1989—Mar. 31, 1989	10%	25	579	11%	27	581
Apr. 1, 1989—Jun. 30, 1989	11%	27	581	12%	29	583
Jul. 1, 1989—Sep. 30, 1989	11%	27	581	12%	29	583
Oct. 1, 1989—Dec. 31, 1989	10%	25	579	11%	27	581
Jan. 1, 1990—Mar. 31, 1990	10%	25	579	11%	27	581
Apr. 1, 1990—Jun. 30, 1990	10%	25	579	11%	27	581
Jul. 1, 1990—Sep. 30, 1990	10%	25	579	11%	27	581
Oct. 1, 1990—Dec. 31, 1990	10%	25	579	11%	27	581
Jan. 1, 1991—Mar. 31, 1991	10%	25	579	11%	27	581
Apr. 1, 1991—Jun. 30, 1991	9%	23	577	10%	25	579
Jul. 1, 1991—Sep. 30, 1991	9%	23	577	10%	25	579
Oct. 1, 1991—Dec. 31, 1991	9%	23	577	10%	25	579
Jan. 1, 1992—Mar. 31, 1992	8%	69	623	9%	71	625
Apr. 1, 1992—Jun. 30, 1992	7%	67	621	8%	69	623
Jul. 1, 1992—Sep. 30, 1992	7%	67	621	8%	69	623
Oct. 1, 1992—Dec. 31, 1992	6%	65	619	7%	67	621
Jan. 1, 1993—Mar. 31, 1993	6%	17	571	7%	19	573
Apr. 1, 1993—Jun. 30, 1993	6%	17	571	7%	19	573
Jul. 1, 1993—Sep. 30, 1993	6%	17	571	7%	19	573
Oct. 1, 1993—Dec. 31, 1993	6%	17	571	7%	19	573
Jan. 1, 1994—Mar. 31, 1994	6%	17	571	7%	19	573
Apr. 1, 1994—Jun. 30, 1994	6%	17	571	7%	19	573
Jul. 1, 1994—Sep. 30, 1994	7%	19	573	8%	21	575
Oct. 1, 1994—Dec. 31, 1994	8%	21	575	9%	23	577
Jan. 1, 1995—Mar. 31, 1995	8%	21	575	9%	23	577
Apr. 1, 1995—Jun. 30, 1995	9%	23	577	10%	25	579
Jul. 1, 1995—Sep. 30, 1995	8%	21	575	9%	23	577
Oct. 1, 1995—Dec. 31, 1995	8%	21	575	9%	23	577
Jan. 1, 1996—Mar. 31, 1996	8%	69	623	9%	71	625
Apr. 1, 1996—Jun. 30, 1996	7%	67	621	8%	69	623
Jul. 1, 1996—Sep. 30, 1996	8%	69	623	9%	71	625
Oct. 1, 1996—Dec. 31, 1996	8%	69	623	9%	71	625
Jan. 1, 1997—Mar. 31, 1997	8%	21	575	9%	23	577
Apr. 1, 1997—Jun. 30, 1997	8%	21	575	9%	23	577
Jul. 1, 1997—Sep. 30, 1997	8%	21	575	9%	23	577
Oct. 1, 1997—Dec. 31, 1997	8%	21	575	9%	23	577
Jan. 1, 1998—Mar. 31, 1998	8%	21	575	9%	23	577

TABLE OF INTEREST RATES FOR LARGE CORPORATE UNDERPAYMENTS FROM JANUARY 1, 1991 – PRESENT

	RATE	TABLE 1995–1 C.B.	PG
Jan. 1, 1991—Mar. 31, 1991	13%	31	585
Apr. 1, 1991—Jun. 30, 1991	12%	29	583
Jul. 1, 1991—Sep. 30, 1991	12%	29	583
Oct. 1, 1991—Dec. 31, 1991	12%	29	583
Jan. 1, 1992—Mar. 31, 1992	11%	75	629
Apr. 1, 1992—Jun. 30, 1992	10%	73	627
Jul. 1, 1992—Sep. 30, 1992	10%	73	627
Oct. 1, 1992—Dec. 31, 1992	9%	71	625
Jan. 1, 1993—Mar. 31, 1993	9%	23	577
Apr. 1, 1993—Jun. 30, 1993	9%	23	577
Jul. 1, 1993—Sep. 30, 1993	9%	23	577
Oct. 1, 1993—Dec. 31, 1993	9%	23	577
Jan. 1, 1994—Mar. 31, 1994	9%	23	577
Apr. 1, 1994—Jun. 30, 1994	9%	23	577
Jul. 1, 1994—Sep. 30, 1994	10%	25	579
Oct. 1, 1994—Dec. 31, 1994	11%	27	581
Jan. 1, 1995—Mar. 31, 1995	11%	27	581
Apr. 1, 1995—Jun. 30, 1995	12%	29	583
Jul. 1, 1995—Sep. 30, 1995	11%	27	581
Oct. 1, 1995—Dec. 31, 1995	11%	27	581
Jan. 1, 1996—Mar. 31, 1996	11%	75	629
Apr. 1, 1996—Jun. 30, 1996	10%	73	627
Jul. 1, 1996—Sep. 30, 1996	11%	75	629
Oct. 1, 1996—Dec. 31, 1996	11%	75	629
Jan. 1, 1997—Mar. 31, 1997	11%	27	581
Apr. 1, 1997—Jun. 30, 1997	11%	27	581
Jul. 1, 1997—Sep. 30, 1997	11%	27	581
Oct. 1, 1997—Dec. 31, 1997	11%	27	581
Jan. 1, 1998—Mar. 31, 1998	11%	27	581

TABLE OF INTEREST RATES FOR CORPORATE OVERPAYMENTS EXCEEDING $10,000

FROM JANUARY 1, 1995 — PRESENT

	RATE	TABLE 1995–1 C.B	PG
Jan. 1, 1995—Mar. 31, 1995	6.5%	18	572
Apr. 1, 1995—Jun. 30, 1995	7.5%	20	574
Jul. 1, 1995—Sep. 30, 1995	6.5%	18	572
Oct. 1, 1995—Dec. 31, 1995	6.5%	18	572
Jan. 1, 1996—Mar. 31, 1996	6.5%	66	620
Apr. 1, 1996—Jun. 30, 1996	5.5%	64	618
Jul. 1, 1996—Sep. 30, 1996	6.5%	66	620
Oct. 1, 1996—Dec. 31, 1996	6.5%	66	620
Jan. 1, 1997—Mar. 31, 1997	6.5%	18	572
Apr. 1, 1997—Jun. 30, 1997	6.5%	18	572
Jul. 1, 1997—Sep. 30, 1997	6.5%	18	572
Oct. 1, 1997—Dec. 31, 1997	6.5%	18	572

Chapter 68.—Additions to the Tax, Additional Amounts, and Assemble Penalties
Subchapter B.—Assessable Penalties
Part II.—Failure to Comply with Certain Information Reporting Requirements

Section 6721.—Failure To File Correct Information Returns

26 CFR 301.6721–1: Failure to file correct information returns.

What information reporting requirements apply to educational institutions for 1998 under § 6050S of the Code, as added by the Taxpayer Relief Act of 1997, in connection with the Hope Scholarship Credit and the Lifetime Learning Credit. See Notice 97–73, page 335.

Section 6722.—Failure To Furnish Correct Payee Statements

26 CFR 301.6722–1: Failure to furnish correct payee statements.

What information reporting requirements apply to educational institutions for 1998 under § 6050S of the Code, as added by the Taxpayer Relief Act of 1997, in connection with the Hope Scholarship Credit and the Lifetime Learning Credit. See Notice 97–73, page 335.

Chapter 74.—Closing Agreements and Compromises

Section 7121.—Closing Agreements

26 CFR 301.7121–1: Closing agreements.

What is the method by which taxpayers can enter a new IRS process designed to settle IRS-related disputes that are connected with Bankruptcy Court proceedings in order to reduce Bankruptcy Court litigation?

Chapter 76.—Judicial Proceedings
Subchapter B.—Proceedings by Taxpayers and Third Parties

Section 7430.—Awarding of Costs and Certain Fees

The Service provides an inflation adjustment to the hourly limit on attorney fees that may be awarded in a judgment or settlement of an administrative or judicial proceeding concerning the determination, collection, or refund of tax, interest, or penalty for calendar year 1998. See Rev. Proc. 97–57, page 584.

Chapter 77.—Miscellaneous Provisions

Section 7508.—Time for Performing Certain Acts Postponed by Reason of Service in Combat Zone

The time for performing certain acts under the Internal Revenue laws is postponed for certain taxpayers located in Grand Forks County, North Dakota, and Polk County, Minnesota. See Notice 97–62, page 320.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of July 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

Chapter 78.—Discovery of Liability and Enforcement of Title
Subchapter B.—General Powers and Duties

Section 7623.—Expenses of Detection of Underpayments and Fraud, Etc.

26 CFR 301.7623–1: Rewards for information relating to violations of Internal Revenue laws.

T.D. 8737

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 301 and 602

Rewards for Information Relating to Violations of Internal Revenue Laws

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations relating to rewards for information that relates to violations of the internal revenue laws. The regulations reflect changes to the law made by the Taxpayer Bill of Rights 2 and affect persons that are eligible to receive an informant's reward.

The text of these regulations also serves as the text of the proposed regulations set forth in REG–252936–96, page 643.

DATE: These regulations are effective October 14, 1997.

For dates of applicability, see §301.7623–1T(g).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

These regulations are being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collections of information contained in these regulations have been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget under control number 1545–1534. Responses to the collection of information are voluntary with respect to the provision of information relating to violations of the internal revenue laws, but are required to obtain a benefit with respect to filing a claim for reward.

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

For further information concerning these collections of information, and where to submit comments on the collections of information and the accuracy of

the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-referencing notice of proposed rulemaking published in REG–252936–96.

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

Background

This document contains amendments to the Procedure and Administration Regulations (26 CFR part 301) under section 7623 relating to rewards for information that relates to violations of the internal revenue laws. This section was amended by section 1209 of the Taxpayer Bill of Rights 2 (TBOR 2) (Public Law 104–168, 110 Stat. 1452 (1996)).

Explanation of Provisions

Section 7623 provides the Secretary with the authority, by regulation, to pay rewards for information that relates to violations of the internal revenue laws. Section 1209 of TBOR 2 amended section 7623 to clarify that rewards may be paid for information relating to civil, as well as criminal, violations. TBOR 2 also provided that the rewards are to be paid out of the proceeds of amounts (other than interest) collected by reason of the information. These temporary regulations reflect those amendments.

In addition, these temporary regulations incorporate and update §301.7623– 1. For example, the regulations increase the limit on awards from 10% to 15% and provide new titles and addresses to which persons should submit information relating to violations of the internal revenue laws.

Special Analyses

It has been determined that this Treasury Decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that the regulations in this document will not have a significant economic impact on a substantial number of small entities. This certification is based on a determination that in the past approximately 10,000 persons have filed claims for reward on an annual basis. Of these persons, almost all have been individuals. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, this Treasury Decision will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small businesses.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 301 and 602 are 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. §301.7623–1 is amended by adding paragraph (g) to read as follows:

§301.7623–1 Rewards for information relating to violations of internal revenue laws.

* * * * *

(g) *Effective date.* This section is applicable with respect to rewards paid on or before January 29, 1997. See §301.7623–1T for rewards paid after January 29, 1997.

Par. 3. Section 301.7623–1T is added to read as follows:

§301.7623–1T Rewards for information relating to violations of internal revenue laws (temporary).

(a) *In general.* In cases where rewards are not otherwise provided for by law, a district or service center director may approve a reward, in a suitable amount, for information that leads to the detection of underpayments of tax, or the detection and bringing to trial and punishment of persons guilty of violating the internal revenue laws or conniving at the same. The rewards provided for by section 7623 and this section will be paid from the proceeds of amounts (other than interest) collected by reason of the information provided.

(b) *Eligibility to file claim for reward—* (1) *In general.* Any person, other than certain present or former federal employees described in paragraph (b)(2) of this section, that submits, in the manner described in paragraph (d) of this section, information relating to the violation of an internal revenue law is eligible to file a claim for reward under section 7623 and this section.

(2) *Federal employees.* No person who was an officer or employee of the Department of the Treasury at the time the individual came into possession of information relating to violations of the internal revenue laws, or at the time the individual divulged such information, is eligible for a reward under section 7623 and this section. Any other current or former federal employee is eligible to file a claim for reward if the information provided came to the individual's knowledge other than in the course of the individual's official duties.

(3) *Deceased informants.* A claim for reward may be filed by an executor, administrator, or other legal representative on behalf of a deceased informant if, prior to the informant's death, the informant was eligible to file a claim for such reward under section 7623 and this section. Certified copies of the letters testamentary, letters of administration, or other similar evidence must be attached to the claim for reward on behalf of a deceased informant in order to show the authority of the legal representative to file the claim.

(c) *Amount and payment of reward.* All relevant factors, including the value of the information furnished in relation to the facts developed by the investigation of the violation, will be taken into account by a district or service center director in determining whether a reward will be paid, and, if so, the amount of the reward. The amount of a reward will represent what the district or service center director deems to be adequate compensation in the particular case, generally not to exceed fifteen percent of the amounts (other than interest) collected by reason of the information. Payment of a reward will be made as promptly as the circumstances of the case permit, but not until the taxes,

penalties, or fines involved have been collected. However, if the informant waives any claim for reward with respect to an uncollected portion of the taxes, penalties, or fines involved, the claim may be immediately processed. Partial reward payments, without waiver of the uncollected portion of the taxes, penalties, or fines involved, may be made when a criminal fine has been collected prior to completion of the civil aspects of a case, and also when there are multiple tax years involved and the deficiency for one or more of the years has been paid in full. No person is authorized under these regulations to make any offer, or promise, or otherwise to bind a district or service center director with respect to the payment of any reward or the amount of the reward.

(d) *Submission of information.* A person that desires to claim a reward under section 7623 and this section may submit information relating to violations of the internal revenue laws, in person, to the office of a district director, preferably to a representative of the Criminal Investigation Division. Such information may also be submitted in writing to the Commissioner of Internal Revenue, Attention: Assistant Commissioner (Criminal Investigation), 1111 Constitution Avenue, NW, Washington, DC 20224, to any district director, Attention: Chief, Criminal Investigation Division, or to any service center director. If the information is submitted in person, either orally or in writing, the name and official title of the person to whom it is submitted and the date on which it is submitted must be included in the formal claim for reward.

(e) *Identification of informant.* No unauthorized person will be advised of the identity of an informant.

(f) *Filing claim for reward.* An informant that intends to claim a reward under section 7623 and this section should notify the person to whom the information is submitted of such intention, and must file a formal claim on Form 211, Application for Reward for Original Information, signed by the informant in the informant's true name, as soon as practicable after the submission of the information. If other than the informant's true name was used in furnishing the information, satisfactory proof of identity as that of the informant must be included with the claim for reward.

(g) *Effective date.* This section is applicable with respect to rewards paid after January 29, 1997. See §301.7623–1 for rewards paid on or before January 29, 1997.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

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

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (c) is amended by adding anentry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(c) * * *

CFR part or section where identified and described	Current OMB control Number
* * * * *	
301.7623–1T	1545–1534
* * * * *	

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

Approved August 26, 1997.

Donald C. Lubick,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on October 10, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 14, 1997, 62 F.R. 53230)

Chapter 79.—Definitions

Section 7702B.—Treatment of Qualified Long-Term Care Insurance

The Service provides an inflation adjustment to the stated dollar amount of the per diem limitation regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual for calendar year 1998. See Rev. Proc. 97–57, page 584.

Chapter 80.—General Rules
Subchapter A.—Application of Internal Revenue Laws

Section 7805.—Rules and Regulations

26 CFR 301.7805–1: Rules and regulations.

Questions and answers about the application of section 475 and the regulations thereunder. See Rev. Rul. 97–39, page 62.

Subchapter C.—Provisions Affecting More Than One Subtitle

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 1997. See Rev. Rul. 97–27, page 97.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of August 1997. See Rev. Rul. 97–30, page 99.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of September 1997. See Rev. Rul. 97–36, page 101.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 1997. See Rev. Rul. 97–41, page 102.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of November 1997. See Rev. Rul. 97–44, page 104.

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of December 1997. See Rev. Rul. 97–50, page 106.

CPI adjustment for below-market loans–1998. The amount that section 7872(g) of the Code permits a taxpayer to lend to a qualified continuing care facility without incurring imputed interest is published and adjusted for inflation for years 1987–1998. Rev. Rul. 96–64 supplemented and superseded.

Rev. Rul. 97–57

This revenue ruling publishes the amount that § 7872(g) of the Internal Revenue Code permits a taxpayer to lend to a qualifying continuing care facility

without incurring imputed interest. The amount is adjusted for inflation for the years after 1986.

Section 7872 of the Code generally treats loans bearing a below-market interest rate as if they bore interest at the market rate.

Section 7872(g)(1) of the Code provides that, in general, § 7872 does not apply for any calendar year to any below-market loan made by a lender to a qualified continuing care facility pursuant to a continuing care contract if the lender (or the lender's spouse) attains age 65 before the close of the year.

Section 7872(g)(2) of the Code provides that, in the case of loans made after October 11, 1985, and before 1987, § 7872(g)(1) applies only to the extent that the aggregate outstanding amount of any loan to which § 7872(g) applies (determined without regard to § 7872(g)(2)), when added to the aggregate outstanding amount of all other previous loans between the lender (or the lender's spouse) and any qualified continuing care facility to which § 7872(g)(1) applies, does not exceed $90,000.

Section 7872(g)(5) of the Code provides that, for loans made during any calendar year after 1986 to which § 7872-(g)(1) applies, the $90,000 limit specified in § 7872(g)(2) is increased by an inflation adjustment. The inflation adjustment for any calendar year is the percentage (if any) by which the Consumer Price Index (CPI) for the preceding calendar year exceeds the CPI for calendar year 1985. Section 7872(g)(5) states that the CPI for any calendar year is the average of the CPI as of the close of the 12-month period ending on September 30 of that calendar year.

Rev. Rul. 96–64, 1996-2 C.B. 199, publishes the amount specified in § 7872(g)(2) of the Code, increased by the inflation adjustment, for the years 1987-97.

Table 1 sets forth the amount specified in § 7872(g)(2) of the Code. The amount is increased by the inflation adjustment for the years 1987–98.

REV. RUL. 97–57 TABLE 1

Limit under 7872(g)(2)

Year	Amount
Before 1987	$ 90,000
1987	$ 92,200
1988	$ 94,800
1989	$ 98,800
1990	$103,500
1991	$108,600
1992	$114,100
1993	$117,500
1994	$121,100
1995	$124,300
1996	$127,800
1997	$131,300
1998	$134,800

Note: These inflation adjustments were computed using the All-Urban, Consumer Price Index 1982-1984 base, published by the Bureau of Labor Statistics.

EFFECT ON OTHER DOCUMENTS

Rev. Rul. 96–64, 1996–2 C.B. 199, is supplemented and superseded.

Part II. Treaties and Tax Legislation

CONTENTS

Subpart B.—Legislation and Related Committee Reports

Public Law 105–35
105th Congress, H.R. 1226
August 5, 1997

An Act to amend the Internal Revenue Code of 1986 to prevent the unauthorized inspection of tax returns or tax returns information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Taxpayer Browsing Protection Act."

SEC. 2. PENALTY FOR UNAUTHORIZED INSPECTION OF TAX RETURNS OR TAX RETURN INFORMATION.

(a) IN GENERAL.—Part I of subchapter A of chapter 75 of the Internal Revenue Code of 1986 (relating to crimes, other offenses, and forfeitures) is amended by adding after section 7213 the following new section:

"SEC. 7213A. UNAUTHORIZED INSPECTION OF RETURNS OR RETURN INFORMATION.

"(a) PROHIBITIONS.—

"(1) FEDERAL EMPLOYEES AND OTHER PERSONS.—It shall be unlawful for—

"(A) any officer or employee of the United States, or

"(B) any person described in section 6103(n) or an officer or employee of any such person,

willfully to inspect, except as authorized in this title, any return or return information.

"(2) STATE AND OTHER EMPLOYEES.—It shall be unlawful for any person (not described in paragraph (1)) willfully to inspect, except as authorized in this title, any return or return information acquired by such person or another person under a provision of section 6103 referred to in section 7213(a)(2).

"(b) PENALTY.—

"(1) IN GENERAL.—Any violation of subsection (a) shall be punishable upon conviction by a fine in any amount not exceeding $1,000, or imprisonment of not more than 1 year, or both, together with the costs of prosecution.

"(2) FEDERAL OFFICERS OR EMPLOYEES.—An officer or employee of the United States who is convicted of any violation of subsection (a) shall, in addition to any other punishment, be dismissed from office or discharged from employment.

"(c) DEFINITIONS.—For purposes of this section, the terms 'inspect', 'return', and 'return information' have the respective meanings given such terms by section 6103(b).".

(b) TECHNICAL AMENDMENTS.—

(1) Paragraph (2) of section 7213(a) of such Code is amended by inserting "(5)," after "(m)(2), (4),".

(2) The table of sections for part I of subchapter A of chapter 75 of such Code 1986 is amended by inserting after the item relating to section 7213 the following new item:

"Sec. 7213A. Unauthorized inspection of returns or return information.".

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to violations occurring on and after the date of the enactment of this Act.

SEC. 3. CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION OF RETURNS AND RETURN INFORMATION; NOTIFICATION OF UNLAWFUL INSPECTION OR DISCLOSURE.

(a) CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION.—Subsection (a) of section 7431 of the Internal Revenue Code of 1986 is amended—

(1) by striking "DISCLOSURE" in the headings for paragraphs (1) and (2) and inserting "INSPECTION OR DISCLOSURE", and

(2) by striking "discloses" in paragraphs (1) and (2) and inserting "inspects or discloses".

(b) NOTIFICATION OF UNLAWFUL INSPECTION OR DISCLOSURE.—Section 7431 of such Code is amended by redesignating subsections (e) and (f) as subsections (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

"(e) NOTIFICATION OF UNLAWFUL INSPECTION AND DISCLOSURE.—If any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of—

"(1) paragraph (1) or (2) of section 7213(a),

"(2) section 7213A(a), or

"(3) subparagraph (B) of section 1030(a)(2) of title 18, United States Code,

the Secretary shall notify such taxpayer as soon as practicable of such inspection or disclosure.".

(c) NO DAMAGES FOR INSPECTION REQUESTED BY TAXPAYER.—Subsection (b) of section 7431 of such Code is amended to read as follows:

"(b) EXCEPTIONS.—No liability shall arise under this section with respect to any inspection or disclosure—

"(1) which results from a good faith, but erroneous, interpretation of section 6103, or

"(2) which is requested by the taxpayer.".

(d) CONFORMING AMENDMENTS.—

(1) Subsections (c)(1)(A), (c)(1)(B)(i), and (d) of section 7431 of such Code are each amended by inserting "inspection or" before "disclosure".

(2) Clause (ii) of section 7431(c)(1)(B) of such Code is amended by striking "willful disclosure or a disclosure" and inserting "willful inspection or disclosure or an inspection or disclosure".

(3) Subsection (f) of section 7431 of such Code, as redesignated by subsection (b), is amended to read as follows:

"(f) DEFINITIONS.—For purposes of this section, the terms 'inspect', 'inspection', 'return', and 'return information' have the respective meanings given such terms by section 6103(b).".

(4) The section heading for section 7431 of such Code is amended by inserting "INSPECTION OR" before "DISCLOSURE".

(5) The table of sections for subchapter B of chapter 76 of such Code is amended by inserting "inspection or" before "disclosure" in the item relating to section 7431.

(6) Paragraph (2) of section 7431(g) of such Code, as redesignated by subsection (b), is amended by striking "any use" and inserting "any inspection or use".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to inspections and disclosures occurring on and after the date of the enactment of this Act.

Approved August 5, 1997.

105th Congress 1st Session | **HOUSE OF REPRESENTATIVES** | **Report 105–51**

TAXPAYER BROWSING PROTECTION ACT

APRIL 14, 1997.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. ARCHER, from the Committee on Ways and Means, submitted the following

REPORT

[To accompany H.R. 1226]

[Including cost estimate of the Congressional Budget Office]

The Committee on Ways and Means, to whom was referred the bill (H.R. 1226) to amend the Internal Revenue Code of 1986 to prevent the unauthorized inspection of tax returns or tax return information, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

CONTENTS

The amendment is as follows:

At the end of the bill insert the following new section:

SEC. 3. CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION OF RETURNS AND RETURN INFORMATION; NOTIFICATION OF UNLAWFUL INSPECTION OR DISCLOSURE.

(a) CIVIL DAMAGES FOR UNAUTHORIZED INSPECTION.—Subsection (a) of section 7431 of the Internal Revenue Code of 1986 is amended—

(1) by striking "DISCLOSURE" in the headings for paragraphs (1) and (2) and inserting "INSPECTION OR DISCLOSURE", and

(2) by striking "discloses" in paragraphs (1) and (2) and inserting "inspects or discloses".

(b) NOTIFICATION OF UNLAWFUL INSPECTION OR DISCLOSURE.—Section 7431 of such Code is amended by redesignating subsections (e) and (f) as subsections (f) and (g), respectively, and by inserting after subsection (d) the following new subsection:

"(e) NOTIFICATION OF UNLAWFUL INSPECTION AND DISCLOSURE.—If any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of—

"(1) paragraph (1) or (2) of section 7213(a),

"(2) section 7213A(a), or

"(3) subparagraph (B) of section 1030(a)(2) of title 18, United States Code,

the Secretary shall notify such taxpayer as soon as practicable of such inspection or disclosure.".

(c) NO DAMAGES FOR INSPECTION REQUESTED BY TAXPAYER.—Subsection (b) of section 7431 of such Code is amended to read as follows:

"(b) EXCEPTIONS.—No liability shall arise under this section with respect to any inspection or disclosure—

"(1) which results from a good faith, but erroneous, interpretation of section 6103, or

"(2) which is requested by the taxpayer.".

(d) CONFORMING AMENDMENTS.—

(1) Subsections (c)(1)(A), (c)(1)(B)(i), and (d) of section 7431 of such Code are each amended by inserting "inspection or" before "disclosure".

(2) Clause (ii) of section 7431(c)(1)(B) of such Code is amended by striking "willful disclosure or a disclosure" and inserting "willful inspection or disclosure or an inspection or disclosure".

(3) Subsection (f) of section 7431 of such Code, as redesignated by subsection (b), is amended to read as follows:

"(f) DEFINITIONS.—For purposes of this section, the terms 'inspect', 'inspection', 'return', and 'return information' have the respective meanings given such terms by section 6103(b).".

(4) The section heading for section 7431 of such Code is amended by inserting "INSPECTION OR" before "DISCLOSURE".

(5) The table of sections for subchapter B of chapter 76 of such Code is amended by inserting "inspection or" before "disclosure" in the item relating to section 7431.

(6) Paragraph (2) of section 7431(g) of such Code, as redesignated by subsection (b), is amended by striking "any use" and inserting "any inspection or use".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to inspections and disclosures occurring on and after the date of the enactment of this Act.

I. SUMMARY AND BACKGROUND

A. SUMMARY

H.R. 1226, as reported by the Committee on Ways and Means, provides for a criminal penalty for unauthorized willful inspection ("browsing") of tax returns and return information. The bill provides for civil damages for unauthorized inspection, and also contains a notification requirement.

B. BACKGROUND AND REASONS FOR LEGISLATION

Widespread indications of browsing have made it imperative that Congress create a criminal penalty in the Internal Revenue Code to penalize this behavior.

C. LEGISLATIVE HISTORY

Committee bill

H.R. 1226 was introduced by Chairman Archer (for himself, Ms. Dunn, Mr. Rangel, Mrs. Johnson of Connecticut, Mr. Coyne, Mr. Thomas, Mr. Herger, Mr. Camp, Mr. Ensign, Mr. Hayworth, Mr. Weller, Mrs. Kennelly of Connecticut, Mr. Levin, Mr. Kleczka, Mr. Lewis of Georgia, Mr. Neal of Massachusetts, Mr. Jefferson, Mr. Tanner, Mrs. Thurman, and Mr. Portman) on April 8, 1997. The bill was considered in a Committee on Ways and Means markup on April 9, 1997, and was ordered favorably reported, with an amendment, by voice vote.

II. EXPLANATION OF THE BILL

PRESENT LAW

The Internal Revenue Code prohibits disclosure of tax returns and return information, except to the extent specifically authorized by the Internal Revenue Code (sec. 6103). Unauthorized willful disclosure is a felony punishable by a fine not exceeding $5,000 or imprisonment of not more than five years, or both (sec. 7213). An action for civil damages also may be brought for unauthorized disclosure (sec. 7431).

There is no explicit criminal penalty in the Internal Revenue Code for unauthorized inspection (absent subsequent disclosure) of tax returns and return information. Such inspection is, however, explicitly prohibited by the Internal Revenue Service ("IRS").[1] In a recent case, an individual was convicted of violating the Federal wire fraud statute (18 U.S.C. 1343 and 1346) and a Federal computer fraud statute (18 U.S.C. 1030) for unauthorized inspection. However, the U.S. First Circuit Court of Appeals overturned this conviction.[2] Unauthorized inspection of information of any department or agency of the United States (including the IRS) via computer was made a crime under 18 U.S.C. 1030 by the Economic Espionage Act of 1996.[3] This provision does not apply to unauthorized inspection of paper documents.

REASONS FOR CHANGE

The Committee believes that it is important to have a criminal penalty in the Internal Revenue Code to punish this type of behavior. The Committee also believes that it is appropriate to provide for civil damages for unauthorized inspection parallel to civil damages for unauthorized disclosure.

EXPLANATION OF PROVISIONS

Criminal penalties (sec. 2 of the bill and new sec. 7213A of the Code)

The bill creates a new criminal penalty in the Internal Revenue Code. The penalty is imposed for willful inspection (except as authorized by the Code) of any tax return or return information by any Federal employee or IRS contractor. The penalty also applies to willful inspection (except as authorized) by any State employee or other person who acquired the tax return or return information under specific provisions of section 6103. Upon conviction, the penalty is a fine in any amount not exceeding $1,000,[4] or imprisonment of not more than 1 year, or both, together with the costs of prosecution. In addition, upon conviction, an officer or employee of the United States would be dismissed from office or discharged from employment.

The Congress views any unauthorized inspection of tax return information as a very serious offense; this new criminal penalty reflects that view. The Congress also believes that unauthorized inspection warrants very serious personnel sanctions against IRS employees who engage in unauthorized inspection, and that it is appropriate to fire employees who do this.

Civil damages (sec. 3 of the bill and sec. 7431 of the Code)

The bill amends the provision providing for civil damages for unauthorized disclosure by also providing for civil damages for unauthorized inspection. Damages are available for unauthorized inspection that occurs either knowingly or by reason of negligence. Accidental or inadvertent inspection that may occur (such as, for example, by making an error in typing in a TIN) would not be subject to damages because it would not meet this standard. The bill also provides that no damages are available to a taxpayer if that taxpayer requested the inspection or disclosure.

The bill also requires that, if any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of section 7213(a) or (b), section 7213A (as added by the bill), or 18 U.S.C. section 1030 (a)(2)(B), the Secretary notify that taxpayer as soon as practicable of the inspection or disclosure.

EFFECTIVE DATE

The bill is effective for violations occurring on or after the date of enactment.

III. VOTE OF THE COMMITTEE

In compliance with clause 2(l)(2)(B) of rule XI of the Rules of the House of Representatives, the following statement is made concerning the vote on the motion to report the bill. The bill (H.R. 1226) was ordered favorably reported, as amended by voice vote on April 9, 1997, with a quorum present.

IV. BUDGET EFFECTS OF THE BILL

A. COMMITTEE ESTIMATES

In compliance with clause 7(a) of rule XIII of the Rules of the House of Representatives, the following statement is made concerning the estimated budget effects of the bill as reported.

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[1] IRS Declaration of Privacy Principles, May 9, 1994.

[2] *U.S.* v. *Czubinski,* DTR 2/25/97, p. K–2.

[3] P.L. 104–294, sec. 201 (October 11, 1996).

[4] Pursuant to 18 U.S.C. sec. 3571 (added by the Sentencing Reform Act of 1984), the amount of the fine is not more than the greater of the amount specified in this new Code section or $100,000.

The bill, as reported, is estimated to have an indeterminate revenue effect.

B. BUDGET AUTHORITY AND TAX EXPENDITURES

Budget authority

In compliance with subdivision (B) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the provisions of the bill as reported involve no new or increased budget authority.

Tax expenditures

In compliance with subdivision (B) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee states that the provisions of the bill as reported involve no new or increased tax expenditures.

C. COST ESTIMATE PREPARED BY THE CONGRESSIONAL BUDGET OFFICE

In compliance with subdivision (C) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, requiring cost estimate prepared by the Congressional Budget Office, the Committee advises that the Congressional Budget Office has submitted the following Statement on this bill.

U.S. CONGRESS,
CONGRESSIONAL BUDGET OFFICE,
Washington, DC, April 11, 1997.

Hon. BILL ARCHER,
Chairman, Committee on Ways and Means, House of Representatives, Washington, DC.

DEAR MR. CHAIRMAN: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 1226, the Taxpayer Browsing Protection Act.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Mark Grabowicz.

Sincerely,

JUNE E. O'NEILL, *Director.*

Enclosure.

H.R. 1226—Taxpayer Browsing Protection Act

H.R. 1226 would ban the authorized inspection of federal tax returns or tax return information. Violators of the bill's provisions would be subject to a criminal fine and imprisonment. In addition, H.R. 1226 would permit taxpayers whose returns are unlawfully inspected to bring a civil action against the United States.

CBO estimates that enacting this legislation would have no significant impact on the federal budget. While the bill could lead to increases in both direct spending and receipts, the amounts involved would be less than $500,000 a year. Because H.R. 1226 could affect direct spending and receipts, pay-as-you-go procedures would apply.

Enacting H.R. 1226 could increase government receipts from criminal fines. Such fines would be deposited in the Crime Victims Fund and would be spent in the following year. Thus, direct spending from the fund would match the increase in revenues with a one-year lag. In any case, CBO estimates that the criminal fines would likely total less than $500,000 a year.

Enacting this legislation also could increase civil actions by taxpayers against the Internal Revenue Service. Successful litigants would be paid from a permanent, indefinite appropriation for Claims, Judgments, and Relief Acts. CBO estimates that any increase in direct spending from such payments also would total less than $500,000 annually.

H.R. 1226 contains no intergovernmental or private-sector mandates as defined in the Unfunded Mandates Reform Act of 1995 and would not impose costs on state, local, or tribal governments.

The CBO staff contact for this estimate is Mark Grabowicz. This estimate was approved by Robert A. Sunshine, Deputy Assistant Director for Budget Analysis.

V. OTHER MATTERS TO BE DISCUSSED UNDER THE RULES OF THE HOUSE

A. COMMITTEE OVERSIGHT FINDINGS AND RECOMMENDATIONS

With respect to subdivision (A) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives (relating to oversight findings), the Committee advises that it was the result of the Committee's oversight activities concerning reports of unauthorized "browsing" of taxpayer's returns and return information by Internal Revenue Service personnel that the Committee concluded that it is appropriate to enact the provisions contained in the bill as reported.

B. SUMMARY OF FINDINGS AND RECOMMENDATIONS OF THE COMMITTEE ON GOVERNMENT REFORM AND OVERSIGHT

With respect to subdivision (D) of clause 2(l)(3) of rule XI of the Rules of the House of Representatives, the Committee advises that no oversight findings or recommendations have been submitted to this Committee by the Committee on Government Reform and Oversight with respect to the provisions contained in the bill.

C. CONSTITUTIONAL AUTHORITY STATEMENT

With respect to clause 2(l)(4) of Rule XI of the Rules of the House of Representatives (relating to Constitutional Authority), the Committee states that the Committee's action in reporting this bill is derived from Article I of the Constitution, Section 7 ("All bills for raising revenue shall originate in the House of Representatives") and Section 8 ("The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts * * * of the United States").

D. INFORMATION RELATING TO UNFUNDED MANDATES

This information is provided in accordance with section 423 of the Unfunded Mandates Act of 1995 (P.L. 104–4).

The Committee has determined that the provisions of the bill do not impose a Federal mandate on the private sector nor a Federal intergovernmental mandate. Thus, the provisions of the bill do not affect the competitive balance between the private sector and State, local, and tribal government.

E. APPLICABILITY OF HOUSE RULE XXI5(C)

Rule XXI5(c) of the Rules of the House of Representatives provides, in part, that "No bill or joint resolution, amendment, or conference report carrying a Federal income tax rate increase shall be considered as passed or agreed to unless so determined by a vote of not less than three-fifths of the Members." The Committee has carefully reviewed the provisions of the bill, and states that the provisions of the bill do not involve any Federal income tax rate increase within the meaning of the rule.

VI. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3 of Rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman).

INTERNAL REVENUE CODE OF 1986

* * * * * * *

Subtitle F–Procedure and Administration

* * * * * * *

CHAPTER 75—CRIMES, OTHER OFFENSES, AND FORFEITURES

Subchapter A—Crimes

PART I—GENERAL PROVISIONS

Sec. 7201. Attempt to evade or defeat tax.

* * * * * * *

Sec. 7213A. Unauthorized inspection of returns or return information.

* * * * * * *

SEC. 7213. UNAUTHORIZED DISCLOSURE OF INFORMATION.

(a) RETURNS AND RETURN INFORMATION.—

(1) * * *

(2) STATE AND OTHER EMPLOYEES.—It shall be unlawful for any person (not described in paragraph (1)) willfully to disclose to any person, except as authorized in this title, any return or return information (as defined in section 6103(b)) acquired by him or another person under subsection (d), (i)(3)(B)(i), (l)(6), (7), (8), (9), (10), (12), or (15) or (m)(2), (4), *(5)*, (6), or (7) of section 6103. Any violation of this paragraph shall be a felony punishable by a fine in any amount not exceeding $5,000, or imprisonment of not more than 5 years, or both, together with the costs of prosecution.

* * * * * * *

SEC. 7213A. UNAUTHORIZED INSPECTION OF RETURNS OR RETURN INFORMATION.

(a) PROHIBITIONS.—

(1) FEDERAL EMPLOYEES AND OTHER PERSONS.—It shall be unlawful for—

(A) any officer or employee of the United States, or

(B) any person described in section 6103(n) or an officer or employee of any such person,

willfully to inspect, except as authorized in this title, any return or return information.

(2) STATE AND OTHER EMPLOYEES.—It shall be unlawful for any person (not described in paragraph (1)) willfully to inspect, except as authorized in this title, any return or return information acquired by such person or another person under a provision of section 6103 referred to in section 7213(a)(2).

(b) PENALTY.—

(1) IN GENERAL.—Any violation of subsection (a) shall be punishable upon conviction by a fine in any amount not exceeding $1,000, or imprisonment of not more than 1 year, or both, together with the costs of prosecution.

(2) FEDERAL OFFICERS OR EMPLOYEES.—An officer or employee of the United States who is convicted of any violation of subsection (a) shall, in addition to any other punishment, be dismissed from office or discharged from employment.

(c) DEFINITIONS.—For purposes of this section, the terms "inspect", "return", and "return information" have the respective meanings given such terms by section 6103(b).

* * * * * * *

CHAPTER 76—JUDICIAL PROCEEDINGS

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Subchapter B—Proceedings by Taxpayers and Third Parties

Sec. 7421. Prohibition of suits to restrain assessment or collection.

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Sec. 7431. Civil damages for unauthorized *inspection or* disclosure of returns and return information.

* * * * * * *

SEC. 7431. CIVIL DAMAGES FOR UNAUTHORIZED *INSPECTION OR* DISCLOSURE OF RETURNS AND RETURN INFORMATION.

(a) IN GENERAL.—

(1) [DISCLOSURE] *INSPECTION OR DISCLOSURE* BY EMPLOYEE OF UNITED STATES.— If any officer or employee of the United States knowingly, or by reason of negligence, *inspects or* discloses any return or return information with respect to a taxpayer in violation of any provision of section 6103, such taxpayer may bring a civil action for damages against the United States in a district court of the United States.

(2) [DISCLOSURE] *INSPECTION OR DISCLOSURE* BY A PERSON WHO IS NOT AN EMPLOYEE OF UNITED STATES.— If any person who is not an officer or employee of the United States knowingly, or by reason of negligence, *inspects or* discloses any return or return information with respect to a taxpayer in violation of any provision of section 6103, such taxpayer may bring a civil action for damages against such person in a district court of the United States.

[(b) NO LIABILITY FOR GOOD FAITH BUT ERRONEOUS INTERPRETATION.—No liability shall arise under this section with respect to any disclosure which results from a good faith, but erroneous, interpretation of section 6103.]

(b) EXCEPTIONS.—No liability shall arise under this section with respect to any inspection or disclosure—

(1) which results from a good faith, but erroneous, interpretation of section 6103, or

(2) which is requested by the taxpayer.

(c) DAMAGES.—In any action brought under subsection (a), upon a finding of liability on the part of the defendant, the defendant shall be liable to the plaintiff in an amount equal to the sum of—

(1) the greater of—

(A) $1,000 for each act of unauthorized *inspection or* disclosure of a return or return information with respect to which such defendant is found liable, or

(B) the sum of—

(i) the actual damages sustained by the plaintiff as a result of such unauthorized *inspection or* disclosure, plus

(ii) in the case of a [willful disclosure or a disclosure] *willful inspection or disclosure or an inspection or disclosure* which is the result of gross negligence, punitive damages, plus

(2) the costs of the action.

(d) PERIOD FOR BRINGING ACTION.—Notwithstanding any other provision of law, an action to enforce any liability created under this section may be brought, without regard to the amount in controversy, at any time within 2 years after the date of discovery by the plaintiff of the unauthorized *inspection or* disclosure.

[(e) RETURN; RETURN INFORMATION.—For purposes of this section, the terms "return" and "return information" have the respective meanings given such terms in section 6103(b).]

(e) NOTIFICATION OF UNLAWFUL INSPECTION AND DISCLOSURE.— If any person is criminally charged by indictment or information with inspection or disclosure of a taxpayer's return or return information in violation of—

(1) paragraph (1) or (2) of section 7213(a),

(2) section 7213A(a), or

(3) subparagraph (B) of section 1030(a)(2) of title 18, United States Code,

the Secretary shall notify such taxpayer as soon as practicable of such inspection or disclosure.

(f) DEFINITIONS.—For purposes of this section, the terms "inspect", "inspection", "return", and "return information" have the respective meanings given such terms by section 6103(b).

[(f)] *(g)* EXTENSION TO INFORMATION OBTAINED UNDER SECTION 3406.—For purposes of this section—

(1) any information obtained under section 3406 (including information with respect to any payee certification failure under subsection (d) thereof) shall be treated as return information, and

(2) any *inspection or* use of such information other than for purposes of meeting any requirement under section 3406 or (subject to the safeguards set forth in section 6103) for purposes permitted under section 6103 shall be treated as a violation of section 6103.

For purposes of subsection (b), the reference to section 6103 shall be treated as including a reference to section 3406.

* * * * * * *

Part III. Administrative, Procedural, and Miscellaneous

CONTENTS

Delegation Order No. 97 (Rev. 34)

Delegation of Authority

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Delegation of Authority

SUMMARY: The authority delegated by the Commissioner of Internal Revenue to the Assistant Commissioner (Employee Plans and Exempt Organizations), to enter into and approve certain closing agreements, may be redelegated to special assistants and division directors reporting directly to the Assistant Commissioner (Employee Plans and Exempt Organizations). The text of the delegation order appears below.

EFFECTIVE DATE: August 18, 1997

Effective: August 18, 1997

Closing Agreements Concerning Internal Revenue Tax Liability (Supplemented by Delegation Orders No. 236, 245, 247 and 248)

1. Authority: To enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he or she acts) in respect to any prospective transactions or completed transactions if the request to the Chief Counsel for determination or ruling was made before any affected returns have been filed. This does not include the authority to set aside any closing agreement.

Delegated to: The Chief Counsel in cases under his/her jurisdiction.

Redelegation: This authority may be redelegated no lower than the Deputy Associate Chief Counsels for cases under their respective jurisdictions and to the Assistant Chief Counsels for cases under their respective jurisdictions that do not involve precedent issues.

2. Authority: To enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he or she acts) for a taxable period or periods ended prior to the date of agreement and related specific items affecting other taxable periods. This does not include the authority to set aside any closing agreement.

Delegated to: The Associate Chief Counsels and the Assistant Commissioners (Examination) and (International) for matters under their respective jurisdictions.

Redelegation: The authority delegated to the Associate Chief Counsels may be redelegated, by the Deputy Chief Counsel, to the Deputy Associate Chief Counsels. The authority delegated to the Assistant Commissioners (Examination) and (International) may be redelegated, respectively, to the Deputy Assistant Commissioners (Examination) and (International).

3. Authority: To enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he or she acts) with respect to the performance of his or her functions as the competent authority under the tax conventions of the United States. This does not include the authority to set aside any closing agreement.

Delegated to: The Assistant Commissioner (International).

Redelegation: This authority may be redelegated to the Deputy Assistant Commissioner (International).

4. Authority: To enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he or she acts). This does not include the authority to set aside any closing agreement.

Delegated to: The Assistant Commissioner (Employee Plans and Exempt Organizations) in cases under his or her jurisdiction.

Redelegation: This authority may be redelegated to special assistants and division directors reporting directly to the assistant commissioner.

5. Authority: To enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he or she acts), for a taxable period or periods ended prior to the date of the agreement and related specific items affecting other taxable periods. This does not include the authority to set aside any closing agreement.

Delegated to: In cases under their jurisdiction (but excluding cases docketed before the United States Tax Court), the Assistant Commissioner (International); regional commissioners; regional counsel; regional chief compliance officers; service center directors; district directors; regional directors of appeals; assistant regional directors of appeals; chiefs and associate chiefs of appeals offices; and appeals team chiefs with respect to their team cases.

Redelegation: 1. Service center directors and the Director, Austin Compliance Center, may redelegate this authority no lower than the Chief, Examination Support Unit, with respect to agreements concerning the administrative disposition of certain tax shelter cases, and no lower than the Chief, Windfall Profit Tax Staff, Austin Service Center or Austin Compliance Center, with respect to entering into and approving a written agreement with the Tax Matters Partner/Person (TMP) and one or more partners or shareholders with respect to whether the partnership or S corporation, acting through its TMP, is duly authorized to act on behalf of the partners or shareholders in the determination of partnership or S corporation items for purposes of the tax imposed by Chapter 45, and for purposes of assessment and collection of the windfall profit tax for such partnership or S corporation taxable year.

2. The Assistant Commissioner (International) and district directors may redelegate this authority no lower than the Chief, Quality Review Staff/Section with respect to all matters, and not below the Chief, Examination Support Staff/Section, or Chief, Planning and Special Programs Branch/Section, with respect to agreements concerning the administrative disposition of certain tax shelter cases, or Chief, Special Procedures function, with respect to the waiver of right to claim refunds for those responsible officers who pay the corporate liability in lieu of a trust fund recovery penalty assessment under IRC 6672.

6. Authority: In cases under their jurisdiction docketed in the United States Tax Court and in other Tax Court cases upon the request of Chief Counsel or his/her delegate, to enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he or she acts), but only in respect to related specific items affecting other taxable periods. This does not include the

authority to set aside any closing agreement.

Delegated to: The associate chief counsels; the Assistant Commissioners (Employee Plans and Exempt Organizations) and (International); regional commissioners; regional counsel; regional directors of appeals; assistant regional directors of appeals; chiefs and associate chiefs of appeals offices; and appeals team chiefs with respect to their team cases.

Redelegation: This authority may not be redelegated.

7. Authority: In cases under the jurisdiction of the Assistant Commissioner (International), to enter into and approve a written agreement with any person relating to the internal revenue tax liability of such person (or of the person or estate for whom he/she acts), and to provide for the mitigation of economic double taxation under section 3 of Revenue Procedure 64–54, 1964–2 C.B. 1008, under Revenue Procedure 72–22, 1972–1 C.B. 747, and under Revenue Procedure 69–13, 1969–1 C.B. 402, and to enter into and approve a written agreement providing the treatment available under Revenue Procedure 65–17, 1965–1 C.B. 833. This does not include the authority to set aside any closing agreement.

Delegated to: The Assistant Commissioner (International).

Redelegation: This authority may not be redelegated.

Sources of Authority: 26 CFR 301.7121–1(a); Treasury Order No. 150–07; Treasury Order No. 150–09; and Treasury Order No. 150–17, subject to the transfer of authority covered in Treasury Order No. 120–01, as modified by Treasury Order No. 150–27, as revised.

To the extent that the authority previously exercised consistent with this order may require ratification, it is hereby affirmed and ratified.

This order supersedes Delegation Order No. 97 (Rev. 33), which was effective March 15, 1996.

Approved August 18, 1997.

Michael P. Dolan,
Deputy Commissioner.

Delegation Order No. 172 (Rev. 5)

Delegation of Authority

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Delegation of authority.

SUMMARY: The authority of the Commissioner of Internal Revenue to waive all or part of the excise tax imposed under section 4971(f) of the Internal Revenue Code (Code) with respect to liquidity shortfalls within the meaning of section 412(m)(5)(E) of the Code is delegated to the Director, Employee Plans Division, and may be redelegated to branch chiefs within the division. The text of the delegation order appears below.

EFFECTIVE DATE: June 15, 1997.

Effective: June 15, 1997.

Waiver of Excise Taxes Imposed Under Section 4971 of the Internal Revenue Code.

Authority: To waive all or part of the 100% excise tax imposed under section 4971(b) of the Internal Revenue Code in accordance with subsection (b) of section 3002 of the Employee Retirement Income Security Act of 1974 (ERISA).

Delegated to: Director, Employee Plans Division.

Redelegation: This authority may be redelegated to branch chiefs within the division for waivers that are not deemed substantial. For purposes of this order, a substantial waiver is a waiver of the additional tax liability resulting from a computation based on an accumulated funding deficiency in excess of one million dollars.

Authority: To waive all or part of the excise tax imposed by section 4971(f) of the Internal Revenue Code with respect to liquidity shortfalls within the meaning of section 412(m)(5)(E).

Delegated to: Director, Employee Plans Division.

Redelegation: This authority may be redelegated to branch chiefs within the division.

Source of Authority: Treasury Order 150–10.

To the extent that the authority previously exercised consistent with this order may require ratification, it is hereby affirmed and ratified.

This order supersedes Delegation Order No. 172 (Rev. 4), which was effective 12-31-96.

Approved April 15, 1997.

James E. Donelson,
Acting Chief Compliance Officer.

(Filed by the Office of the Federal Register on May 28, 1997, 8:45 a.m., and published in the issue of the Federal Register for May 29, 1997, 62 F.R. 29187)

Elections Into Mark-to-Market Accounting Under Section 1.475(c)–1 of the Regulations

Notice 97–37

On December 24, 1996, final regulations (T.D. 8700, [1997–7 I.R.B. 5] 61 F.R. 67715) were published to furnish guidance under § 475 of the Internal Revenue Code, including the scope of exemptions from the mark-to-market requirements. These regulations contain elections out of certain exemptions, including the intragroup-customer election (§ 1.475(c)–1(a)(3)(iii)(B) of the Income Tax Regulations), the customer paper election (§ 1.475(c)–1(b)(4)(i)), and the negligible sales election (§ 1.475(c)–1(c)–(1)(ii). Section 1.475(c)–1(b)(4)(i)(B) provides a June 23, 1997, deadline to make the customer paper election on an amended return.

The Internal Revenue Service recognizes that taxpayers need further guidance concerning these elections. The Service intends to issue guidance that will address the interplay of the elections under § 1.475(c)–1, the extent to which these elections are available on a retroactive basis, and the application of the § 475(b)(2) identification requirements to taxpayers making these elections. Because taxpayers need additional guidance to evaluate whether to make an election, and because the elections cannot be revoked without the consent of the Commissioner, the additional guidance will extend the filing deadline from June 23,

1997, to at least 45 days after that guidance is released. It should be noted, however, that an amended return making an election must be filed within the statute of limitations on assessment under § 6501(a).

1997 Marginal Production Rates

Notice 97–38

Section 613A(c)(6)(C) of the Internal Revenue Code defines the term "applicable percentage" for purposes of determining percentage depletion for oil and gas produced from marginal properties. The applicable percentage is the percentage (not greater than 25 percent) equal to the sum of 15 percent, plus one percentage point for each whole dollar by which $20 exceeds the reference price (determined under § 29(d)(2)(C)) for crude oil for the calendar year preceding the calendar year in which the taxable year begins. The reference price determined under § 29(d)(2)(C) for the 1996 calendar year is $18.46.

Table 1 contains the applicable percentages for marginal production for taxable years beginning in calendar years 1991 through 1997.

Notice 97–38 Table 1

APPLICABLE PERCENTAGE FOR MARGINAL PRODUCTION

Calendar Year	*Applicable Percentage*
1991	15 percent
1992	18 percent
1993	19 percent
1994	20 percent
1995	21 percent
1996	20 percent
1997	16 percent

1997 Section 43 Inflation Adjustment

Notice 97–39

Section 43(b)(3)(B) of the Internal Revenue Code requires the Secretary to publish an inflation adjustment factor. The enhanced oil recovery credit under § 43 for any taxable year is reduced if the "reference price," determined under § 29(d)(2)(C), for the calendar year preceding the calendar year in which the taxable year begins is greater than $28 multiplied by the inflation adjustment factor for that year.

The term "inflation adjustment factor" means, with respect to any calendar year, a fraction the numerator of which is the GNP implicit price deflator for the preceding calendar year and the denominator of which is the GNP implicit price deflator for 1990.

Because the reference price for the 1996 calendar year ($18.46) does not exceed $28 multiplied by the inflation adjustment factor for the 1997 calendar year, the enhanced oil recovery credit for qualified costs paid or incurred in 1997 is determined without regard to the phase-out for crude oil price increases.

Table 1 contains the GNP implicit price deflator used for the 1997 calendar year, as well as the previously published GNP implicit price deflators used for the 1991 through 1996 calendar years.

Notice 97–39 Table 1

GNP IMPLICIT PRICE DEFLATORS

Calendar Year	*GNP Implicit Price Deflator*
1990	112.9 (used for 1991)
1991	117.0 (used for 1992)
1992	120.9 (used for 1993)
1993	124.1 (used for 1994)
1994	126.0 (used for 1995)
1995	107.5 (used for 1996)*
1996	109.7 (used for 1997)

*Beginning in 1995, the GNP implicit price deflator was rebased relative to 1992. The 1990 GNP implicit price deflator used to compute the 1996 § 43 inflation adjustment factor is 93.6.

Table 2 contains the inflation adjustment factor and the phase-out amount for taxable years beginning in the 1997 calendar year as well as the previously published inflation adjustment factors and phase-out amounts for the 1991 through 1996 calendar years.

Notice 97–39 Table 2

INFLATION ADJUSTMENT FACTORS AND PHASE-OUT AMOUNTS

Calendar Year	*Inflation Adjustment Factor*	*Phase-out Amount*
1991	1.0000	0
1992	1.0363	0
1993	1.0708	0
1994	1.0992	0
1995	1.1160	0
1996	1.1485	0
1997	1.1720	0

Treatment of Hong Kong and China

Notice 97–40

This Notice sets forth the Service's position on the treatment of the Hong Kong Special Administrative Region of the People's Republic of China (Hong Kong) and The People's Republic of China (China) on and after July 1, 1997, for purposes of the application of certain bilateral agreements and the Internal Revenue Code and Income Tax Regulations, including subpart F of the Code. Under the 1984 Sino-British Joint Declaration, China and the United Kingdom agreed that China will resume the exercise of sovereignty over Hong Kong on July 1, 1997.

I. *U.S. China Tax Convention*

The Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, T.I.A.S. No. 12065, 1988–1 C.B. 414 (the "Convention"), provides that its geographical scope is limited to the areas in which the laws relating to Chinese tax (as defined in Article 2(1) of the Convention) are in force. This limitation precludes application of the Convention to Hong Kong because the relevant law governing Hong Kong as of July 1, 1997, provides that the laws relating to Chinese tax will not apply in Hong Kong on or after July

1, 1997. The Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China, Articles 106 and 108 (1990); S. Exec. Rep. No. 7, 99th Cong., 1st Sess. 14–15, 18–19 (1985).

II. *Reciprocal Shipping Exemption*

On and after July 1, 1997, the Agreement between the Government of the United States of America and the Government of Hong Kong for the Reciprocal Exemption with Respect to Taxes on Income from the International Operation of Ships, effected by an exchange of notes, T.I.A.S. No. 11892, 1995–1 C.B. 228 (the "Shipping Agreement"), will continue to apply in accordance with its terms. The Shipping Agreement will not apply with respect to China.

III. *Internal Revenue Code*

Hong Kong has historically been treated as a separate country for purposes of the Internal Revenue Code and Income Tax Regulations, including subpart F of the Code. Consistent with the treatment of Hong Kong and China as separate countries under the Convention and the Shipping Agreement on and after July 1, 1997, the Service will continue to treat Hong Kong and China as separate countries on and after July 1, 1997, for purposes of the Code and regulations, including subpart F. *See* United States-Hong Kong Policy Act of 1992, § 201, 22 U.S.C. § 5721 (1996) (providing that notwithstanding any change in the exercise of sovereignty over Hong Kong, the laws of the United States will continue to apply with respect to Hong Kong on and after July 1, 1997, in the same manner as before that date unless otherwise expressly provided by law or Executive Order).

Interim Rules for Health Insurance Portability for Group Health Plans; Correction

Notice 97–41

AGENCIES: Internal Revenue Service, Department of the Treasury; Pension and Welfare Benefits Administration, Department of Labor; Health Care Financing Administration, Department of Health and Human Services.

ACTION: Correction to interim rules.

SUMMARY: This document contains corrections to interim rules which were published in the **Federal Register** on Tuesday, April 8, 1997 (62 FR 16894 [T.D. 8716, 1997–19 I.R.B. 5]). The interim rules govern the access, portability and renewability requirements for group health plans and issuers of health insurance coverage offered in connection with a group health plan under the Health Insurance Portability and Accountability Act of 1996 (HIPAA).

EFFECTIVE DATE: June 1, 1997.

SUPPLEMENTARY INFORMATION:

Background

The interim rules that are subject to these corrections are issued under sections 102(c)(4), 101(g)(4), and 401(c)(4) of HIPAA.

Need for Correction

As published, the interim rules contain errors which may prove to be misleading and are in need of clarification.

Correction of Publication

Accordingly, the publication of the interim rules which are the subject of FR Doc. 97–8275 is corrected as follows:

1. On page 16895, column 3, in the preamble under the paragraph heading **"C. Overview of Coordination of Group Market Regulation Among Departments",** line 3 from the top of the column, the language "Part A of Title XXVII of the PHS Act, a" is corrected to read "Title XXVII of the PHS Act, a".

2. On page 16896, column 1, in the preamble under the paragraph heading **"D. Special Information Concerning State Insurance Law",** line 2 from the bottom of the column, the language "sections 144 through 148 in the PHS Act" is corrected to read "parts 144 through 148 in the PHS Act".

3. On page 16896, column 2, in the preamble under the paragraph heading **"D. Special Information Concerning State Insurance Law",** lines 3 through 7, the language "(See section 146) and the individual market (see section 148). The group market is further divided into the large group market and the small group market. Section 146 of the PHS Act" is, corrected to read "(see part 146) and the individual market (see part 148). The group market is further divided into the large group market and the small group market. Part 146 of the PHS Act".

4. On page 16896, column 2, in the preamble, the paragraph headin *"Definitions—26 CFR 54.9801–2, 29 CFR 2590.701–2, 45 CFR 144.103",* is corrected to read *"Definitions—26 CFR 54.9801–2T, 29 CFR 2590.701–2, 45 CFR 144.103".*

5. On page 16896, column 3, in the preamble, the paragraph heading *"Limitation on Preexisting Condition Exclusion Period—26 CFR 54.9801–3, 29 CFR 2590.71–3, 45 CFR 146.111",* is corrected to read *"Limitation on Preexisting Condition Exclusion Period—26 CFR 54.9801–3T, 29 CFR 2590.701–3, 45 CFR 146.111".*

6. On page 16896, column 3, in footnote 4, in the last line, the reference to "26 CFR 54.9801–3" is corrected to read "26 CFR 54.9801–3T".

7. On page 16897, column 3, in the preamble, the paragraph heading *"Rules Relating to Creditable Coverage—26 CFR 54.9801–4, 29 CFR 2590.701–4, 45 CFR 146.113"* is corrected to read *"Rules Relating to Creditable Coverage—26 CFR 54.9801–4T, 29 CFR 2590.701–4, 45 CFR 146.113".*

8. On page 16899, column 1, in the preamble, the paragraph heading *"Certificates and Disclosure of Previous Coverage—26 CFR 54.9801–5, 29 CFR 2590.701–5, 45 CFR 146.115"* is corrected to read *"Certificates and Disclosure of Previous Coverage—26 CFR 54.9801–5T, 29 CFR 2590.701–5, 45 CFR 146.115".*

9. On page 16899, column 2, in the preamble under the paragraph heading *"Certificates and Disclosure of Previous Coverage—26 CFR 54.9801–5T, 29 CFR 2590.701–5, 45 CFR 146.115",* the first full paragraph, line 2, the language "Paragraph (a)(5) describes the rights of" is corrected to read "Paragraph (a)(2) describes the rights of".

10. On page,16900, column 3, in the preamble under the paragraph heading

"Certificates and Disclosure of Previous Coverage—26,CFR 54.9801–5T, 29 CFR 2590.701–5, 45 CFR 146.115", lines 6 and 7 from the top of the column, the language "category of benefits described in paragraph (b). The requested entity may" is corrected to read "of the specified categories of benefits. The requested entity may".

11. On page 16900, column 3, in the preamble under the heading of the model form **"Information on Categories of Benefits",** in the unnumbered paragraph of the model form, lines 1 through 7 are corrected as follows:

'For each category above, (i) enter 'N/A' if the individual had no coverage within the category, (ii) enter both the date that the individual's coverage within the category began and the date that the individual's coverage within the category ended (or indicate if continuing), or (iii) enter 'same' ".

12. On page 16901, column 2, in the preamble under the heading of the model certificate **"Certificate of Group Health Plan Coverage",** number 8, line 2, the language "line 5 has at least 18 months of creditable" is corrected to read "line 5 has (have) at least 18 months of creditable".

13. On page 16901, column 2, in the preamble under the heading of the model certificate **"Certificate of Group Health Plan Coverage",** in the paragraph entitled **"Note:",** last line, the language "the participant and each beneficiary." is corrected to read "the participant and each dependent.".

14. On page 16901, column 2, in the preamble, the paragraph heading *"Special Enrollment Periods—26 CFR 54.9801–6, 29 CFR 2590.701–6, 45 CFR 146.117"* is corrected to read *"Special Enrollment Periods—26 CFR 54.9801–6T, 29 CFR 2590.701–6, 45 CFR 146.117".*

15. On page 16902, column 2, in the preamble, the paragraph heading *"Nondiscrimination in Eligibility and Premiums in the Group Market—26 CFR 54.9802–1, 29 CFR 2590.702, 45 CFR 146.121"* is corrected to read *"Nondiscrimination in Eligibility and Premiums in the Group Market—26 CFR 54.9802–1T, 29 CFR 2590.702, 45 CFR 146.121".*

16. On page 16903, column 2, in the preamble, the paragraph heading *"Special Rules—Excepted Plans and Excepted Benefit—26 CFR 54.9804–1, 29 CFR 2590.732, 45 CFR 146.145"* is corrected to read *"Special Rules—Excepted Plans and Excepted Benefits—26 CFR 54.9804–1T, 29 CFR 2590.732, 45 CFR 146.145".*

17. On page 16906, column 2, in the preamble, the paragraph heading *"Effective Dates—26 CFR 54.9806–1, 29 CFR 2590.736, 45 CFR 146.125"* is corrected to read *"Effective Dates—26 CFR 54.9806–1T, 29 CFR 2590.736, 45 CFR 146.125".*

18. On page 16907, column 1, in the preamble, under the paragraph heading **"G. Interim Rules and Request for Comments",** line 3, the language "NMHPA), Section 2707 of the PHS Act," is corrected to read "NMHPA), Section 2792 of the PHS Act,".

19. On page 16909, column 2, in the preamble, the fourth full paragraph, line 9, the language "help level the playing for small" is corrected to read "help level the playing field for small".

20. On page 16913, column 2, in the preamble, the second full paragraph, line 10, the language "explore innovative options and intend" is corrected to read "explore innovative options and HHS intends".

20a. On page 16919, column 2, in the preamble, under the paragraph heading "Exclusion of Certain Plans from the PHS Act Group Market Requirements", first paragraph, line 8, the language "Act. Section 146.180(b) includes rules" is corrected to read "Act. Section 146.180 includes rules".

21. On page 16921, column 2, in the preamble, line 2 from the top of the column, the language "for certification (29 CFR 2590.710(e) and" is corrected to read "for certification (29 CFR 2590.736(e) and".

22. On page 16923, column 1, in the preamble, the paragraph heading *"Estimated Total Burden Cost"* is removed.

23. On page 16924, column 2, in the preamble, the paragraph heading *"45 CFR 146.120 Certificates and Disclosure of Previous Coverage"* is corrected to read *"45 CFR 146.115 Certificates and Disclosue of Previous Coverage".*

24. On page 16925, column 1, in the preamble, the paragraph heading *"45 CFR 146.122 Special Enollment Periods"* is corrected to read *"45 CFR 146.117 Special Enollment Periods".*

25. On page 16925, column 2, in the preamble, lines 1 through 4 from the bottom of the column, the language "annually per issuer, for a total burden of 2,800 hours. The cost associated with this hour burden is estimated to be $30,800 annually." is corrected to read "per issuer, for a total burden of 2,800 hours. The cost associated with this hour burden is estimated to be $30,800.".

26. On page 16927, column 1, in the preamble, the paragraph heading is corrected to read as follows:

"45 CFR 146.180 Treatment of Non-Federal Governmental Plans".

26a. On page 16927, column 1, in the preamble, under the paragraph heading "45 CFR 146.180 Teatment of Non-Federal Governmental Plans", first paragraph, line 1, the language "Section 145.180(b) includes rules" is corrected to read "Section 146.180 includes rules".

27. On page 16927, column 2, in the preamble, under the paragraph heading "Statutory Authorities", the third paragraph, last line, the language "the authority contained in Section." is corrected to read "the authority contained in 26 U.S.C. 7805, 9806; Sec. 401, Pub. L. 104–191, 101 Stat. 1936.".

26 CFR PART 54 [CORRECTED]

§ 54.9801–1T [Corrected]

28. On page 16927, column 3, § 54.9801–1T, paragraph (c), line 6, the language "sections 701, 702, 703, 705, and 706 of" is corrected to read "sections 701, 702, 703, 732, and 733 of".

§ 54.9801–2T [Corrected]

29. On page 16928, column 1, § 54.9801–2T, paragraph (3) of the definition for *"COBRA"*, line 2, the language "means sections 601–608 of the ERISA," is corrected to read "means sections 601–608 of ERISA,".

§ 54.9801–3T [Corrected]

30. On page 16930, column 1, § 54.9801–3T, paragraph (a)(1)(iii), line 2 from the top of the column, the language "coverage' as such term is used in" is cor-

rected to read "coverage' as such phrase is used in".

31. On page 16930, column 3, § 54.9801–3T, paragraph (b)(1)(ii), paragraph (ii) of the *Example.*, line 5 from the bottom of the paragraph, the language "to 2 months for any preexisting condition of" is corrected to read "to 65 days for any preexisting condition of".

§ 54.9801–4T [Corrected]

32. On page 16931, column 3, § 54.9801–4T, paragraph (b)(2)(iv), paragraph (i) of *Example 6.*, line 5, the language "ceases. *C* is then unemployed for 51 days" is corrected to read "ceases. *C* is then unemployed and does not have any creditable coverage for 51 days".

33. On page 16932, column 1, § 54.9801–4T, paragraph (b)(2)(iv), paragraph (ii) of *Example 7.*, line 3, the language "coverage under the policy ultimately became" is corrected to read "and coverage under the policy ultimately became".

34. On page 16932, column 1, § 54.9801–4T, paragraph (b)(2)(v)(B), paragraph (ii) of the *Example.*, line 9, the language "month anniversary of her enrollment (May" is corrected to read "month anniversary of F's enrollment (May".

§ 54.9801–5T [Corrected]

35. On page 16933, column 1, § 54.9801–5T, paragraph (a)(1)(i), lines 3 and 4 from the top of the column, the language "accordance with this paragraph (a) of this section. (See PHSA section 2701(e)" is corrected to read "accordance with this paragraph (a). (See PHSA section 2701(e)".

36. On page 16933, column 2, § 54.9801–5T, paragraph (a)(1)(iv)(B)(1), line 24, the language "request made under paragraph (b)(2) of" is corrected to read "request made under paragraph (b)(1) of".

37. On page 16933, column 2, § 54.9801–5T, paragraph (a)(1)(iv)(B)(2), paragraph (i) of the *Example.*, lines 7 through 9, the language "agreement with the plan to provide automatic certificates as permitted under paragraph (a)(2)(ii) of this section." is corrected to read "agreement with the plan to provide certificates as permitted under paragraph (a)(1)(iii) of this section.".

38. On page 16934, column 1, § 54.9801–5T, paragraph (a)(2)(iv), paragraph (i) of *Example 4.*, line 8, the language "expiration of a 30-day grace period, S's group" is corrected to read "expiration of a 30-day grace period, Employer S's group".

39. On page 16934, column 2, § 54.9801–5T, paragraph (a)(2)(iv), paragraph (i) of *Example 5.*, line 2 from the top of the column, the language "permitted under paragraph (a)(2)(iii). Under" is corrected to read "permitted under paragraph (a)(2)(iii) of this section. Under".

40. On page 16935, column 1, § 54.9801–5T, paragraph (a)(5)(i)(A), line 5, the language "relating to the dependent coverage. In" is corrected to read "relating to dependent coverage. In".

41. On page 16935, columns 1 and 2 § 54.9801–5T, paragraph (a)(5)(i)(B), paragraph (ii) of the *Example.*, the last line of column 1 and first line of column 2, the language "the standard in this paragraph (a)(5)(i) of this section that it make reasonable efforts to" is corrected to read "the standard in this paragraph (a)(5)(i) that it make reasonable efforts to".

42. On page 16935, column 3, § 54.9801–5T, paragraph (a)(6)(ii), line 2 from the bottom of the paragraph, the language "requirements of Subparts 1 and 3 of Part" is corrected to read "requirements of Subparts 1 through 3 of Part".

43. On page 16936, column 2, § 54.9801–5T, paragraph (c)(2)(ii), line 3 from the top of the column, the language "explanations of benefit claims (EOB) or" is corrected to read "explanations of benefit claims (EOBs) or".

44. On page 16937, column 1, § 54.9801–5T, paragraph (d)(3), paragraph (ii) of *Example 3.*, last 4 lines of the paragraph, the language "is consistent with the urgency of *H's health condition* (this determination may be modified as permitted under paragraph (d)(2) of this section)." is corrected to read "is consistent with the urgency of *H's* health condition. (This determination may be modified as permitted under paragraph (d)(2) of this section.)".

§ 54.9801–6T [Corrected]

45. On page 16938, column 1, § 54.9801–6T, paragraph (b)(2), line 6, the language "enrolled, in the plan, the individual" is corrected to read "enrolled, for coverage under the terms of the plan, the individual".

46. On page 16938, column 1, § 54.9801–6T, paragraph (b)(4) introductory text, line 2, the language "who is eligible, but not enrolled, in the" is corrected to read "who is eligible, but not enrolled, for coverage under the terms of the".

47. On page 16938, column 1, § 54.9801–6T, paragraph (b)(6), line 4, the language "eligible, but not enrolled, in the plan," is corrected to read "eligible, but not enrolled, for coverage under the terms of the plan,".

§ 54.9806–1T [Corrected]

48. On page 16940, column 1, § 54.9806–1T, paragraph (a)(1), line 6, the language "through 54.9804–1T apply with respect" is corrected to read "through 54.9801–6T, 54.9802–1T, and 54.9804–1T apply with respect".

49. On page 16940, column 1, § 54.9806–1T, paragraph (a)(2), line 12, the language "1T through 54.9804–1T do not apply to" is corrected to read "1T through 54.9801–6T, 54.9802–1T, and 54.9804–1T do not apply to".

50. On page 16940, column 1, § 54.9806–1T, paragraph (a)(2), line 3 from the bottom of the paragraph, the language "requirement of such part, is not treated" is corrected to read "requirement of such Chapter, is not treated ".

51. On page 16940, column 3, § 54.9806–1T, paragraph (d), line 11, the language "and a health insurance issuer is not" is corrected to read "and a health insurance issuer are not".

52. On page 16940, column 3, § 54.9806–1T, paragraph (e)(3)(1), line 4, the language "§ 54.9801–5T(a)(5)(ii), that occur on or" is corrected to read "§ 54.9801–5T(a)(2)(ii), that occur on or".

53. On page 16940, column 3, § 54.9806–1T, paragraph (e)(3)(iv), last line, the language "5T(a)(5)(iii)." is corrected to read "5T(a)(2)(iii)."

54. On page 16941, column 1, in the signature block, the language *"Assistant Secretary of the Treasury"* is corrected to read *"Acting Assistant Secretay of the Treasury"*.

29 CFR PART 2590 [CORRECTED]

§ 2590.701–2 [Corrected]

55. On pages 16941 and 16492, col-

umns 3 and 1, respectively, § 2590.701–2, the definitions of *"Enollment date"* and *"Late enrollment"* are corrected to read as follows:

* * * * *

Enrollment date definitions *(enrollment date* and *first day of coverage)* are set forth in § 2590.701–3(a)(2)(i) and (ii).

* * * * *

Late enrollment definitions *(late enrollee* and *late enrollment)* are set forth in § 2590.701–3(a)(2)(iii) and (iv).

* * * * *

§ 2590.701–3 [Corrected]

56. On page 16943, column 1, § 2590.701–3, paragraph (a)(1)(i)(C), paragraph (1) of *Example 3.*, line 2 from the bottom of the paragraph, the language "plan. Two months later, *B* is hospitalized" is corrected to read "plan. Two months later, *B* is hospitalized for".

57. On page 16943, column 2, § 2590.701–3, paragraph (a)(1)(iii), line 2 from the bottom of the paragraph, the language "term is used in section 701(a)(3) of the" is corrected to read "phrase is used in section 701(a)(3) of the".

58. On page 16944, column 1, § 2590.701–3, paragraph (b)(1)(ii), paragraph (ii) of the *Example.*, line 5 from the bottom of the paragraph, the language "to 2 months for any preexisting condition of" is corrected to read "to 65 days for any preexisting condition of".

59. On page 16944, column 2, § 2590.701–3, paragraph (c), line 3, the language "plan, and health insurance issuer" is corrected to read "plan, and a health insurance issuer".

§ 2590.701–4 [Corrected]

60. On page 16945, column 2, § 2590.701–4, paragraph (b)(2)(iv), paragraph (i) of *Example 6,* line 5, the language "ceases. *C* is then unemployed for 51 days" is corrected to read "ceases. *C* is then unemployed and does not have any creditable coverage for 51 days".

§ 2590.701–5 [Corrected]

61. On page 16946, column 2, § 2590.701–5, paragraph (a)(1)(i), last line, the language "this paragraph (a) of this section." is corrected to read "this paragraph (a).".

62. On page 16946, column 3, § 2590.701–5, paragraph (a)(1)(iv)(B)(1), line 12 from the bottom of the column, the language "request made under paragraph (b)(2) of" is corrected to read "request made under paragraph (b)(1) of".

63. On page 16947, column 1, § 2590.701–5, paragraph (a)(1)(iv)(B)(2), paragraph (i) of the *Example.*, last 3 lines, the language "agreement with the plan to provide automatic certificates as permitted under paragraph (a)(2)(ii) of this section." is corrected to read "agreement with the plan to provide certificates as permitted under paragraph (a)(1)(iii) of this section.".

64. On page 16947, column 3, § 2590.701–5, paragraph (a)(2)(iv), paragraph (i) of *Example 4.*, line 8, the language "expiration of a 30-day grace period, *S*'s group" is corrected to read "expiration of a 30-day grace period, Employer *S*'s group".

65. On page 16948, column 3, § 2590.701–5, paragraph (a)(5)(i)(A), line 5, the language "relating to the dependent coverage. In" is corrected to read "relating to dependent coverage. In".

66. On page 16948, column 3, § 2590.701–5, paragraph (a)(5)(i)(B), paragraph (ii) of the *Example.*, lines 2 and 3, the language "the standard in this paragraph (a)(5)(i) of this section that it make reasonable efforts to" is corrected to read "the standard in this paragraph (a)(5)(i) that it make reasonable efforts to".

66a. On page 16949, column 2, § 2590.701–5, paragraph (a)(6)(ii), line 3 from the top of the column, the language "requirements of subparts 1 and 3 of part" is corrected to read "requirements of Subparts 1 through 3 of Part".

67. On page 16949, column 3, § 2590.701–5, paragraph (c)(2)(ii), line 5, the language "explanations of benefit claims (EOB) or" is corrected to read "explanations of benefit claims (EOBs) or".

§ 2590.701–6 [Corrected]

68. On page 16951, column 3, § 2590.701–6, paragraph (b)(2), line 6, the language "enrolled, in the plan, the individual" is corrected to read "enrolled, for coverage under the terms of the plan, the individual".

69. On page 16951, column 3, § 2590.701–6, paragraph (b)(4) introductory text, line 2, the language "who is eligible, but not enrolled, in the" is corrected to read "who is eligible, but not enrolled, for coverage under the terms of the".

70. On page 16951, column 3, § 2590.701–6, paragraph (b)(6), line 4, the language "eligible, but not enrolled, in the plan" is corrected to read "eligible, but not enrolled, for coverage under the terms of the plan".

§ 2590.731 [Corrected]

71. On page 16953, column 3, § 2590.731, paragraph (d)(1), line 2, the language "purposes of this § 2590.736 the term" is corrected to read "purposes of this section the term".

§ 2590.736 [Corrected]

72. On page 16955, column 1, § 2590.736, paragraph (d), line 11, the language "and a health insurance issuer is not" is corrected read "and a health insurance issuer are not".

73. On page 16955, column 1, § 2590.736, paragraph (e)(3)(i), line 4, the language "§ 2590.701–5(a)(5)(ii), that occur on or" is corrected to read "§ 2590.701–5(a)(2)(ii), that occur on or".

74. On page 16955, column 2, § 2590.736, paragraph (e)(3)(iv), last line, the language "5(a)(5)(iii)." is corrected to read "5(a)(2)(iii)."

45 CFR PART 144 [CORRECTED]

§ 144.103 [Corrected]

75. On page 16956, column 3, § 144.103, the definitions of *"Creditable coverage"* and *"Enrollment date"* are corrected to read as follows:

* * * * *

Creditable coverage has the meaning given the term under 45 CFR 146.113(a).

* * * * *

Enrollment date definitions *(enrollment date* and *first day of coverage)* are set forth in 45 CFR 146.111(a)(2)(i) and (a)(2)(ii).

* * * * *

76. On page 16956, column 3, § 144.103, paragraph (2) under the definition *"Excepted benefits"*, line 1, the language "(2) The individual market provisions" is corrected to read "(2) Individual market provisions".

77. On page 16957, column 2, § 144.103, in the definition *"medical care"*, line 1, the language *"Medical care* or *condition means*" is corrected to read "*Medical care* means".

78. On page 16957, column 2, § 144.103, in the definition *"medical condition"*, line 1, the language "*Medical condition* means any" is corrected to read "*Medical condition* or *condition* means any".

79. On page 16957, column 3, § 144.103, in the definition *"Non-Federal governmental plan"*, line 3, the language "a Federal government plan." is corrected to read "a Federal governmental plan.".

80. On page 16957, column 3, § 144.103, in the definition *"PHS Act"*, line 2, the language "Service Act." is corrected to read "Service Act (42 U.S.C. 201, *et seq.*).".

81. On page 16958, column 1, § 144.103, in the definition *"Public health plan"*, lines 1 and 2, the language "*Public health plan* means 'public health plan' within the meaning of 45" is corrected to read "*Public health plan* has the meaning given the term under 45".

82. On page 16958, column 2, § 144.103, in the definition *"State health benefits risk pool"*, lines 1 through 3, the language "*State health benefits risk pool* means a 'State health benefits risk pool' within the meaning of 45 CFR" is corrected to read "*State health benefits risk pool* has the meaninng given the term under 45 CFR".

45 CFR PART 146 [CORRECTED]

§ 146.111 [Corrected]

83. On page 16959, column 2, § 146.111, paragraph (a)(1)(i)(C), paragraph (ii) of *Example 3,* line 4, the language "this of illness because the care is related to" is corrected to read "this illness because the care is related to".

84. On page 16959, column 3, § 146.111, paragraph (a)(1)(iii), line 7 from the top of the column, the language "creditable coverage' as such term is" is corrected to read "creditable coverage' as such phrase is".

85. On page 16960, column 2, § 146.111, paragraph (b)(1)(ii), paragraph (ii) of the *Example,* line 5 from the bottom of the paragraph, the language "to 2 months for any preexisting condition of" is corrected to read "to 65 days for any preexisting condition of".

86. On page 16960, column 2, § 146.111, paragraph (c), line 3, the language "plan, and health insurance issuer" is corrected to read "plan, and a health insurance issuer".

§ 146.113 [Corrected]

87. On page 16961, column 3, § 146.113, paragraph (b)(2)(iv), paragraph (i) of *Example 6,* line 5, the language "ceases. *C* is then unemployed for 51 days" is corrected to read "ceases. *C* is then unemployed and does not have any creditable coverage for 51 days".

88. On page 16962, column 1, § 146.113, paragraph (c)(1), last line, the language "(b)." is corrected to read "(b) of this section."

89. On page 16962, column 2, § 146.113, paragraph (c)(7)(ii), line 7, the language "paragraph (b), up to a total of 365 days" is corrected to read "paragraph (b) of this section, up to a total of 365 days".

90. On page 16962, column 3, § 146.113, paragraph (c)(7)(iii), paragraph (ii) of the *Example,* lines 4 and 5, the language "drug benefits because D had the equivalent of 90-days of creditable coverage relating to" is corrected to read "drug benefits because D had 90 days of creditable coverage relating to".

§ 146.115 [Corrected]

91. On page 16962, column 3, § 146.115, paragraph (a)(1)(i), line 5, the language "required to certificates of creditable" is corrected to read "required to furnish certificates of creditable".

92. On page 16962, column 3, § 146.115, paragraph (a)(1)(ii), line 2 from the bottom of the paragraph, the language "paragraph (a)(3) with respect to the" is corrected to read "paragraph (a)(3) of this section with respect to the".

93. On page 16963, column 1, § 146.115, paragraph (a)(1)(iv)(B)(1), line 21, the language "paragraph (b)(2) of this section (relating" is corrected to read "paragraph (b)(1) of this section (relating".

94. On page 16963, column 1, § 146.115, paragraph (a)(1)(iv)(B)(2), paragraph (i) of the *Example,* last 3 lines, the language "agreement with the plan to provide automatic certificates as permitted under paragraph (a)(2)(ii) of this section." is corrected to read "agreement with the plan to provide certificates as permitted under paragraph (a)(1)(iii) of this section."

95. On page 16963, column 2, § 146.115, paragraph (a)(2)(i), line 2 from the bottom of the paragraph, the language "described in paragraph (a)(2)(ii) and" is corrected to read "described in paragraph (a)(2)(ii) or".

96. On page 16963, column 2, § 146.115, paragraph (a)(2)(ii) introductory text, line 2, the language "paragraph (a)(2)(ii) of this section are" is corrected to read "paragraph (a)(2)(ii) are".

97. On page 16963, column 2, § 146.115, paragraph (a)(2)(ii)(A), line 4 from the bottom of the paragraph, the language "section 606 of the Act, section" is corrected to read "section 606 of ERISA, section".

98. On page 16963, column 3, § 146.115, paragraph (a)(2)(iii), line 8 from the bottom of the paragraph, the language "acting in a reasonable or prompt fashion" is corrected to read "acting in a reasonable and prompt fashion,".

99. On page 16964, column 1, § 146.115, paragraph (a)(2)(iv), paragraph (i) of *Example 4.,* line 8, the language "expiration of a 30-day grace period, *S*'s group" is corrected to read "expiration of a 30-day grace period, Employer *S*'s group".

100. On page 16964, column 1, § 146.115, paragraph (a)(2)(iv), paragraph (i) of *Example 5.,* line 4, the language "permitted under paragraph (a)(2)(iii). Under" is corrected to read "permitted under paragraph (a)(2)(iii) of this section. Under".

101. On page 16964, column 1, § 146.115, paragraph (a)(3)(i)(B)(3), line 3, the language "to accept the information in paragraph" is corrected to read "to accept the information in this paragraph".

102. On page 16964, column 3, § 146.115, paragraph (a)(5)(i)(A), line 4, the language "needed for a certificate relating to the" is corrected to read "needed for a certificate relating to".

103. On page 16965, column 1, § 146.115, paragraph (a)(5)(iii)(B), line 9,

the language "requested to be provided. It does not" is corrected to read "requested to be provided. If a certificate does not".

104. On page 16965. column 2, § 146.115, paragraph (a)(6)(ii), line 5 from the bottom of the column, the language "requirements of subparts 1 and 3 of part" is corrected to read "requirements of Subparts 1 through 3 of Part".

105. On page 16966, column 1, § 146.115, paragraph (c)(2)(ii), line 5, the language "explanations of benefit claims (EOB) or" is corrected to read "explanations of benefit claims (EOBs) or".

106. On page 16966, column 2, § 146.115, paragraph (c)(2)(iv), paragraph (i) of the *Example,* line 1, the language "*Example:* (i) Employer *X*'s group health" is corrected to read "*Example:* (i) Individual *F* terminates employment with Employer *W* and, a month later, is hired by Employer *X*. Employer *X*'s group health".

107. On page 16966, column 3, § 146.115, paragraph (d)(3), paragraph (i) of the *Example,* lines 1 through 3, the language "*Example:* (i) Individual *F* terminates employment with Employer *W* and, a month later, is hired by Employer *X*. *Example 1:*" is corrected to read "*Example 1:* (i)".

§ 146.117 [Corrected]

108. On page 16968, column 1, § 146.117, paragraph (b)(2), line 1, the language "enrolled, in the plan, the individual" is corrected to read "enrolled, for coverage under the terms the plan, the individual".

109. On page 16968, column 1, § 146.117, paragraph (b)(4) introductory text, line 2, the language "who is eligible, but not enrolled, in the" is corrected to read "who is eligible, but not enrolled, for coverage under the terms of the".

110. On page 16968, column 1, § 146.117, paragraph (b)(6), line 4, the language "eligible, but not enrolled, in the plan," is corrected to read "eligible, but not enrolled, for coverage under the terms of the plan,".

§ 146.121 [Corrected]

111. On page 16969, column 1, § 146.121, paragraph (a)(1)(ii), last line, the language "defined in § 146.102" is corrected to read "defined in 45 CFR 144.103".

112. On page 16969, column 1, § 146.121, paragraph (a)(1)(vi), last line, the language "§ 146.102." is corrected to read "45 CFR 144.103".

§ 146.125 [Corrected]

113. On page 16970, column 1, § 146.125, paragraph (c), line 2, the language "enforcement action is taken, under," is corrected to read "enforcement action is to be taken".

114. On page 16970, column 1, § 146.125, paragraph (d), line 4 from the bottom of the column, the language "health insurance issuer is not subject to" is corrected to read "health insurance issuer are not subject to".

115. On page 16970, column 2, § 146.125, paragraph (e)(3)(i), line 3, the language "events described in § 146.115(a)(5)(ii)," is corrected to read "events described in § 146.115(a)(2)(ii),".

116. On page 16970, column 2, § 146.125, paragraph (e)(3)(iv), last line, the language "§ 146.115(a)(5)(iii)." is corrected to read "§ 146.115(a)(2)(iii)."

§ 146.150 [Corrected]

117. On page 16971, column 3, § 146.150, paragraph (a)(2), last 5 lines in the paragraph, the language "eligible individual, which is inconsistent with the nondiscrimination provisions of § 146.121 on an eligible individual being a participant or beneficiary." is corrected to read "eligible individual's being a participant or beneficiary, which is inconsistent with the nondiscrimination provisions of § 146.121."

118. On page 16972, column 2, § 146.150, paragraph (d)(5), line 3, the language "paragraph (d) of this section on a" is corrected to read "paragraph (d) on a".

§ 146.180 [Corrected]

119. On page 16973, column 3, § 146.180, paragraph (a) introductory text, line 2, the language "election described in this paragraph (a)" is corrected to read "election described in this section".

120. On page 16973, column 3, § 146.180, paragraph (a)(2), last 2 lines, the language "individuals (and dependents) losing other coverage (§ 146.117)." is corrected to read "individuals and dependents (§ 146.117)."

121. On page 16974, column 1, § 146.180, paragraph (c)(4), line 1, the language "requirements described in paragraph (a)" is corrected to read "requirements described in paragraph (a) of this section".

122. On page 16974, column 2, § 146.180, paragraph (i)(2), line 4, the language "of paragraphs (f) through (h), and has" is corrected to read "of paragraphs (f) through (h) of this section, and has".

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Coporate),
Department of the Treasury.

Signed at Washington, DC, this 2nd day of June 1997.

Daniel Maguire,
Director, Health Care Task Force,
Pension and Welfare Benefits
Administration,
Department of Labor.

Dated: June 2, 1997.

Neil J. Stillman,
Deputy Assistant,
Secretary for Information
Resources Management
Department of Health
and Human Services.

(Filed by the Office the Federal Register on June 9, 1997, 8:45 a.m., and published in the issue of the Federal Register for June 10, 1997, 62 FR. 31669 and 31690)

Time for Reporting Transfers to Foreign Entities Under Sections 1491 Through 1494

Notice 97–42

This notice modifies the guidance set forth in Notice 97–18, 1997–10 I.R.B. 35, regarding the time for reporting transfers of property to foreign corporations, partnerships, trusts, or estates as described in section 1491 ("section 1491 transfers").

Background

Notice 97–18 provides guidance with respect to section 1491 transfers occurring after August 20, 1996, that are reportable under section 1494, including the time and manner for reporting such trans-

fers, the manner for making elections pursuant to section 1492, and the penalty imposed by section 1494(c) for failure to report a section 1491 transfer. That notice provides that a U.S. transferor who is required to report a section 1491 transfer may either file Form 926 with the U.S. transferor's annual tax return or information return for the taxable year that includes the date of the transfer or may file Form 926 on the day the transfer is made. Interest must be paid on the amount of excise tax due with respect to the period between the date on which the transfer occurred and the date on which the excise tax is actually paid.

A U.S. transferor can avoid the section 1491 excise tax by making certain elections under section 1492. One election allows a U.S. transferor to avoid the excise tax by electing, before the transfer, to apply principles similar to the principles of section 367. Section 1492(2)(B). Alternatively, a U.S. transferor can avoid the section 1491 excise tax by electing to treat the transfer as a taxable exchange under section 1057. Section 1492(3). Section III.B of Notice 97–18 provides guidance on the time and manner for making these elections.

Section VIII of Notice 97–18 contains a transition provision with respect to the reporting requirements for the U.S. transferor's tax year that includes August 20, 1996. That section provides that no penalties will be imposed under section 1494(c) if a Form 926 reporting a section 1491 transfer (or certain other adequate reporting described in the notice) is filed by the later of the due date of the U.S. transferor's income tax return, including extensions, for the taxable year in which the transfer occurred, or May 9, 1997 (the date that is 60 days after the date that notice was published in the Internal Revenue Bulletin).

This notice extends the time during which certain section 1491 transfers may be reported under that transition provision without the imposition of the section 1494(c) penalty. This notice does not affect the interest that accrues on any excise tax due between the date of the transfer and the date on which the excise tax is actually paid. Moreover, this notice does not extend the time for filing under any duplicative reporting provision described in section II.B of Notice 97–18.

Guidance

With respect to Form 926 for the taxable year that includes August 20, 1996 (the "1996 Form 926"), no penalty will be imposed under section 1494(c) if the taxpayer files the 1996 Form 926 with the taxpayer's timely–filed (including extensions) income tax return or information return for the first taxable year beginning on or after January 1, 1997, provided the taxpayer's income tax return or information return for the tax year that includes August 20, 1996, includes the items of gross income required to be taken into account as a result of an election on the 1996 Form 926 (for example, any gain recognized by the taxpayer as a result of a section 1057 election). Alternatively, no penalty will be imposed under section 1494(c) if the taxpayer files the 1996 Form 926 within the period set forth in Section VIII of Notice 97–18.

The U.S. transferor will be deemed to have made, as the case may be, a section 1492(2)(B) election before the transfer, or a section 1057 election in accordance with Treas. Reg. § 301.9100–12T, if the following requirements are satisfied:

(i) The U.S. transferor otherwise complies with the requirements set forth in Notice 97–18 for making an election under section 1494(2)(B) to apply principles similar to the principles of section 367, or under section 1492(3) for treating the transfer as a taxable exchange under section 1057; and

(ii) With respect to either election, the U.S. transferor's 1996 Form 926 is filed within the time period set forth in this notice.

Effect on Other Guidance

Sections III.B and VIII of Notice 97–18 are hereby modified.

Electronic Funds Transfer — Temporary Waiver of Failure-To-Deposit Penalty for Certain Taxpayers and Request for Comments on Future Guidance

Notice 97–43

This notice provides guidance relating to the waiver of penalties announced in News Release IR–97–32, issued June 2, 1997. In IR–97–32, the Internal Revenue Service announced that it will waive the failure to deposit penalty under § 6656 of the Internal Revenue Code for certain taxpayers first required to make federal tax deposits by electronic funds transfer on or after July 1, 1997. This notice also requests comments regarding possible alternatives for future amendments to § 31.6302–1(h) of the Employment Taxes and Collection of Income Tax at Source Regulations with respect to the requirement to deposit by electronic funds transfer for periods beginning after 1999.

Background

Section 6302(h)(1)(A) provides that the Secretary will prescribe regulations necessary for the development and implementation of an electronic funds transfer system for the collection of depository taxes. Section 6302(h)(2) provides a phase-in schedule for the new system.

Section 31.6302–1(h) prescribes rules for implementing an electronic funds transfer system for the collection of depository taxes. Under the regulation, taxpayers are required to deposit taxes by electronic funds transfer if the amount of their depository taxes in a specified earlier year exceeds the applicable threshold amount. The regulation provides that taxpayers with more than $50,000 of federal employment tax deposits in calendar year 1995 must use electronic funds transfer to make deposits that are due on or after July 1, 1997 and relate to return periods beginning on or after January 1, 1997. For example, a corporation to which this rule applies, and which files its income tax returns on a calendar year basis, must use electronic funds transfer to make corporate and estimated income tax deposits that are due on or after July 1, 1997. Therefore, the corporation's September 15, 1997, and subsequent estimated tax payments must be made by electronic funds transfer.

Section 6656(a) provides that in the case of any failure by any person to deposit taxes on the prescribed date in an authorized government depository, a penalty applies unless the failure is due to reasonable cause and not due to willful neglect. Rev. Rul. 95–68, 1995–2 C.B. 272, provides that, absent reasonable cause, a taxpayer that is required to deposit federal taxes by electronic funds transfer is subject to the 10 percent failure

to deposit penalty if the taxpayer deposits the taxes by means other than electronic funds transfer.

Temporary Waiver of Penalty for Certain Taxpayers

Although taxpayers with more than $50,000 of federal employment tax deposits in calendar year 1995 are required to make federal tax deposits electronically on and after July 1, 1997, the Service will not impose the 10 percent § 6656 penalty solely for the failure to make those deposits by electronic funds transfer. However, a taxpayer will remain liable for the failure to deposit penalty under § 6656 (absent reasonable cause) if the taxpayer fails to make a required deposit (using either electronic funds transfer or paper coupons) in a timely manner.

This waiver of the failure to deposit penalty applies only to deposit obligations incurred on or before December 31, 1997. The penalty waiver includes deposits made after December 31, 1997, so long as the deposit obligation was incurred on or before December 31, 1997.

This waiver of the failure to deposit penalty does not apply to taxpayers that were required to begin using electronic funds transfer in 1995 or 1996.

Request for Comments on Future Guidance

Under § 31.6302–1(h), taxpayers that are not currently required to use electronic funds transfer must begin making federal tax deposits electronically in 1999 if they exceed a $50,000 threshold in 1997. Currently, § 31.6302–1(h) provides no requirement that a new or growing taxpayer that exceeds $50,000 in annual deposits only after 1997 use electronic funds transfer. In addition, a taxpayer that deposits employment taxes but never exceeds $50,000 a year in employment tax deposits is not currently required to use electronic funds transfer even if its deposits of other taxes have exceeded $50,000 per year. The Service and Treasury Department intend to develop regulations that will address these matters. At this time, two options are being considered.

The first option would be a two-pronged test. If during a calendar year determination period the taxpayer deposits more than $50,000 of the employment taxes imposed by chapters 21, 22, and 24, or more than $50,000 of other depository taxes, the taxpayer becomes subject to the requirement to deposit electronically in the second succeeding calendar year.

The second option would be an aggregate deposits test. If during a calendar year determination period the taxpayer's aggregate deposits of all depository taxes exceed $50,000, the taxpayer becomes subject to the requirement to deposit electronically in the second succeeding calendar year.

The Service and Treasury Department invite public comment on these two options and also welcome any suggestions for a different future rule. Comments and suggestions are requested by October 10, 1997. An original and eight copies of written comments should be sent to:

Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5228 (IT&A:Br4)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044,

or hand delivered between the hours of 8:00 a.m. and 5:00 p.m to:

Courier's Desk
Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5228 (IT&A:Br4)
1111 Constitution Ave., NW
Washington, DC

Alternatively, comments may be submitted electronically via the Service's Internet site at "http://www.irs.ustreas.gov/prod/tax_regs/comments.html". All comments will be available for public inspection and copying in their entirety.

For Further Information on Electronic Funds Transfer

For information on the Treasury's electronic funds transfer system — the Electronic Federal Tax Payment System (EFTPS) — or to get a form to enroll in EFTPS, call either of the two Treasury Financial Agents for EFTPS at (800) 945-8400 or (800) 555-4477. Taxpayers may also request enrollment forms by calling the Service Distribution Center at (800) 829-3676.

Weighted Average Interest Rate Update

Notice 97–44

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of §412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for June 1997 is 6.77 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
July	1997	6.86	6.18 to 7.34	6.18 to 7.55

Highly Compensated Employee Definition

Notice 97–45

I. PURPOSE

This notice provides guidance relating to the definition of highly compensated employee ("HCE") under §414(q) of the Internal Revenue Code ("Code"), as amended by §1431 of the Small Business Job Protection Act of 1996, Pub. L. 104-188 ("SBJPA"). The §414(q) definition of HCE is incorporated by certain provisions of the Code that apply nondiscrimination requirements to various employee benefit plans, entities, or arrangements ("plans").

Specifically, this notice provides:

- Guidance on making the top-paid group election permitted by §414(q)(1)(B)(ii), under which an employee (other than a 5-percent owner) with compensation in excess of the dollar threshold is an HCE only if the employee is among the highest paid 20 percent of an employer's workforce.
- A new calendar year data election under which an employer that maintains one or more plans on a fiscal year basis has the option to use calendar year data to simplify the determination of whether an employee is an HCE on account of compensation under §414(q)(1)(B).
- Transition relief from certain requirements of the top-paid group election and the calendar year data election.
- Guidance on plan amendments to reflect the revised definition of HCE, including the application of the remedial amendment period under § 401(b), and certain other matters relating to the determination of HCE status.

II. BACKGROUND

(1) *Section 414(q) prior to SBJPA.* Prior to amendment by SBJPA, § 414(q)(1) generally provided that an employee was an HCE if, at any time during the year or the preceding year, the employee:

(A) was a 5-percent owner,

(B) received more than $100,000 (for 1996) in annual compensation from the employer,

(C) received more than $66,000 (for 1996) in annual compensation from the employer and was in the top-paid group of employees during the same year, or

(D) was an officer of the employer who received compensation in excess of $60,000 (for 1996).

(2) *Guidance under § 414(q) prior to SBJPA.* Under §1.414(q)–1T, A–14(b) of the temporary Income Tax Regulations, employers were allowed to make a calendar year calculation election, under which the preceding year's calculations relating to HCE determinations were made on the basis of the calendar year ending with or within the current year. Under section 4 of Rev. Proc. 93–42, 1993–2 C.B. 540, as modified by Rev. Proc. 95–34, 1995–2 C.B. 385, an employer was permitted to use a simplified method for determining HCEs. Rev. Proc. 95–34 also provided model plan language for employers to use the simplified method.

(3) *SBJPA amendments to § 414(q).* Section 414(q)(1), as amended by SBJPA, provides that the term "highly compensated employee" means any employee who:

(A) was a 5-percent owner at any time during the year or the preceding year, or

(B) for the preceding year had compensation from the employer in excess of $80,000 and, if the employer so elects, was in the top-paid group for the preceding year.

The $80,000 amount is adjusted at the same time and in the same manner as under § 415(d), except that the base period is the calendar quarter ending September 30, 1996.

Pursuant to § 414(q)(3), an employee is in the top-paid group for any year if the employee is in the group consisting of the top 20 percent of the employees of the employer when ranked on the basis of compensation paid to employees during such year. An election pursuant to § 414(q)(1)(B)(ii), under which an employee (who is not a 5-percent owner) who has compensation in excess of $80,000 is not an HCE if the employee is not a member of the top-paid group, is referred to in this notice as a "top-paid group election."

The amendments made by § 1431 of SBJPA generally apply to years beginning after December 31, 1996.

III. EFFECT OF STATUTORY CHANGES ON PRIOR GUIDANCE

(1) *Prior guidance.* Because of the amendments made to § 414(q) by SBJPA, certain portions of § 1.414(q)–1T do not reflect current law. Except as provided in section III(2), the calendar year calculation election under A–14(b) of § 1.414(q)–1T does not apply for years beginning after December 31, 1996. In addition, the guidance provided under section 4 of Rev. Proc. 93–42 and under Rev. Proc. 95–34 does not apply for years beginning after December 31, 1996. The Service intends to publish guidance in the future that will make appropriate modifications to these items of guidance.

(2) *Transition relief for 1997.* For any year beginning on or after January 1, 1997 and before January 1, 1998, employers may continue to utilize the calendar year calculation election, taking into account the statutory amendments to § 414(q)(1)(B), and the elimination of § 414(q)(1)(C) and (D), by SBJPA.

IV. PERIODS FOR DETERMINING HCE STATUS

(1) *Determination years and look-back years.* HCE status is determined on the basis of the applicable year (as defined below) of the plan or other entity for which a determination is being made ("determination year") and the preceding twelve-month period ("look-back year") in accordance with § 414(q). Thus, under § 414(q), as amended by SBJPA, an employee is an HCE for a determination year if, (a) at any time during the determination year or the look-back year, the employee was a 5-percent owner or (b) for the look-back year, the employee had compensation from the employer in excess of $80,000 (as adjusted) and, if the employer so elects, was in the top-paid group.

(2) *Applicable year.*

(a) *Retirement plans.* The applicable year for a retirement plan is the plan year. For purposes of this notice, a retirement plan is a plan that is qualified under § 401(a) or 403(a) or described in § 403(b) or 408(k).

(b) *Nonretirement plans.* The applicable year for a nonretirement plan is the plan year, as defined in the written plan document or otherwise identified in the

Code and regulations. If a nonretirement plan does not have an identified plan year, then the employer may treat either the calendar year or the employer's fiscal year as the applicable year. For purposes of this notice, a nonretirement plan is any employee benefit arrangement to which the definition of HCE is applicable under a provision of the Code, other than a retirement plan.

V. IMPLEMENTATION OF ELECTIONS

(1) *Top-paid group election.* An employer may make a top-paid group election for a determination year. The effect of the top-paid group election is that an employee (who is not a 5-percent owner at any time during the determination year or the look-back year) with compensation in excess of $80,000 (as adjusted) for the look-back year is an HCE only if the employee was in the top-paid group for the look-back year. A top-paid group election, once made, applies for all subsequent determination years unless changed by the employer.

(2) *Calendar year data election.*

(a) This notice provides a new calendar year data election which an employer may make for a determination year. The effect of the calendar year data election is that the calendar year beginning with or within the look-back year is treated as the employer's look-back year for purposes of determining whether an employee is an HCE on account of the employee's compensation for a look-back year under § 414(q)(1)(B). A calendar year data election, once made, applies for all subsequent determination years unless changed by the employer.

(b) A calendar year data election made by an employer does not apply in determining whether the employer's employees are HCEs under § 414(q)(1)(A) on account of being 5-percent owners. Accordingly, if an employee is a 5-percent owner in either the look-back year or the determination year, then the employee is an HCE, without regard to whether the employee's employer makes a calendar year data election.

(c) If a plan has a calendar year as its determination year, then the immediately preceding calendar year is the look-back year for the plan. This is the case whether or not a calendar year data election is made. Thus, a calendar year data election would have no effect on the HCE determination for a calendar year plan.

(3) *No separate notification requirement.* Notification or filing with the Internal Revenue Service of a top-paid group election or a calendar year data election is not required in order for the election to be valid. However, under certain circumstances, plan amendments may be required to reflect the election. See section VII of this notice.

(4) *Cross-references.* Section VI of this notice provides a consistency requirement that applies if an employer maintains more than one plan. Section VII of this notice describes circumstances under which a top-paid group election or calendar year data election, or changes to such elections, may have to be reflected in plan documents.

VI. CONSISTENCY REQUIREMENT FOR ELECTIONS

(1) *Consistency requirement — in general.* Except as provided in section VI(3) and (4), in order to be effective, a top-paid group election made by an employer must apply consistently to the determination years of all plans of the employer that begin with or within the same calendar year. Similarly, except as provided in section VI(3) and (4), in order to be effective, a calendar year data election made by an employer must apply consistently to the determination years of all plans of the employer, other than a plan with a calendar year determination year, that begin within the same calendar year.

(2) *Interaction of top-paid group election and calendar year data election.* The top-paid group election and the calendar year data election are independent of each other. Thus, an employer making one of the elections is not required also to make the other election. However, if both elections are made, the look-back year in determining the top-paid group must be the calendar year beginning with or within the look-back year, in accordance with section V of this notice.

(3) *Multiemployer plans.* Satisfaction of the consistency requirement is determined without regard to any multiemployer plans in which the employer participates.

(4) *Transition relief for years prior to 2000.*

(a) *Transition relief for 1997.* The consistency requirement will not apply to determination years beginning with or within the 1997 calendar year. Thus, an employer may make a top-paid group election or a calendar year data election for a plan for a determination year beginning with or within 1997, without regard to whether the employer makes that election for any other plan.

(b) *Transition relief for 1998 and 1999.* For determination years beginning on or after January 1, 1998, and before January 1, 2000, (i) nonretirement plans are not subject to the consistency requirement, and (ii) satisfaction of the consistency requirement with respect to retirement plans is determined without regard to any plans of the employer that are nonretirement plans.

VII. QUALIFIED RETIREMENT PLAN AMENDMENTS FOR HCE DEFINITION

(1) *Qualified plans that must be amended.* If a retirement plan qualified under § 401(a) or 403(a) contains the definition of HCE under § 414(q), as in effect before SBJPA, the plan must be amended to reflect the definition of HCE under § 414(q), as amended by SBJPA. If an employer makes either a top-paid group or calendar year data election for a determination year, a plan that contains the definition of HCE must reflect the election. If the employer changes either a top-paid group or calendar year data election, the plan must be amended to reflect the change. However, a plan is not required to add a definition of HCE merely to reflect a top-paid group or calendar year data election.

(2) *Amendment date.* Rev. Proc. 97–41, 1997–33 IRB, provides that qualified retirement plans have a remedial amendment period under § 401(b) so that certain plan amendments for SBJPA are not required to be adopted before the last day of the first plan year beginning on or after January 1, 1999 (with a later date for governmental plans). Pursuant to Rev. Proc. 97–41, a plan provision reflecting the definition of HCE is a disqualifying provision and thus any plan amendments to reflect the definition of HCE in § 414(q), as

amended by SBJPA, and to reflect any choices regarding the top-paid group or calendar year data elections, are not required to be made until the end of this remedial amendment period. However, plans must be operated in accordance with the SBJPA changes to the HCE definition in § 414(q) as of the statutory effective date, and plans required to be amended to reflect those changes must be so amended retroactively effective as of that date. In addition, under Rev. Proc. 97–41, any retroactive amendments must reflect the choices made in the operation of the plan for each determination year, including choices made with respect to the top-paid group election and the calendar year data election (and any changes to those elections), and the first date that the plan operated in accordance with those choices (and any such changes).

VIII. OTHER ISSUES RELATING TO DETERMINATION OF HCE STATUS

(1) *Determining HCE status for 1997.* As noted earlier, the amendments made by § 1431 of the SBJPA generally apply to years beginning after December 31, 1996. However, § 1431(d)(1) provides that, in determining whether an employee is an HCE for years beginning in 1997, the amendments to § 414(q) are treated as having been in effect for years beginning in 1996. Accordingly, in determining whether an employee is an HCE for the determination year beginning with or within the 1997 calendar year, an employer must consider whether the employee was a 5-percent owner or had compensation in excess of $80,000 for the look-back year that began with or within the 1996 calendar year. An employer also may make the calendar year data election and/or the top-paid group election with respect to determination years beginning with or within the 1997 calendar year, in accordance with the guidance in this notice. The SBJPA amendments to § 414(q) are not applicable in determining the employer's HCEs for determination years beginning prior to January 1, 1997.

(2) *Highly compensated former employees.* For purposes of determining status as a highly compensated former employee under § 1.414(q)–1T, A–4, whether an employee was a highly compensated active employee for a determination year that ended on or after the employee's 55th birthday, or that was a separation year, is based on the rules applicable to determining HCE status as in effect for that determination year.

(3) *Determining 5-percent ownership by attribution of ownership interest to family members.* The definition of 5-percent owner in § 414(q)(2) refers to § 416(i)(1), which in turn refers to the attribution rules of § 318. Under the rules of §318, an individual is considered to own any stock owned directly or indirectly by the individual's spouse, children, grandchildren or parents. Consequently, an employee who is the spouse, child, parent or grandparent ("family member") of an individual who has a 5-percent interest in the employer at any time during the look-back year or the determination year is treated as an HCE under § 414(q)(1)(A), regardless of the family member's compensation level. These statutory provisions relating to the definition of 5-percent owner under § 414(q)(2) are different from the family aggregation rules under former § 414(q)(6) and are unaffected by the repeal of those rules under § 1431(b)(1) of SBJPA.

IX. EXAMPLES

The following examples illustrate the rules in this notice:

Example 1: (a) Employer A has maintained a defined benefit plan qualified under § 401(a) (Plan M) since 1996 with a plan year beginning April 1 and ending March 31. Employer A has never had a 5-percent owner. For Plan M's determination year beginning April 1, 2000 and ending March 31, 2001, Employer A does not make a calendar year data election or a top-paid group election.

(b) Under § 414(q)(1)(B), Employer A determines HCEs for Plan M's determination year beginning April 1, 2000, based upon the compensation of Employer A's employees in Plan M's look-back year. Thus, the HCEs are those employees who had compensation over $80,000 (as adjusted) during the period beginning April 1, 1999 and ending March 31, 2000.

Example 2: (a) Assume the same facts as in Example 1, except that Employer A hires a new employee, Employee X, on March 1, 2000 at an annual salary of $240,000. Employee X is not a 5-percent owner during the determination year beginning April 1, 2000 or the look-back year beginning April 1, 1999. During the month of March, 2000, Employee X's compensation was $20,000.

(b) Because Employee X's compensation during Plan M's look-back year beginning April 1, 1999 was less than $80,000 (as adjusted), Employee X is not an HCE for Plan M's determination year beginning April 1, 2000.

Example 3: (a) Employer B has maintained a qualified defined benefit plan (Plan N) since 1996 that has a calendar plan year. Employer B makes a top-paid group election for Plan N's 1998 determination year, which is the 1998 calendar year. Employer B had 15 employees in the 1997 calendar year and has never had a 5-percent owner. These employees, along with their compensation for the 1997 calendar year, are listed below.

Employees	*1997 Compensation*
1	$200,000
2	110,000
3	101,000
4	90,000
5-15	50,000 or less

(b) In determining Employer B's HCEs for the calendar year 1998 under the top-paid group election, Plan N's relevant look-back year is the 1997 calendar year. Employer B must determine whether any employee had compensation above $80,000, and was in the group consisting of the top 20 percent of the employees of Employer B in the 1997 calendar year, when ranked on the basis of compensation from Employer B during the 1997 calendar year.

(c) Employees 1, 2 and 3 comprise the top 20 percent of Employer B's 15 employees for the 1997 calendar year based on compensation from Employer B during the 1997 calendar year. Although Employee 4 had compensation over $80,000 in the 1997 calendar year, Employee 4 was not in the top-paid group for the 1997 calendar year and is therefore not an HCE for Plan N's 1998 determination year. This will be the case regardless of whether Employees 1, 2 and 3 continue to be employed in the 1998 calendar year.

Example 4: (a) Employer C has a qualified profit sharing plan (Plan O) with a

calendar plan year. Employer C also has a qualified defined benefit plan (Plan P) with a plan year beginning April 1 and ending March 31. Employer C makes the top-paid group election for Plan O for the calendar year 2000.

(b) Pursuant to the consistency rule requiring that the employer make the same election for all determination years of all plans of the employer that begin with or within the same calendar year, Employer C must also make the top-paid group election for Plan P's determination year beginning April 1, 2000 and ending March 31, 2001.

(c) The look-back year for purposes of determining whether any of Employer C's employees is an HCE under Employer C's top-paid group election for Plan O is the 1999 calendar year and for Plan P is the April 1, 1999 to March 31, 2000 year. The group of Employer C's employees that are HCEs for Plan O's 2000 determination year are those employees who had compensation above $80,000 (as adjusted) and who were in the top 20 percent of employees based on compensation for the 1999 calendar year, while the group of Employer C's employees that are HCEs for Plan P's determination year beginning April 1, 2000 are those employees who had compensation above $80,000 (as adjusted) and who were in the top 20 percent of employees based upon compensation for Plan P's look-back year beginning April 1, 1999.

Example 5: (a) Since 1998, Employer D has maintained a qualified cash or deferred arrangement under § 401(k) (Plan Q). Plan Q has a calendar plan year. Employer D has never made a calendar year data election or a top-paid group election for Plan Q and has never had a 5-percent owner. Under § 401(k)(3)(A)(ii), as amended by the SBJPA, unless an employer elects to use current year data for all eligible employees, the actual deferral percentage (ADP) test for the plan year is applied by comparing the ADP for all eligible HCEs for the plan year to the ADP for all other eligible employees (nonHCEs) for the preceding plan year. Employer D has not elected to use current year data for the nonHCEs for the 2000 calendar year.

(b) In conducting the ADP test for the 2000 calendar year, Employer D compares the ADP for the 2000 calendar year for the group of employees who had compensation above $80,000 (as adjusted) for the 1999 calendar year, and who are eligible under the plan for the 2000 calendar year, with the ADP for the 1999 calendar year for the group of employees who were nonHCEs for the 1999 calendar year and who were eligible under the plan for the 1999 calendar year. Employer D would have previously determined who the HCEs were for the 1999 calendar year, that is, the employees of Employer D who had compensation above $80,000 (as adjusted) for the 1998 calendar year. The nonHCEs for the 1999 calendar year are those employees who were employees in the 1999 calendar year and who were not determined to be HCEs for the 1999 calendar year.

Example 6: (a) Employer E has maintained a qualified profit sharing plan (Plan R) since 1996 with an April 1 to March 31 plan year. Employer E has also maintained a defined benefit plan (Plan S) since 1996 with an October 1 to September 30 plan year. Employer E decides to make the calendar year data election for determination years of Plan R and Plan S beginning in the 2000 calendar year. Thus, Employer E makes the election for Plan R's determination year beginning April 1, 2000 and ending March 31, 2001, and Plan S's determination year beginning October 1, 2000 and ending September 30, 2001.

(b) The 2000 calendar year begins within Plan R's look-back year beginning April 1, 1999 and ending March 31, 2000, and Plan S's look-back year beginning October 1, 1999 and ending September 30, 2000 and is treated as Employer E's look-back year for both Plans R and S for purposes of determining Employer E's HCEs on the basis of compensation. Thus, in determining HCE status under § 414(q)(1)(B) Employer E determines whether an employee has compensation for the look-back year in excess of $80,000 (as adjusted), and if applicable, the composition of the top-paid group, on the basis of compensation for the 2000 calendar year.

Example 7: (a) Assume the same facts as in *Example 6,* except that Employer E also maintains Plan T, a qualified defined benefit plan with a calendar plan year. Employer E fails to make the calendar year data election for Plan T.

(b) Because the consistency requirement for the calendar year data election is applied without regard to calendar year plans, the consistency requirement is satisfied regardless of whether Employer E makes a calendar year data election for Plan T.

Example 8: Assume the same facts as in *Example 6.* For Plan R, in determining whether any of Employer E's employees is an HCE on account of being a 5-percent owner, the employee's ownership in Employer E is examined for Plan R's 2000 and 2001 plan years (April 1, 1999 to March 31, 2000, and April 1, 2000 to March 31, 2001). For Plan S, in determining whether any of Employer E's employees is an HCE on account of being a 5-percent owner, the employee's ownership in Employer E is examined for Plan S's 2000 and 2001 plan years (October 1, 1999 to September 30, 2000, and October 1, 2000 to September 30, 2001). This is because the calendar year data election does not apply in determining whether an employee is a 5-percent owner.

Example 9: (a) Employer F maintains Plan U, a defined benefit plan with a calendar year plan year. Employee Y was employed by Employer F since 1990. Employee Y retired at age 65 from employment with Employer F in 1998. Employee Y was an HCE in 1992 under the rules applicable in 1992 to determine HCE status, but was not an HCE in any other year, including 1998.

(b) Because Employee Y was an HCE for a determination year (1992) ending on or after Employee Y's 55th birthday, Employee Y is a highly compensated former employee for determination years beginning after Employee Y's retirement.

X. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1550.

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

The collection of information in this notice is in Section VII. This requirement to amend plan documents is necessary to update plan documents to reflect the amended definition of HCE under § 414(q). This information will be used to determine which employees are HCEs for purposes of determining contributions, benefits, or the availability of other rights or features under the plan. The collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual recordkeeping burden is 65,605 hours.

The estimated annual burden per recordkeeper varies from 10 minutes to 30 minutes, depending on individual circumstances, with an estimated average of 18 minutes. The estimated number of recordkeepers is 218,683.

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.

XI. COMMENTS

This notice does not address all of the procedural requirements that may be necessary to implement the top-paid group election or the calendar year data election for future years. However, any additional requirements would be applied prospectively only. The Treasury and the Service invite comments and suggestions regarding procedural issues and the other matters discussed in this notice.

Comments can be addressed to CC:DOM:CORP:R (Notice 97–45), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97–45), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Income Tax; Allocation of Interest Expense Among Expenditures; Correction

Notice 97–46

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to temporary regulations (T.D. 8145), which were published in the Federal Register on Thursday, July 2, 1987 (52 F.R. 24996) relating to the allocation of interest expense among a taxpayer's expenditures.

EFFECTIVE DATE: July 2, 1987.

SUPPLEMENTARY INFORMATION:

Background

The temporary regulations that are the subject of this correction are under section 163 of the Internal Revenue Code.

Need for Correction

As published, temporary regulations (T.D. 8145 [1987–2 C.B. 47]) contains an error which may prove to be misleading and is in need of clarification.

* * * * *

Correcting Amendment to Regulations

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendment:

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 * * *

§ 1.163-8T [Corrected]

Par. 2. In § 1.163-8T, paragraph (e) immediately following *Example (2).* in paragraph (c)(2)(iii) is redesignated as paragraph (c)(3)(i) to read as follows:

§ 1.163-8T Allocation of interest expense among expenditures (temporary).

* * * * *

(c) * * *

(3) *Allocation of debt; proceeds not disbursed to borrower—(i) Third-party financing.* * * *

* * * * *

Cynthia E. Grigsby,
Chief, Regulations Unit
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on July 25, 1997, 8:45 a.m., and published in the issue of the Federal Register for July 28, 1997, 62 F.R. 40269)

Weighted Average Interest Rate Update

Notice 97–47

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for July 1997 is 6.51 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
August	1997	6.85	6.16 to 7.33	6.16 to 7.53

Notice 97–48

Revenue Procedure 96–11, Publication 1187, Specifications for Filing Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, Magnetically or Electronically, will not be reissued for Tax Year (TY) 97 filing, which is processed in 1998. Following are the changes that have occurred since the 1/96 revision:

1. The ZIP Code has changed from 25401–1359 to 25402–1359 for the IRS P.O. Box address for the Martinsburg Computing Center.

If by Postal Service:

IRS-Martinsburg Computing Center
Information Reporting Program
P. O. Box 1359, MS–360
Martinsburg, WV **25402**-1359

or

If by private delivery service:

IRS-Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road, MS–360
Martinsburg, WV 25401

2. To provide clarification of the correction process for Forms 1042–S, the following definitions have been provided:
   a. **A void** record is an information return (Form 1042–S) submitted by the transmitter to replace a previously filed incorrect original return. A void record must be a duplicate of the original successfully processed return with the exception of a "V" in field position 371 of the "Q" record. **This record can be filed with or without a corresponding "C" record.** For example, a Form 1042–S was submitted, and it should have been prepared as a Form 1099. A "Q" record with the original Form 1042–S information would be filed with a "V" in position 371. In this instance, a corresponding "C" coded "Q" record would **NOT** be necessary.
   b. **A correction** is an information return (Form 1042–S) submitted by the transmitter to correct a return that was successfully processed by IRS/MCC, but contained erroneous information. A "C" in field position 371 of the "Q" record identifies a correction record. **This record must always have a corresponding "V" coded record.**

Following is a chart showing the steps to be taken for correcting Forms 1042–S:

Guidelines for Filing Corrected Returns Magnetically/Electronically

Transaction 1: Identify incorrect returns (void process)

The record sequence for filing corrections is the same as for original returns. Create the file in the following order exactly the same as the original transmission:

a. Transmitter "T" Record
b. Recipient "Q" Record with the exact information as submitted originally, however,
c. Place a "V" (See Note) in field position 371 of the "Q" Record
d. Prepare a Withholding Agent "W" Record summarizing the preceding "V" Coded "Q" Records. (See sample format below.)

☞ **Note: A "V" coded "Q" Record may or may not have a corresponding "C" Coded "Q" Record.**

Transaction 2: Report the correct information (correction process)

On the same media or electronic submission, prepare:

a. Recipient "Q" Record with the correct information
b. Place a "C" **(See Note)** in Field Position 371 of the "Q" Record
c. Prepare a Withholding Agent "W" Record summarizing the preceding "C" coded "Q" records
d. Prepare an End of Transmission "Y" record
e. "V" and "C" Coded Corrected returns submitted to IRS/MCC **must** be in the same submission.

☞ **Note : Each "C" Coded "Q" Record MUST have a corresponding "V" Coded Record**

Sample data sequences for void/ correction records:

T
Q with V
Q with V
Q with V
Q with V
Q with V
Q with V
W
Q with C
Q with C
Q with C
Q with C
W
Y

3. "T" Record—Change Tax Year (positions 2–3) to 97 for income and withholding reported for 1997 (unless reporting for a different tax year). All other "T" record data fields in the 1/96 revision remain the same.
4. "Q" Record Changes—The following fields (items A–E) indicate changes made to the information contained in the 1/96 revision. All other "Q" record data fields remain the same.

Positions	Field Title	Length	Description and Remarks
(A) Field Position 112 has changed to include the definition for the Individual Taxpayer Identification Number.			
112	Type of TIN	1	This field is used to identify the Taxpayer Identification Number (TIN) in positions 112–121 as either an Employer Identification Number (EIN), or a Social Security Number (SSN) or an Individual Taxpayer Identification Number (ITIN). Enter the appropriate code from the following table: **Type of TIN** **Type of Account** 1 EIN A business, organization, sole proprietor, or other entity 2 SSN An individual, including a sole proprietor **OR** ITIN An individual required to have a taxpayer identification number, but who is not eligible to obtain an SSN Blank If the type of TIN is not determinable, enter a blank.
(B) The Form 1042–S Paper instructions are updated each year. Changes are made to the list of Country Codes at that time.			
137–138	Country Code	2	The list of country codes included in the **1997** Paper Instructions for Forms 1042–S should be used to ensure the proper coding of the country code field.

(C) In addition to the Income Code information provided in the Publication 1187, the following information is included as a result of the tax law change in the reporting of Canadian Interest.

Positions	Field Title	Length	Description and Remarks
355–356	Income Code	2	Use Income Code 1 for the reporting of interest payments to Canadian residents who are not U.S. citizens

(D) In addition to the Exemption Code information provided in the Publication 1187, the following information is included as a result of the tax law change in the reporting of Canadian Interest.

370	Exemption Code	1	Use Exemption Code 2 for the reporting of interest payments to Canadian residents who are not U.S. citizens.

(E) The title of this field position changed.

371	Original, Void, or Corrected Return Indicator	1	**Required.** Enter the one position code below to identify an Original, Incorrect or Corrected Return. (See Part A. Sec. 13.)

Code	Description
Zero	If this is an Original Return.
V	Enter a "V" to void the incorrect original return submitted. **(See Transaction 1)**
C	Enter a "C" if this is to identify the Correct Return. **(See Transaction 2)**

5. "W" Record—Change Tax Year (positions 2–3) to 97 for income and withholding reported for 1997 (unless reporting for a different tax year).

6. In all records, alpha characters entered must be upper case.

7. Notice to filers:

   Format changes to accommodate Year 2000 will occur for **TY98** in calendar year **1999.**

   Treasury has mandated that all electronic year dates exchanged with non-IRS organizations, both government and private, both input and output, shall adhere to the following:

   — All Gregorian date formats will be in the format 'YYYYMMDD'.

   — All other year date formats (e.g., Julian, Tax Period, Cycle Dates) will expand representations from two-digit year to four-digit year: 'YYYY'.

Electing Small Business Trusts

Notice 97-49

BACKGROUND

Section 1302 of the Small Business Job Protection Act of 1996, Pub. L. No. 104–188, 110 Stat. 1755 (1996), amended § 1361 of the Internal Revenue Code to permit an electing small business trust (ESBT) to be a shareholder of an S corporation. This notice provides guidance regarding the definitions of beneficiary and potential current beneficiary under §§ 1361(e)(1)(A)(i) and 1361(e)(2) respectively, and the ordering of ESBT distributions under § 641(d).

Only a corporation that meets the definition of a small business corporation may be an S corporation. To be a small business corporation, the corporation may have as shareholders only those persons permitted by § 1361(b)(1), including trusts described in § 1361(c)(2). Section 1361(c)(2) contains two separate provisions. The first provision is a requirement that the trust holding stock in the corporation must be a trust listed in § 1361(c)(2)(A) (e.g., ESBT, qualified subchapter S trust, etc.). Under the second provision, the respective persons listed in § 1361(c)(2)(B) are treated as shareholders of the S corporation for purposes of the shareholder restrictions under § 1361(b)(1). To qualify as an ESBT (an eligible trust under § 1361(c)(2)(A)(v)), a trust must meet the requirements set forth in § 1361(e)(1) (including the limitation on the types of beneficiaries). Pursuant to § 1361(c)(2)(B)(v), the ESBT's potential current beneficiaries (as defined in § 1361(e)(2)) must be qualifying shareholders of the S corporation for purposes of § 1361(b)(1).

As used in this notice, the term "distributee trust" means a trust that is receiving or may receive a distribution from an intended ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

ESBT BENEFICIARIES

Section 1361(e)(1)(A)(i) provides that an ESBT may not have as a beneficiary any person other than (I) an individual, (II) an estate, or (III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), which holds a contingent interest and is not a potential current beneficiary. For tax years beginning after December 31, 1997, the clause "which holds a contingent interest and is not a potential current beneficiary" is deleted. Section 1361(e) does not provide a specific definition of the term "beneficiary".

Solely for purposes of section 1361(e)(1)(A)(i), the following rules apply in defining the term "beneficiary":

1. The term "beneficiary" does not include a distributee trust (other than a trust described in paragraphs (2) or (3) of § 170(c)), but does include those persons who have a beneficial interest in the property held by the distributee trust. For example, an intended ESBT's governing instrument provides for discretionary distributions of income or principal to A for life, and upon A's death the division of the remainder into separate trusts for the benefit of A's children. For purposes of § 1361(e)(1)(A)(i), the beneficiaries of the intended ESBT are A and A's children, and not the separate trusts for the benefit of A's children. Therefore, because all the beneficiaries of the intended ESBT are individuals, the intended ESBT meets the requirements of § 1361(e)(1)(A)(i).

2. The term "beneficiary" does not include a person in whose favor a power of appointment could be exercised. Such a person becomes a beneficiary only when the holder of the power of appointment actually exercises the power of appointment in such person's favor.

3. The term "beneficiary" does not include a person whose contingent interest is so remote as to be negligible. For example, except in unusual circumstances, the contingent interest a State has under its laws pertaining to escheat would be considered negligible, and the State would not be considered a beneficiary of the intended ESBT.

ESBT POTENTIAL CURRENT BENEFICIARIES

Section 1361(c)(2)(B)(v) provides that each potential current beneficiary of an ESBT shall be treated as a shareholder for purposes of determining whether a corporation qualifies as a small business corporation, except that the trust is treated as the shareholder for any period in which there is no potential current beneficiary.

Section 1361(e)(2) provides that, for purposes of § 1361, the term "potential current beneficiary" means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust. Section 7701(a)(1) defines person to include a trust for all purposes of the Code where not otherwise distinctly expressed or manifestly incompatible with the intent of the specific provision.

For purposes of § 1361, the following rules apply in defining the term "potential current beneficiary":

1. If a distributee trust becomes entitled to, or at the discretion of any person may receive, a distribution from principal or income of the intended ESBT, then the S corporation election will terminate unless the distributee trust is a trust described in § 1361(c)(2)(A) (e.g., ESBT, qualified subchapter S trust, etc.). In addition, if the distributee trust is a trust described in § 1361(c)(2)(A), the persons described in § 1361(c)(2)(B) are treated as shareholders of the corporation for purposes of determining whether the shareholder restrictions under § 1361(b)(1) are met. In the above example involving the distributee trusts for A's children, the distributee trusts for A's children will become entitled to receive distributions from the ESBT upon A's death. At such time, the S corporation election will terminate unless (i) the distributee trusts are trusts described in § 1361(c)(2)(A), and (ii) the persons described in § 1361(c)(2)(B), with respect to the distributee trusts, satisfy the shareholder restrictions in § 1361(b)(1). If, for example, the distributee trusts are qualified subchapter S trusts, and A's children are the current income beneficiaries, A's children are treated as shareholders of the corporation for purposes of satisfying the shareholder restrictions under § 1361(b)(1).

2. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of the power of appointment) is not a potential current beneficiary until such time or the occurrence of such event. Whether a person to whom a distribution is or may be made during a period pursuant to a power of appointment is a potential current beneficiary is currently under study.

ESBT DISTRIBUTIONS

Section 641(d)(1) provides that the portion of an ESBT that consists of stock in one or more S corporations ("S portion") is taxed as a separate trust. Section 641(d)(2)(C) specifies that the only items of income, loss, deduction, or credit to be taken into account by the S portion ("S portion items") are (i) the items required to be taken into account under § 1366; (ii) any gain or loss from the disposition of stock in an S corporation; and (iii) to the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).

Section 641(d)(3) provides that the S portion items are excluded for purposes of determining the amount of tax on the portion of the trust that is not treated as a separate trust under § 641(d)(1) ("non-S portion") and are excluded in determining the distributable net income (DNI) of the entire trust. Section 641(d)(3) also provides that, except as otherwise provided, § 641(d) does not affect the taxation of any distribution from the trust.

Guidance has been requested on the treatment of distributions from an ESBT when the trust has fiduciary accounting income in both the S portion and the non-S portion of the trust. Section 641(d)(3) specifically provides that, except as otherwise specified, § 641(d) does not change the taxation of any distribution from the trust. Because the S portion items are not included in the computation of the ESBT's DNI, they are treated for purposes of determining the treatment of trust distributions in the same manner as any other item that does not enter into the DNI computation (e.g., capital gains and losses allocated to corpus). For example, for the tax year an ESBT has $40 of DNI from the non-S portion and $70 of net fiduciary accounting income from the S portion. If the ESBT makes a distribution of $100, the distribution includes $40 of DNI.

Designated Private Delivery Services

Notice 97–50

This notice provides that the list of private delivery services ("PDSs") designated under Notice 97–26, 1997–17 I.R.B. 6, ("designated PDSs") for purposes of the "timely mailing as timely filing/paying" rule of § 7502 of the Internal Revenue Code will remain in effect until further notice. This notice also modifies Rev. Proc. 97–19, 1997–10 I.R.B. 55, and Notice 97–26 by changing the periods during which PDSs can apply for designation and the dates that the Service will announce the new list of designated PDSs.

Section 7502(f) authorizes the Secretary to designate certain PDSs for the "timely mailing as timely filing/paying" rule of § 7502. Rev. Proc. 97–19 provides the criteria currently applicable for designation of a PDS. Rev. Proc. 97–19 (section 7.01(2)) provides for semiannual application periods ending on June 30th and December 31st. Rev. Proc. 97–19 (section 8.02) and Notice 97–26 provide that the Service will issue a revised list of designated PDSs on or before September 1st and March 1st of each year for which Rev. Proc. 97–19 is in effect.

Notice 97–26 designates the following PDSs with respect to the following specific services they provide:

1. Airborne Express (Airborne): Overnight Air Express Service, Next Afternoon Service, and Second Day Service

2. DHL Worldwide Express (DHL): DHL "Same Day" Service and DHL USA Overnight

3. Federal Express (FedEx): FedEx Priority Overnight, FedEx Standard Overnight, and FedEx 2Day

4. United Parcel Service (UPS): UPS Next Day Air, UPS Next Day Air Saver, UPS 2nd Day Air, and UPS 2nd Day Air A.M.

Airborne, DHL, FedEx, and UPS are not designated with respect to any type of delivery service not identified above. Notice 97-26 also provides special rules used to determine the date that will be treated as the postmark date for purposes of § 7502.

The Service received no applications for designation during the most recent application period, which ended June 30, 1997. Accordingly, until further notice, the list of designated PDSs in Notice 97–26 will remain in effect.

Section 7.01(2) of Rev. Proc. 97–19 is modified to provide that each year there will be only one application period, which will end on June 30th. Also, section 8.02 of Rev. Proc. 97–19 and Notice 97–26 are modified to provide that the Service will issue a notice providing a new list of designated PDSs on or before September 1st of each year for which Rev. Proc. 97–19 is in effect.

EFFECT ON OTHER DOCUMENTS

Notice 97–26 and Rev. Proc. 97–19 are modified.

EFFECTIVE DATE

This notice is effective on September 1, 1997.

Weighted Average Interest Rate Update

Notice 97–51

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for August 1997 is 6.58 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
September	1997	6.84	6.15 to 7.31	6.15 to 7.52

Qualified State Tuition Programs

Notice 97–52

Section 529 of the Internal Revenue Code provides tax-exempt status to qualified State tuition programs ("QSTPs"). This notice extends the relief granted in Notice 96–58, 1996–2 C.B. 215 concerning the reporting requirements applicable to QSTPs described in § 529 through 1998. Notice 96–58 provides that reporting will not be required for any distribution made by, or benefit furnished in-kind under, a QSTP prior to 1998. In addition, Notice 96–58 provides that the Internal Revenue Service will not assess penalties against program administrators who do not file information returns or provide payee statements on distributions made during 1997 and prior years.

Sections 211 and 1601(h)(1) of the Taxpayer Relief Act of 1997, Pub. L. 105–34 (the "Act") amend § 529. The Act expands the definitions of "qualified higher education expenses" to include room and board expenses, "eligible educational institution" to include certain proprietary institutions and post-secondary vocational institutions, and "member of the family" to include persons described in § 152(a)(1) through (8). The Act clarifies the prohibition against investment direction in § 529(b)(5). The Act amends the gift tax treatment of contributions or transfers to QSTPs made after August 5, 1997, and the estate tax treatment for decedents dying after June 8, 1997.

The Internal Revenue Service is continuing to develop reporting requirements for QSTPs. Because guidance on the reporting requirements must now take account of these amendments and because States will need additional time to implement appropriate recordkeeping and reporting procedures, reporting will not be required for calendar years prior to 1999. Further, the Internal Revenue Service will not assess penalties against program administrators who do not file information returns or provide payee statements on distributions made during 1998 and prior years.

Penalty-Free Withdrawals from IRAs for Higher Education Expenses

Notice 97–53

Section 203 of the Taxpayer Relief Act of 1997 provides that the 10-percent additional tax on early distributions from individual retirement arrangements (IRAs) does not apply to certain distributions for educational expenses after 1997. This Notice provides guidance concerning the effective date of this provision.

In general, section 72(t) of the Internal Revenue Code imposes an additional 10-percent tax on amounts withdrawn from a qualified retirement plan (including an IRA) before age 59½ subject to certain exceptions. Section 203 of the Taxpayer Relief Act of 1997 added certain educational expenses to the list of exceptions to the 10-percent additional tax. The exception for educational expenses is limited to the qualified higher education expenses of the taxpayer, the taxpayer's spouse, or any child or grandchild of the taxpayer or spouse.

Section 203 is effective for IRA distributions made after December 31, 1997, with respect to expenses paid after that date, for education provided in academic periods beginning after that date. An "academic period" includes a semester, trimester, quarter, or other academic term designated by the educational institution. For this purpose, an academic period begins on the first day of classes, and does not include periods of orientation, counseling or vacation.

For example, assume the 1997-1998 schedule of a college or university divides the academic year into two semesters; the first semester begins in September 1997, and the second semester begins in January 1998. The benefits are not available for the September semester. The benefits of section 203 would be available, however, for the qualified expenses for the semester that begins in January 1998, provided the IRA distribution is made after December 31, 1997 and the expenses are paid after that date. This result applies to students who are enrolled in both semesters as well as to students whose enrollment begins only with the January semester.

Work Opportunity Tax Credit and Welfare-to-Work Tax Credit

Notice 97–54

The Taxpayer Relief Act of 1997, Pub. L. No. 105–34, (the Act) was enacted on August 5, 1997. The Act extended and amended the Work Opportunity Tax Credit (WOTC) under section 51 of the Internal Revenue Code and created the Welfare-to-Work tax credit under new section 51A of the Code. This notice describes the principal statutory changes. It also announces the release of a new Form 8850 (issued September 1997) for use in pre-screening job applicants and requesting certifications in connection with both credits and a transition period for using the earlier version of Form 8850 (issued September 1996), which does not reflect the changes contained in the Act.

WOTC Overview

The WOTC is a tax credit for employers who hire individuals belonging to one of the targeted groups listed in section 51 of the Code. For purposes of the credit, an individual is not a member of a targeted group unless the individual is certified as such by the State employment security agency (SESA). *See* section 51(d)(11) of the Code and Notice 96–52, 1996–2 C.B. 218.

• *Extension and Amendment of WOTC*

Prior to amendment, (1) the WOTC was scheduled to expire on September 30, 1997, (2) there were seven targeted groups, (3) the credit was 35 percent of first-year wages up to $6,000 (for a maximum credit of $2,100 per individual), and (4) the minimum employment period was generally 400 hours or 180 days. Act section 603 made several changes to the WOTC. First, it extended the credit to cover individuals who begin work by June 30, 1998. The Act modified the definitions of two targeted groups: (i) qualified recipients of benefits under Aid to

Families with Dependent Children (AFDC) or a successor program and (ii) qualified veterans. It added a new targeted group consisting of certain individuals who receive supplemental security income (SSI) benefits under the Social Security Act. It increased the credit percentage to 40 percent for certified workers who work at least 400 hours (for a maximum credit of $2,400 per individual). Finally, the Act amended the minimum employment period so that employers may also claim the WOTC for certified workers who work at least 120 hours but less than 400 hours. Workers who meet this minimum work requirement will entitle the employer to a credit of 25 percent of qualified wages. No credit is available for workers who work less than 120 hours.

• *Certification Process*

There are two ways an employer can satisfy the requirement to obtain a certification that a worker is a member of a targeted group. First, the employer can obtain a certification from the SESA, on or before the day the individual begins work, stating that the individual belongs to a targeted group. Section 51(d)(11)(A)(i) of the Code.

Alternatively, the employer can complete a "pre-screening notice" with respect to the prospective employee on or before the day the individual is offered employment. Then, within 21 days after the individual begins work, the employer submits that notice to the SESA as part of a request for certification. Section 51(d)(11)(A)(ii). For this purpose, employers have been using Form 8850, *Work Opportunity Tax Credit Pre-Screening Notice and Certification Request* (issued September 1996). (See Revised Form 8850 discussion on page 8.)

Welfare-to-Work Tax Credit Overview

The new Welfare-to-Work tax credit, added by section 801 of the Act, is a tax credit for employers who hire individuals certified by the SESA as long-term family assistance recipients. The credit is effective for wages paid to such individuals who begin work after December 31, 1997, and before May 1, 1999. Long-term family assistance recipients are (1) members of a family that has received family assistance (AFDC or a successor program) for at least 18 consecutive months ending on the hiring date; (2) members of a family that has received family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997; and (3) members of a family that ceases after August 5, 1997, to be eligible for family assistance because of either federal or state time limits.

The Welfare-to-Work tax credit is 35 percent of qualifying first-year wages and 50 percent of qualifying second-year wages. For this purpose (although not for the WOTC), wages include certain tax-exempt amounts relating to accident and health coverage, educational assistance programs, and dependent care assistance programs. For each employment year, up to $10,000 of wages (in contrast with the $6,000 maximum for the WOTC) may be considered in determining the amount of the Welfare-to-Work tax credit.

Although the substantive requirements are different for the WOTC and the Welfare-to-Work tax credit, the certification process is the same. Thus, the employer must either receive a certification from the SESA on or before the day the individual begins work, stating that the individual is a long-term family assistance recipient, or the employer must complete a "pre-screening notice" on or before the day the individual is offered employment. In the latter case the employer must, within 21 days after the individual begins work, submit that notice to the SESA as part of a request for certification.

Coordination of WOTC and Welfare-to-Work Tax Credit

The Welfare-to-Work tax credit is coordinated with the WOTC so that in any one taxable year an employer cannot claim both credits with respect to the same individual. For example, assume that an individual begins work on March 1, 1998, and works at least 400 hours for an employer whose taxable year is the calendar year. The employer pays "first-year wages" from March 1998 through February 1999, and pays "second-year wages" from March 1999 through February 2000. If the individual is certified as both a member of one of the WOTC targeted groups and a long-term family assistance recipient and the requirements for both credits are otherwise satisfied, the employer will have the following choices. For 1998, the employer may claim either the WOTC (40 percent of wages up to $6,000) or the Welfare-to-Work tax credit (35 percent of wages as defined in section 51A(b)(5) of the Code up to $10,000). For 1999, the employer may choose again which credit to claim. The WOTC would be based solely on the amount of first-year wages (up to the $6,000 limit) paid in 1999, during the balance of the first employment year (i.e., January and February 1999). The Welfare-to-Work tax credit would have two components: 35 percent of the amount of first-year wages (up to the $10,000 limit) paid in January and February 1999, and 50 percent of the amount of the second-year wages (up to a separate $10,000 limit) paid in March through December 1999. For 2000, the taxpayer could claim only the Welfare-to-Work tax credit, based on the amount of second-year wages (up to the second $10,000 limit) paid in January and February 2000.

Revised Form 8850

On September 20, 1997, the IRS issued a revised and renamed Form 8850, *Pre-Screening Notice and Certification Request for the Work Opportunity and Welfare-to-Work Credits.* The changes to the WOTC and the enactment of the Welfare-to-Work tax credit are reflected on a single form to simplify the certification process for prospective employees, employers, and SESAs.

How to Get the Revised Form 8850

The new form is available to computer users through the IRS home page on the World Wide Web, http://www.irs.ustreas.gov, and by modem directly at 703-321-8020 (not a toll-free number). Employers may also request Form 8850 by calling 1-800-TAX-FORM (1-800-829-3676).

Transition Relief

Employers should begin using the new Form 8850 for employees whose first day of work is on or after October 1, 1997 (for the WOTC), or on or after January 1, 1998 (for the Welfare-to-Work tax credit). Employers may continue to use the old Form 8850, however, for individuals who are in one of the original seven WOTC targeted groups and begin work before January 1, 1998.

Employers that submit Forms 8850 to SESAs are not entitled to the applicable

credits unless the employers receive the required certifications. Before claiming the WOTC or the Welfare-to-Work tax credit with respect to an individual, the employer must receive a certification from the SESA that the individual is, in fact, a member of a targeted group or a long-term family assistance recipient, as the case may be.

Section 6662—Imposition of the Accuracy-Related Penalty; Correction

Notice 97–55

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Correcting amendment.

SUMMARY: This document contains a correction to final regulations (T.D. 8656[1996–1 C.B. 329]) in the Code of Federal Regulations, which were published in the **Federal Register** on Friday, February 9, 1996 (61 FR 4876). The final regulations provide guidance on the imposition of the accuracy related penalty.

EFFECTIVE DATE: February 9, 1996.

SUPPLEMENTARY INFORMATION:

Background

The final regulations that are the subject of these corrections are under section 6662 of the Internal Revenue Code.

Need for Correction

As published, T.D. 8656 contains an error that may prove to be misleading and is in need of clarification.

* * * * *

Accordingly, 26 CFR part 1 is corrected by making the following correcting amendment:

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 * * *

§ 1.6662–6 [Corrected]

Par. 2. In § 1.6662-6, paragraph (d)(2)-(ii)(E) is amended by removing the language "§1.482–1(e)(2)(ii)(B)" from the last sentence and adding the language "§1.482–1(e)(2)(iii)(B)" in its place.

Cynthia E. Grigsby,
Chief, Regulations Unit,
Assistant Chief Counsel (Corporate).

(Filed by the Office of the Federal Register on September 4, 1997, 8:45 a.m., and published in the issue of the Federal Register for September 5, 1997, 62 F.R. 46877)

Weighted Average Interest Rate Update

Notice 97–56

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for September 1997 is 6.50 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
October	1997	6.83	6.14 to 7.30	6.14 to 7.51

Nonbank Trustees and Custodians for Education Individual Retirement Accounts

Notice 97–57

(1) Purpose

This notice informs entities already approved to serve as nonbank trustees and custodians of individual retirement accounts (IRAs) that they are also approved to serve as nonbank trustees and custodians of Education IRAs and provides guidance on the procedures for being approved to be a nonbank trustee or custodian of an Education IRA.

(2) Education IRAs

Section 530 of the Internal Revenue Code, added by section 213 of the Taxpayer Relief Act of 1997, Pub. L. 105–34, provides a new type of tax-free savings vehicle for higher education expenses, called an Education Individual Retirement Account (Education IRA). A total amount of $500 per year may be contributed to Education IRAs for any beneficiary under the age of 18 years. To contribute the maximum of $500 for a beneficiary, a contributor must have adjusted gross income for the year not exceeding $95,000 ($150,000 for joint returns). The $500 maximum permitted contribution is phased out for contributors with adjusted gross income between $95,000 and $110,000 ($150,000 and $160,000 for joint returns). Education IRAs may be established in taxable years beginning after 1997.

(3) Approval of nonbank trustees and custodians

Under section 530 of the Code, the trustee or custodian of an Education IRA must be a bank (as defined in section 408(n) of the Code) or another person approved by the Internal Revenue Service.

Section 1.408–2(e) of the Income Tax Regulations sets forth the rules which an entity must meet to be approved by the Service as a nonbank trustee or custodian of an individual retirement account (IRA). Pursuant to this notice, any entity already approved by the Service to be a nonbank trustee or custodian of an IRA is automatically approved by the Service to be a nonbank trustee or custodian of an Education IRA. In addition, entities other than banks or previously approved nonbank IRA trustees or custodians may request approval to be a trustee or custodian of an Education IRA in accordance with the procedures set forth in section 1.408–2(e) and section 3.10 of Rev. Proc. 97-4, 1997–1 I.R.B. 97, dated January 6, 1997.

1998 Pension Plan Limitations, Etc.[1]

Notice 97–58

Section 415 of the Internal Revenue Code (the Code) provides for dollar limitations on benefits and contributions under qualified plans. Section 415 also requires that the Commissioner annually adjust these limits for cost-of-living increases. Other limitations applicable to deferred compensation plans are also affected by these adjustments.

Effective January 1, 1998, the limitation for the annual benefit under § 415(b)(1)(A) for defined benefit plans is increased from $125,000 to $130,000. For participants who separated from service before January 1, 1998, the limitation for defined benefit plans under § 415(b)(1)(B) is computed by multiplying the participant's compensation limitation, as adjusted through 1997 by 1.0220. The limitation for defined contribution plans under § 415(c)(1)(A) remains unchanged at $30,000.

The Code provides that various other dollar amounts are to be adjusted at the same time and in the same manner as the dollar limitation of § 415(b)(1)(A) is adjusted. These dollar amounts and the adjusted amounts are as follows:

The dollar limitation on early retirement benefits for qualified police or firefighters in a defined benefit plan was amended by § 1527 of the Taxpayer Relief Act of 1997 (TRA '97), effective for years beginning after December 31, 1996. This section amended § 415(b)(2)(G) of the Code so that the dollar limitation for qualified police or firefighters is not reduced where the benefit begins before the social security retirement age.

The limitation on the exclusion for elective deferrals under § 402(g)(1) is increased from $9,500 to $10,000.

The dollar amount under § 409(o)(1)-(C)(ii) for determining the maximum account balance in an employee stock ownership plan subject to a 5-year distribution period is increased from $710,000 to $725,000, while the dollar amount used to determine the lengthening of the 5-year distribution period is increased from $140,000 to $145,000.

The excess distribution and excess retirement accumulation tax was repealed by § 1073 of TRA '97, effective for excess distributions received after, and to estates of decedents dying after, December 31, 1996. This section of TRA '97 repealed § 4980A of the Code, thereby removing the threshold amount under § 4980A(c)-(1)(B) regarding excess distributions.

The limitation used in the definition of highly compensated employee under § 414(q)(1)(B) remains unchanged at $80,000.

The annual compensation limit under §§ 401(a)(17) and 404(l) remains unchanged at $160,000. The annual compensation limit under § 401(a)(17) for eligible participants in certain governmental plans that, under the plan as in effect on July 1, 1993, allowed cost-of-living adjustments to the compensation limitation under the plan under § 401(a)(17) to be taken into account, is $265,000.

The compensation amount under § 408(k)(2)(C) regarding simplified employee pension plans (SEPs) remains unchanged at $400. The compensation amount under § 408(k)(3)(C) for SEPs remains unchanged at $160,000.

The limitation under § 408(p)(2)(A) regarding simple retirement accounts remains unchanged at $6,000.

The limitation on deferrals under § 457(b)(2) and (c)(1) concerning eligible deferred compensation plans of state and local governments and of tax-exempt organizations is increased from $7,500 to $8,000.

Administrators of defined benefit or defined contribution plans that have received favorable determination letters should not request new determination letters solely because of yearly amendments to adjust maximum limitations in the plans.

Capital Gains Rates

Notice 97–59

PURPOSE

The Taxpayer Relief Act of 1997 (the "1997 Act") amended § 1(h) of the Internal Revenue Code ("new § 1(h)") to provide for new capital gains rates for noncorporate taxpayers (individuals, estates, and trusts), effective for tax years ending after May 6, 1997. Pub. L. No. 105–34, § 311, 111 Stat. 788 (Aug. 5, 1997). The chairmen and ranking members of both the House Ways and Means Committee and the Senate Finance Committee have advised the Department of the Treasury of their intent to pursue technical corrections legislation which would correct and clarify the rules for netting capital gains and losses under new § 1(h) and coordinate new § 1(h) with certain other provisions of the Code. Such legislation has already been approved by the House Ways and Means Committee. *See* H.R. 2645, 105th Cong. § 4(d) (1997). When enacted, the legislation will be effective retroactively for tax years ending after May 6, 1997. This notice summarizes new § 1(h) and describes how the Internal Revenue Service is taking into account the pending retroactive legislative corrections in administering the provision.

BACKGROUND

Under prior law, capital gains were taxed at the same rate as ordinary income, except that a noncorporate taxpayer was subject to a maximum marginal rate of 28 percent on net capital gain. Under § 1222, net capital gain is the excess of net long- term capital gain (from assets held for more than one year) over net short-term capital loss (from assets held for one year or less).

The definitions of net capital gain, net long-term capital gain or loss, and net short-term capital gain or loss were not changed by the 1997 Act. However,

[1]Based on News Release IR-97-41, dated October 22, 1997.

under new § 1(h), if a noncorporate taxpayer has a net capital gain, the taxpayer's long-term capital gains and losses are separated into three tax rate groups.

(1) *The 28-percent group.* The 28-percent group consists of the following:

(a) capital gains and losses properly taken into account before May 7, 1997, from assets held for more than one year;

(b) capital gains and losses properly taken into account after July 28, 1997, from assets held for more than one year but not more than 18 months; and

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

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

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

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

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

NETTING GAINS AND LOSSES

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

(1) *Short-term capital gains and losses.* As under prior law, short-term capital losses (including short-term capital loss carryovers) are applied first to reduce short-term capital gains, if any, otherwise taxable at ordinary income rates. A net short-term capital loss is then applied to reduce any net long-term gain from the 28-percent group, then to reduce gain from the 25-percent group, and finally to reduce net gain from the 20-percent group.

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

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

COORDINATION WITH OTHER PROVISIONS

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

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

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

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

FORMS AND PUBLICATIONS

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

Education Tax Incentives

Notice 97-60

PURPOSE

The questions and answers contained in this notice provide guidance on the higher education tax incentives recently enacted by the Taxpayer Relief Act of 1997 (Pub. L. No. 105–34, 111 Stat. 788) (TRA '97). Specifically, TRA '97 added § 25A of the Internal Revenue Code providing the Hope Scholarship Credit and Lifetime Learning Credit, § 221 providing a deduction for student loan interest, and § 530 creating Education Individual Retirement Accounts ("Education IRAs"). TRA '97 also amended § 72(t) eliminating the early withdrawal tax on certain IRA withdrawals, § 127 providing an exclusion from income for employer-provided edu-

cational assistance, and § 529 setting the requirements for tax-exempt status for qualified state tuition programs (QSTPs).

These provisions create several new tax benefits for families who are saving for, or already paying, higher education costs or are repaying student loans. In addition, TRA '97 extends the exclusion for employer-provided educational assistance and makes the rules for qualified state tuition programs more flexible. The following discussion reviews in greater detail the requirements for each of these benefits. Whether a taxpayer may take advantage of these benefits depends on the taxpayer's individual facts and circumstances.

DISCUSSION

SECTION 1. THE HOPE SCHOLARSHIP CREDIT

Beginning January 1, 1998, taxpayers may be eligible to claim a nonrefundable Hope Scholarship Credit against their federal income taxes. The Hope Scholarship Credit may be claimed for the qualified tuition and related expenses of each student in the taxpayer's family (i.e., the taxpayer, the taxpayer's spouse, or an eligible dependent) who is enrolled at least half-time in one of the first two years of postsecondary education and who is enrolled in a program leading to a degree, certificate, or other recognized educational credential. The amount that may be claimed as a credit is generally equal to: (1) 100 percent of the first $1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses, plus (2) 50 percent of the next $1,000 of the taxpayer's out-of-pocket expenses for each student's qualified tuition and related expenses. Thus, the maximum credit a taxpayer may claim for a taxable year is $1,500 multiplied by the number of students in the family who meet the enrollment criteria described above.

The amount a taxpayer may claim as a Hope Scholarship Credit is gradually reduced for taxpayers who have modified adjusted gross income between $40,000 ($80,000 for married taxpayers filing jointly) and $50,000 ($100,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over $50,000 ($100,000 for married taxpayers filing jointly) may not claim the Hope Scholarship Credit. Both the dollar limitation on the expenses for which the credit may be claimed and the modified adjusted gross income limitation will be indexed for inflation in 2002 and years thereafter.

The Hope Scholarship Credit may be claimed for payments of qualified tuition and related expenses made on or after January 1, 1998, for academic periods beginning on or after January 1, 1998. Therefore, the first time taxpayers will be able to claim the credit is when they file their 1998 tax returns in 1999. The Hope Scholarship Credit is not available for any amount paid in 1997.

Q1: Who may claim the Hope Scholarship Credit?

A1: An individual paying qualified tuition and related expenses at a postsecondary educational institution may claim the credit, provided the student whose expenses are being paid and the institution meet certain eligibility requirements.

Q2: May an individual claim a Hope Scholarship Credit for paying qualified tuition and related expenses for other family members?

A2: Yes. An individual may claim the credit for his/her own qualified tuition and related expenses and the qualified tuition and related expenses of his/her spouse and other eligible dependents (including children) for whom the dependency exemption is claimed. Generally, a parent may claim the dependency exemption for his/her unmarried child if: (1) the parent supplies more than half the child's support for the taxable year, and (2) the child is under age 19 or is a full-time student under age 24.

Q3: What are the eligibility requirements for the student?

A3: A student is eligible for the Hope Scholarship Credit if: (1) for at least one academic period (e.g., semester, trimester, quarter) beginning during the calendar year, the student is enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential and is enrolled in one of the first two years of postsecondary education, and (2) the student is free of any conviction for a Federal or State felony offense consisting of the possession or distribution of a controlled substance. For purposes of the Hope Scholarship Credit, a student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full- time workload must equal or exceed the standards established by the Department of Education under the Higher Education Act and set forth in 34 C.F.R. § 674.2(b).

Q4: What are the eligibility requirements for the institution?

A4: The college, university, vocational school, or other postsecondary educational institution where the student is enrolled must be an institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Lifetime Learning Credit, described in the next section.)

Q5: The Hope Scholarship Credit may be claimed only for amounts spent on "qualified tuition and related expenses." Which expenses are included in qualified tuition and related expenses?

A5: The term "qualified tuition and related expenses" means the tuition and fees an individual is required to pay in order to be enrolled at or attend an eligible institution. Amounts paid for any course or other education involving sports, games, or hobbies are not eligible for the credit, unless the course or other education is part of the student's degree program. Charges and fees associated with room, board, student activities, athletics, insurance, books, equipment, transportation, and similar personal, living, or family expenses are not qualified tuition or related expenses. (The same definition of

"qualified tuition and related expenses" applies for the Lifetime Learning Credit, described in the next section.)

Q6: The Hope Scholarship Credit is available only if a taxpayer's "modified adjusted gross income" is below a specified amount. How does a taxpayer know what his/her modified adjusted gross income is?

A6: For most taxpayers, modified adjusted gross income is the same as adjusted gross income. Taxpayers compute adjusted gross income as part of completing a Federal income tax return. For those few taxpayers who earn income abroad or receive income from certain American territories or possessions, modified adjusted gross income will be greater than adjusted gross income. In those cases, the individual's adjusted gross income will be increased by: (1) certain amounts that the individual earns abroad, (2) amounts effectively connected with the individual's conduct of a trade or business or derived from sources in Guam, American Samoa, or the Northern Mariana Islands (if the individual is a resident of the possession where the source of the income is located), and (3) amounts derived from sources in Puerto Rico (if the individual is a Puerto Rican resident). (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q7: May a nonresident alien claim the Hope Scholarship Credit?

A7: Generally no. There is an exception for certain nonresident aliens who are married to U.S. citizens or resident aliens. Nonresident aliens should consult a U.S. tax advisor to determine whether the exception applies to them. (The same rules apply to the Lifetime Learning Credit, described in the next section.)

Q8: Are qualified tuition and related expenses for graduate-level degree work eligible for the Hope Scholarship Credit?

A8: No. However, the Lifetime Learning Credit is available for these expenses. (See Sec. 2, Q&A5.)

Q9: May an individual claim a Hope Scholarship Credit for more than one family member?

A9: Yes. Furthermore, the credit is calculated on a per student, rather than a per family, basis. For example, if an individual whose modified adjusted gross income is $35,000 pays over $2,000 in qualified tuition and related expenses for himself and over $2,000 in qualified tuition and related expenses for his dependent child, and both he and his dependent child meet the eligibility requirements, the individual may claim a Hope Scholarship Credit of $3,000 (i.e., a credit of $1,500 for his expenses plus a credit of $1,500 for his child's expenses).

Q10: May both the parent and a dependent child claim the Hope Scholarship Credit for the child's qualified tuition and related expenses in the same year?

A10: No. Either the parent or the child, but not both, may claim the credit for the child's expenses in a particular year. If an individual claims the child as a dependent on his/her Federal income tax return for the year, only the individual may claim the Hope Scholarship Credit for the child's qualified tuition and related expenses. If no one claims the child as a dependent on a Federal income tax return for the year, only the child may claim the Hope Scholarship Credit for the child's expenses. (The same rules relating to individuals and dependents apply for the Lifetime Learning Credit, described in the next section.)

Q11: If a married taxpayer files a separate return, may the taxpayer claim a Hope Scholarship Credit on his/her income tax return?

A11: No. Married taxpayers may claim the credit only if the taxpayer and the taxpayer's spouse file a joint return for the taxable year. (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q12: How does a parent claim a Hope Scholarship Credit for the qualified tuition and related expenses of a dependent child?

A12: The parent may claim the credit on his/her tax return even if the child files his/her own tax return. When a child is claimed as a dependent on a parent's return, any qualified tuition or related expenses paid by the child during the year are treated as if the parent had paid them. Therefore, these expenses are included in calculating the parent's Hope Scholarship Credit. A child may not claim a Hope Scholarship Credit on his/her tax return for a particular year if the child's parent claims the child as a dependent in that same year. (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q13: What is the maximum Hope Scholarship Credit a taxpayer may claim for an eligible student?

A13: Until 2002 (when the dollar limitations are indexed for inflation), for each student who meets the eligibility requirements, the credit amount is 100 percent of the first $1,000 of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses, plus 50 percent of the next $1,000 of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses. Therefore, the maximum credit amount for the expenses of an eligible student is $1,500. If the taxpayer is claiming a credit for more than one person, the credit amount for each student in the taxpayer's family is added together to determine the maximum total credit the taxpayer may claim.

Q14: The amount a taxpayer may claim as a Hope Scholarship Credit is gradually reduced for taxpayers with modified adjusted gross income between $40,000 and $50,000 (between $80,000 and $100,000 for married taxpayers filing jointly). How does this reduction work?

A14: The reduction works on a sliding scale that reflects where the taxpayer's modified adjusted gross income is in the phase-out range. For example, until 2002 (when the dollar limitations on the credit and the income ranges are indexed for inflation), if an eligible student (who is not anyone's dependent for tax purposes) pays $2,000 or more in qualified tuition and related ex-

penses in a particular year, and the student's modified adjusted gross income for the year is $45,000 (half way along the $10,000 phase-out range), the credit amount for the student is limited to $750. By contrast, if the same student's modified adjusted gross income was $35,000, the credit amount for the student would be the maximum $1,500.

Q15: How does a taxpayer claim the Hope Scholarship Credit?

A15: The first year that the credit will be available is 1998. Thus, taxpayers will not be able to claim the credit until they file their 1998 tax returns in 1999. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to calculate the credit and how to claim it on the tax return.

Q16: Is there a limit to the number of times a taxpayer may claim the Hope Scholarship Credit for each student?

A16: Yes. The credit may be claimed in no more than two years for each student. Thus, for example, a couple with a child who starts as a freshman in the fall of 1998, continues as a sophomore in 1999, and meets the eligibility requirements may claim the credit for their child's expenses in 1998 and again in 1999. After 1999, neither the parents, the student, nor anyone else may claim any additional Hope Scholarship Credits for this student's qualified tuition and related expenses. However, in 2000 and thereafter, the Lifetime Learning Credit may be available for this child's expenses. Furthermore, if the couple has another child who starts as a freshman in the fall of 1999, the couple may claim the Hope Scholarship Credit for that child's expenses in 1999 and one additional year.

Q17: May an individual claim both the Hope Scholarship Credit and the Lifetime Learning Credit for a student's expenses in a single taxable year?

A17: No. For each year in which a student meets the eligibility requirements for the Hope Scholarship Credit, the student's expenses may be used as the basis for a Hope Scholarship Credit or a Lifetime Learning Credit, but not both. If, for example, an eligible student pays more than $2,000 in qualified tuition and related expenses during the calendar year, the student (or the individual claiming the student as a dependent) may not claim the Hope Scholarship Credit for the first $2,000 of expenses and the Lifetime Learning Credit for the rest.

Q18: If a couple has two children, one who is a freshman and one who is a junior, may the couple claim a Hope Scholarship Credit for the freshman's expenses and a Lifetime Learning Credit for the junior's expenses?

A18: Yes. Assuming the applicable eligibility requirements have been met for each credit, a taxpayer may claim the Hope Scholarship Credit for one student's expenses and the Lifetime Learning Credit for another student's expenses in the same year.

Q19: May a parent or student claim a Hope Scholarship Credit for tuition paid in advance of when the academic period begins?

A19: Generally, the credit is available only for payments of qualified tuition and related expenses that cover an academic period beginning in the same calendar year as the payment is made. (An academic period begins on the first day of classes, and does not include periods of orientation, counseling, or vacation.) An exception, however, allows a parent or student to claim a Hope Scholarship Credit for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. Because the Hope Scholarship Credit does not apply to expenses paid before January 1, 1998, this exception does not apply to tuition paid in 1997 to cover academic periods beginning in 1998.

Q20: If a student (who is not claimed as a dependent on anyone's Federal income tax return) pays qualified tuition and related expenses using a combination of a Pell Grant, a loan, a gift from a family member, and some personal savings, what expenses may be taken into account in calculating the Hope Scholarship Credit the student may claim?

A20: The student may take into account only "out-of-pocket" expenses in calculating the credit. Qualified tuition and related expenses paid with the student's earnings, a loan, a gift, an inheritance, or personal savings (including savings from a qualified state tuition program) are taken into account in calculating the credit amount. However, qualified tuition and related expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are not taken into account in calculating the credit amount. (The same rules apply for the Lifetime Learning Credit, described in the next section.)

Q21: May a student's parents claim the Hope Scholarship Credit for the student's expenses for a taxable year in which the student takes money out of an Education IRA on a tax-free basis?

A21: No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Hope Scholarship Credit for that taxable year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on the Education IRA distributions received in any taxable year so that the student or the student's parents may claim a Hope Scholarship Credit for expenses paid in the same year the Education IRA distributions are received.

SECTION 2. LIFETIME LEARNING CREDIT

Beginning on July 1, 1998, taxpayers may be eligible to claim a nonrefundable Lifetime Learning Credit against their

federal income taxes. The Lifetime Learning Credit may be claimed for the qualified tuition and related expenses of the students in the taxpayer's family (i.e., the taxpayer, the taxpayer's spouse, or an eligible dependent) who are enrolled in eligible educational institutions. Through 2002, the amount that may be claimed as a credit is equal to 20 percent of the taxpayer's first $5,000 of out-of-pocket qualified tuition and related expenses for all the students in the family. After 2002, the credit amount is equal to 20 percent of the taxpayer's first $10,000 of out-of-pocket qualified tuition and related expenses. Thus, the maximum credit a taxpayer may claim for a taxable year is $1,000 through 2002 and $2,000 thereafter. These amounts are not indexed for inflation.

If the taxpayer is claiming a Hope Scholarship Credit for a particular student, none of that student's expenses for that year may be applied toward the Lifetime Learning Credit. The amount a taxpayer may claim as a Lifetime Learning Credit is gradually reduced for taxpayers who have modified adjusted gross income between $40,000 ($80,000 for married taxpayers filing jointly) and $50,000 ($100,000 for married taxpayers filing jointly). Taxpayers with modified adjusted gross income over $50,000 ($100,000 for married taxpayers filing jointly) may not claim a Lifetime Learning Credit. The modified adjusted gross income limitation will be indexed for inflation in 2002 and years thereafter. The definition of modified adjusted gross income is the same as it is for purposes of the Hope Scholarship Credit. (See Sec. 1, Q&A6.)

The Lifetime Learning Credit may be claimed for payments of qualified tuition and related expenses made on or after July 1, 1998, for academic periods beginning on or after July 1, 1998. Therefore, the first time taxpayers will be able to claim the credit will be when they file their 1998 tax returns in 1999. The Lifetime Learning Credit is not available for any amount paid in 1997.

Q1: Who may claim the Lifetime Learning Credit?

A1: An individual paying qualified tuition and related expenses at a postsecondary educational institution may claim the credit, provided the institution is an eligible educational institution. Unlike the Hope Scholarship Credit, students are not required to be enrolled at least half-time in one of the first two years of postsecondary education. Nonresident aliens generally are not eligible to claim the Lifetime Learning Credit. (See Sec. 1, Q&A7.)

Q2: May an individual claim a Lifetime Learning Credit for paying qualified tuition and related expenses for other family members?

A2: Yes. An individual may claim the credit for his/her own qualified tuition and related expenses and the qualified tuition and related expenses of his/her spouse and other eligible dependents (including children) for whom the dependency exemption is allowed. Generally, a parent may claim the dependency exemption for his/her unmarried child if: (1) the parent supplies more than half the child's support for the taxable year, and (2) the child is under age 19 or is a full-time student under age 24.

Q3: What are the eligibility requirements for the institution?

A3: They are the same requirements that apply for the Hope Scholarship Credit. (See Sec. 1, Q&A4.)

Q4: Is the Lifetime Learning Credit available for a student taking only one course?

A4: Yes. For example, a student who has just graduated from high school and is taking a single course at a community college may claim the Lifetime Learning Credit if the student comes within the income limits and is not claimed as a dependent by someone else.

Q5: Are qualified tuition and related expenses for graduate- level education eligible for the Lifetime Learning Credit?

A5: Yes.

Q6: May an individual claim a Lifetime Learning Credit for more than one family member?

A6: Yes. However, unlike the Hope Scholarship Credit, the Lifetime Learning Credit is calculated on a per family, rather than a per student, basis. Therefore, the maximum available credit does not vary with the number of students in the family. For example, if in 1999 a married individual whose modified adjusted gross income is $35,000 pays $5,000 of qualified tuition and related expenses to attend an eligible educational institution, the individual may claim a $1,000 Lifetime Learning Credit. If in the same year the individual also pays another $2,000 in qualified tuition and related expenses for his spouse to attend an eligible educational institution, the individual's Lifetime Learning Credit is still $1,000.

Q7: May both the parent and a dependent child claim the Lifetime Learning Credit for the child's qualified tuition and related expenses in the same year?

A7: No. Either the parent or the child, but not both, may claim the credit for the child's expenses in a particular year. If an individual claims the child as a dependent on his/her Federal income tax return for the year, only the individual may claim the Lifetime Learning Credit for the child's qualified tuition and related expenses. If no one claims the child as a dependent on a Federal income tax return for the year, only the child may claim the Lifetime Learning Credit for the child's expenses.

Q8: How does a parent claim a Lifetime Learning Credit for the qualified tuition and related expenses of a dependent child?

A8: The parent may claim the credit on his/her Federal income tax return even if the child files his/her own tax return. When a child is claimed as a dependent on the parent's return, any qualified tuition and related expenses paid by the child during the year are treated as if the parent had paid them and, therefore, are included in calculating the parent's Lifetime Learning Credit. A child may not claim a Lifetime Learning Credit on his/her tax return for any year if the child's parent claims the child as a dependent in that same year. Also, a married taxpayer who does not file a joint return is not eligible to claim the Lifetime Learning Credit. (See Sec. 1, Q&A11.)

Q9: What is the maximum Lifetime Learning Credit a taxpayer may claim?

A9: The credit is equal to 20 percent of the taxpayer's out-of-pocket expenses for qualified tuition and related expenses of all eligible family members, up to a maximum of $5,000 in expenses annually through 2002. Thus, the maximum Lifetime Learning Credit a taxpayer may claim through 2002 is $1,000. After 2002, the credit is equal to 20 percent of the taxpayer's out-of-pocket expenses up to a maximum of $10,000 in expenses. Thus, the maximum Lifetime Learning Credit a taxpayer may claim after 2002 is $2,000. The maximum credit does not change even if the taxpayer is claiming a credit for the expenses of more than one student in the family.

Q10: What does the term "qualified tuition and related expenses" mean for purposes of the Lifetime Learning Credit?

A10: The term "qualified tuition and related expenses" for purposes of the Lifetime Learning Credit has the same meaning as it does for purposes of the Hope Scholarship Credit. (See Sec. 1, Q&A5.)

Q11: If a student (who is not claimed as a dependent on anyone's Federal income tax return) pays qualified tuition and related expenses using a combination of a Pell Grant, a loan, a gift from a family member, and some personal savings, what expenses may be taken into account in calculating the Lifetime Learning Credit the student may claim?

A11: The student may take into account only "out-of-pocket" expenses in calculating the Lifetime Learning Credit. Qualified tuition and related expenses paid with the student's earnings, a loan, a gift, an inheritance, or personal savings (including savings from a qualified state tuition program) are taken into account in calculating the credit amount. However, qualified tuition and related expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are not taken into account in calculating the credit amount.

Q12: How does a taxpayer claim the Lifetime Learning Credit?

A12: The first year that the credit will be available is 1998. Taxpayers will not be able to claim the credit until they file their 1998 returns in 1999. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to calculate the credit and how to claim it on the tax return.

Q13: Is there a limit on the number of years in which a Lifetime Learning Credit may be claimed, as there is for the Hope Scholarship Credit?

A13: No. Unlike the Hope Scholarship Credit, there is no limit to the number of years in which a Lifetime Learning Credit may be claimed for each student. Thus, for example, an individual who enrolls in one college-level class every year would be able to claim the Lifetime Learning Credit for an unlimited number of years, provided the individual meets the income limits and is taking the classes at institutions that meet the eligibility requirements. (See Q&A3 in this section.)

Q14: May a parent or student claim a Lifetime Learning Credit for tuition paid in advance of when the academic period begins?

A14: Generally, the credit is available only for payments of qualified tuition and related expenses that cover an academic period beginning in the same calendar year as the year in which payment is made. (An academic period begins on the first day of classes, and does not include periods of orientation, counseling, or vacation.) An exception, however, allows a parent or student to claim a Lifetime Learning Credit for payments of qualified tuition and related expenses made during the calendar year to cover an academic period that begins in January, February, or March of the following taxable year. Because the Lifetime Learning Credit does not apply to expenses paid before July 1, 1998, this exception does not apply to tuition paid before that date to cover academic periods beginning before or after that date.

Q15: May a student or a student's parents take the Lifetime Learning Credit for the student's expenses in a taxable year in which the student takes money out of an Education IRA on a tax-free basis?

A15: No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Lifetime Learning Credit for that year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on the Education IRA distributions so that the student or the student's parents may claim a Lifetime Learning Credit for expenses paid in the same year the Education IRA distributions are received.

SECTION 3. EDUCATION IRAs

Beginning January 1, 1998, taxpayers may deposit up to $500 per year into an Education IRA for a child under age 18. Parents, grandparents, other family members, friends, and a child him/herself may contribute to the child's Education IRA, provided that the total contributions for the child during the taxable year do not exceed the $500 limit. Amounts deposited in the account grow tax-free until distributed, and the child will not owe tax on any withdrawal from the account if the child's qualified higher education expenses at an eligible educational institution for the year equal or exceed the amount of the withdrawal. If the child does not need the money for postsecondary education, the account balance can be rolled over to the Education IRA of certain family members who can use it for their higher education. Amounts withdrawn from an Education IRA that exceed the child's qualified higher education expenses in a taxable year are generally subject to income tax and to an additional tax of 10 percent. The Hope Scholarship Credit and Lifetime Learning Credit may not be claimed for a student's expenses in a taxable year in which the student takes a tax-free withdrawal from an Education IRA.

Q1: What is an Education IRA?

A1: An Education IRA is a trust or custodial account that is created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of the designated beneficiary of the

account. The account must be designated as an Education IRA when it is created in order to be treated as an Education IRA for tax purposes.

Q2: For whom may an Education IRA be established?

A2: An Education IRA may be established for the benefit of any child under age 18. Contributions to the Education IRA will not be accepted after the designated beneficiary reaches his/her 18th birthday.

Q3: Where may an individual open an Education IRA?

A3: An individual may open an Education IRA with any bank, or other entity that has been approved to serve as a nonbank trustee or custodian of an individual retirement account (IRA), and the bank or entity is offering Education IRAs. Other entities that wish to offer Education IRAs but are not approved to serve as IRA trustees or custodians may seek approval by following the same IRS procedures used for approval of other IRA nonbank trustees. See Notice 97–57, 1997–43 I.R.B. 19 (October 27, 1997).

Q4: When may a taxpayer start contributing to an Education IRA for a child?

A4: A taxpayer may start making contributions on January 1, 1998, or at any time thereafter.

Q5: How much may be contributed to a child's Education IRA?

A5: Up to $500 per year in aggregate contributions may be made for the benefit of any child. The contributions may be placed in a single Education IRA or in multiple Education IRAs.

Q6: What happens if more than $500 is contributed to an Education IRA on behalf of a child in a calendar year?

A6: Aggregate contributions for the benefit of a particular child in excess of $500 for a calendar year are treated as excess contributions. If the excess contributions (and any earnings attributable to them) are not withdrawn from the child's account (or accounts) before the tax return for the year is due, the excess contributions are subject to a 6 percent excise tax for each year the excess amount remains in the account.

Q7: May contributions other than cash be made to a child's Education IRA?

A7: No. Education IRAs are permitted to accept contributions made in cash only.

Q8: May contributors take a deduction for contributions made to an Education IRA?

A8: No.

Q9: Are there any restrictions on who can contribute to an Education IRA?

A9: Any individual may contribute up to $500 to a child's Education IRA if the individual's modified adjusted gross income for the taxable year is no more than $95,000 ($150,000 for married taxpayers filing jointly). (See Sec. 1, Q&A6 for a description of modified adjusted gross income.) The $500 maximum contribution per child is gradually reduced for individuals with modified adjusted gross income between $95,000 and $110,000 (between $150,000 and $160,000 for married taxpayers filing jointly). For example, an unmarried taxpayer with modified adjusted gross income of $96,500 in a taxable year could make a maximum contribution per child of $450 for that year. Taxpayers with modified adjusted gross income above $110,000 ($160,000 for married taxpayers filing jointly) cannot make contributions to anyone's Education IRA.

Q10: May a child contribute to his/her own Education IRA?

A10: Yes.

Q11: Does a taxpayer have to be related to the designated beneficiary in order to contribute to the designated beneficiary's Education IRA?

A11: No.

Q12: How many Education IRAs may a child have?

A12: There is no limit on the number of Education IRAs that may be established designating a particular child as beneficiary. However, in any given taxable year the total aggregate contributions to all the accounts designating a particular child as beneficiary may not exceed $500.

Q13: May a designated beneficiary take a tax-free withdrawal from an Education IRA to pay qualified higher education expenses if the designated beneficiary is enrolled less than full-time at an eligible educational institution?

A13: Yes. Whether the designated beneficiary is enrolled full- time, half-time, or less than half-time, he/she may take a tax-free withdrawal to pay qualified higher education expenses.

Q14: What happens when a designated beneficiary withdraws assets from an Education IRA to pay for college?

A14: Generally, the withdrawal is tax-free to the designated beneficiary to the extent the amount of the withdrawal does not exceed the designated beneficiary's qualified higher education expenses.

Q15: What are "qualified higher education expenses"?

A15: "Qualified higher education expenses" mean expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. Qualified higher education expenses also include amounts contributed to a qualified state tuition program. Qualified higher education expenses also include room and board (generally the school's posted room and board charge, or $2,500 per year for students living off-campus and not at home) if the designated beneficiary is at least a half-time student at an eligible educational institution. The standards for determining whether a student is enrolled at least half-time are the same as those used for the Hope Scholarship Credit. (See Sec. 1, Q&A3.)

Q16: What is an eligible educational institution?

A16: An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply

for the Hope Scholarship Credit, the Lifetime Learning Credit, and early withdrawals from IRAs for qualified higher education expenses. (See Sec. 1, Q&A4, Sec. 2, Q&A3, and Sec. 4, Q&A2.))

Q17: What happens if a designated beneficiary withdraws an amount from an Education IRA but does not have any qualified higher education expenses to pay in the taxable year he/she makes the withdrawal?

A17: Generally, if a designated beneficiary withdraws an amount from an Education IRA and does not have any qualified higher education expenses during the taxable year, a portion of the distribution is taxable. The taxable portion is the portion that represents earnings that have accumulated tax-free in the account. The taxable portion of the distribution is also subject to a 10 percent additional tax unless an exception applies.

Q18: Is a distribution from an Education IRA taxable if the distribution is contributed to another Education IRA?

A18: Any amount distributed from an Education IRA and rolled over to another Education IRA for the benefit of the same designated beneficiary or certain members of the designated beneficiary's family is not taxable. An amount is rolled over if it is paid to another Education IRA on a date within 60 days after the date of the distribution. Members of the designated beneficiary's family include the designated beneficiary's children and their descendants, stepchildren and their descendants, siblings and their children, parents and grandparents, stepparents, and spouses of all the foregoing. The $500 annual contribution limit to Education IRAs does not apply to these rollover contributions. For example, an older brother who has $2,000 left in his Education IRA after he graduates from college can roll over the full $2,000 balance to an Education IRA for his younger sister who is still in high school without paying any tax on the transfer.

Q19: What happens to the assets remaining in an Education IRA after the designated beneficiary finishes his/her postsecondary education?

A19: There are two options. The amount remaining in the account may be withdrawn for the designated beneficiary. The designated beneficiary will be subject to both income tax and the additional 10 percent tax on the portion of the amount withdrawn that represents earnings if the designated beneficiary does not have any qualified higher education expenses in the same taxable year he/she makes the withdrawal. Alternatively, if the amount in the designated beneficiary's Education IRA is withdrawn and rolled over (as described in Q&A18 of this section) to another Education IRA for the benefit of a member of the designated beneficiary's family, the amount rolled over will not be taxable.

Q20: Rather than rolling over money from one Education IRA to another, may the designated beneficiary of the account be changed from one child to another without triggering a tax?

A20: Yes, provided: (1) the terms of the particular trust or custodial account permit a change in designated beneficiaries (each trustee or custodian will control whether options like this one are available in the accounts they offer), and (2) the new designated beneficiary is a member of the previous designated beneficiary's family. (See Q&A18 in this section).

Q21: May a student or the student's parents claim the Hope Scholarship Credit or Lifetime Learning Credit for the student's expenses in a taxable year in which the student receives money from an Education IRA on a tax-free basis?

A21: No. If a student is receiving a tax-free distribution from an Education IRA in a particular taxable year, none of that student's expenses may be claimed as the basis for a Hope Scholarship Credit or Lifetime Learning Credit for that year. However, the student may waive the tax-free treatment of the Education IRA distribution and elect to pay any tax that would otherwise be owed on an Education IRA distribution so that the student or the student's parents may claim a Hope Scholarship Credit or Lifetime Learning Credit for expenses paid in the same year the Education IRA distributions are received.

Q22: May contributions be made to both a qualified state tuition program and an Education IRA on behalf of the same designated beneficiary in the same taxable year?

A22: No. Any amount contributed to an Education IRA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition program on behalf of the same beneficiary will be treated as an excess contribution to the Education IRA. (See Q&A6 in this section for the treatment of excess contributions.)

SECTION 4. USING IRA WITHDRAWALS TO PAY HIGHER EDUCATION EXPENSES

Beginning January 1, 1998, a taxpayer may make withdrawals from an individual retirement account (IRA) to pay the qualified higher education expenses for the taxpayer, the taxpayer's spouse, or the child or grandchild of the taxpayer or taxpayer's spouse at an eligible educational institution. The taxpayer will owe federal income tax on the amount withdrawn, but will not be subject to the 10 percent early withdrawal tax that applies when amounts are withdrawn from an individual retirement account before the account holder reaches age 59½.

Q1: When can an individual first make a withdrawal from an IRA to pay for qualified higher education expenses without paying the 10 percent early withdrawal tax?

A1: On or after January 1, 1998, an individual can make withdrawals from his/her IRA to pay for qualified higher education expenses for academic periods beginning on or after January 1, 1998, without paying the 10 percent early withdrawal tax. See Notice 97–53, 1997–40 I.R.B. 6 (October 6, 1997). The 10 percent early

withdrawal tax does not apply to a distribution from an IRA to the extent that the amount of the distribution does not exceed the qualified higher education expenses during the taxable year for the taxpayer, the taxpayer's spouse, and the child or grandchild of the taxpayer or the taxpayer's spouse at an eligible educational institution. For purposes of this rule, the term "qualified higher education expenses" means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the student at an eligible educational institution. Qualified higher education expenses also include room and board if the student is enrolled at least half-time. Qualified higher education expenses paid with an individual's earnings, a loan, a gift, an inheritance given to the student or the individual making the withdrawal, or personal savings (including savings from a qualified state tuition program) are included in determining the amount of the IRA withdrawal which is not subject to the 10 percent early withdrawal tax. Qualified higher education expenses paid with a Pell Grant or other tax-free scholarship, a tax-free distribution from an Education IRA, or tax-free employer-provided educational assistance are excluded.

Q2: What are the requirements for an "eligible educational institution".

A2: An "eligible educational institution" is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. (The same eligibility requirements for institutions apply for the Hope Scholarship Credit, the Lifetime Learning Credit, and Education IRAs. (See Sec. 1, Q&A4, Sec. 2, Q&A3, and Sec. 3, Q&A16.))

Q3: When are IRA withdrawals usually subject to the 10 percent early withdrawal tax?

A3: Generally, if a taxpayer makes a withdrawal from his/her IRA before reaching age 59½, the taxpayer must pay the 10 percent early withdrawal tax on all or part of the amount withdrawn.

Q4: In addition to the Education IRA, TRA '97 also created the Roth IRA. May a taxpayer make a withdrawal from a Roth IRA to pay for his/her child's qualified higher education expenses without paying the 10 percent early withdrawal tax?

A4: Yes. A taxpayer may make a withdrawal from a Roth IRA, as they can from other IRAs, to pay qualified higher education expenses without paying the 10 percent early withdrawal tax.

SECTION. 5. STUDENT LOAN INTEREST DEDUCTION

Beginning January 1, 1998, taxpayers who have taken loans to pay the cost of attending an eligible educational institution for themselves, their spouse, or their dependent generally may deduct interest they pay on these student loans. The maximum deduction each taxpayer is permitted to take increases from $1,000 in 1998 to $2,500 in 2001 and thereafter. The following table summarizes the yearly increases.

Year	*Maximum Deduction*
1998	$1,000
1999	$1,500
2000	$2,000
2001 and thereafter	$2,500

The deduction is available only for interest payments made during the first 60 months in which interest payments are required on the loan. The student loan interest deduction is available for interest payments due and made on or after January 1, 1998. Thus, the first time taxpayers will be able to claim the deduction is when they file their 1998 tax returns in 1999. No student loan interest deduction will be allowed for interest due or paid before 1998.

Q1: Are there any limits on what qualifies as a student loan?

A1: Yes. The loan must have been used to pay the costs of attendance at an eligible educational institution for a student enrolled at least half-time in a program leading to a degree, certificate, or other recognized educational credential. An eligible educational institution is any college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions. For purposes of the student loan interest deduction, eligible educational institutions also include institutions that conduct an internship or residency program leading to a degree or certificate awarded by an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

Q2: Is a student loan interest deduction available if the student loan is not federally guaranteed or otherwise subsidized?

A2: Yes. As long as the loan was used to pay the costs of attendance at an eligible educational institution and the other eligibility requirements are met, the deduction is available for the interest on the loan. The deduction does not depend on whether the loan is federally guaranteed or subsidized.

Q3: What costs are included in the costs of attendance?

A3: Costs of attendance include all items that are included in costs of attendance for purposes of calculating a student's financial need in accordance with the Higher Education Act. Thus, they include tuition, fees, room, board, books, equipment, and other necessary expenses, such as transportation. Costs of attendance include more items than are included in qualified tuition and related expenses for purposes of the Hope Scholarship and Lifetime Learning Credits. (See Sec. 1, Q&A5 and Sec. 2, Q&A10.)

Q4: Is the deduction available for interest paid on loans used to pay for graduate school?

A4: Yes.

Q5: Are there any limits on who may take the student loan interest deduction?

A5: Yes, there are income restrictions. To claim the maximum deduction, a taxpayer must have modified adjusted gross income of $40,000 or less ($60,000 for married taxpayers filing jointly). The amount of the taxpayer's deduction is gradually reduced for taxpayers with modified adjusted gross income between $40,000 and $55,000 (between $60,000 and $75,000 for married taxpayers filing jointly). For example, for 1998, the maximum deduction a single taxpayer with modified adjusted gross income of $47,500 could take would be $500. Taxpayers with modified adjusted gross income above $55,000 ($75,000 for married taxpayers filing jointly) may not claim the student loan interest deduction. The modified adjusted gross income limitations are indexed for inflation after 2002.

Q6: May former students whose loans are already in repayment deduct the interest they pay on a student loan on or after January 1, 1998?

A6: Yes, but they may deduct only those payments made during the first 60 months that interest payments are required on a loan. If interest payments on a student loan were first required before January 1, 1998, the months in which those payments were required count against the 60-month time limit for that loan. The 60-month period may run out at different times for different loans.

Q7: May a parent claim the student loan interest deduction if the parent borrows to pay his/her child's costs of attending college?

A7: Yes. An individual may claim the student loan interest deduction if the individual borrows money to pay the costs of attending college for certain members of the individual's family or household (including his/her children) and incurs the debt in a year in which the individual supplies more than half of the student's support.

Q8: If an individual has paid more than $1,000 in interest on student loans in 1998 and is otherwise eligible to take the maximum student loan interest deduction, how large a deduction may the individual claim?

A8: The individual's student loan interest deduction for 1998 is $1,000, provided the individual's modified adjusted gross income falls below the point where the deduction is reduced or eliminated.

Q9: Does an individual have to itemize his/her income tax deductions to claim the student loan interest deduction?

A9: No. The student loan interest deduction is available regardless of whether an individual elects to take the standard deduction or to itemize deductions. Instructions accompanying the 1998 tax forms (for returns required to be filed in 1999) will explain how to compute and claim the deduction.

Q10: If a student is claimed as a dependent by his/her parent in a particular taxable year, may the student take the student loan interest deduction for student loan interest that he/she pays in that year?

A10: No. The student may not claim the student loan interest deduction in any taxable year in which he/she is claimed as a dependent on another taxpayer's Federal income tax return. However, if the student continues to pay interest on a student loan and meets the other eligibility requirements, the student may claim the student loan interest deduction for payments made in a later year when the student is no longer a dependent on his/her parent's Federal income tax return.

Q11: Are there any tax benefits available if the student repays his/her loan by performing community service rather than making cash payments?

A11: There may be. Loan forgiveness provided in return for community service is tax-free when it is part of certain lending programs run by Federal, state, or local governments, educational institutions, or charitable organizations. Students should consult a tax advisor to determine whether they qualify.

SECTION 6. QUALIFIED STATE TUITION PROGRAMS

Under current law, a qualified state tuition program (QSTP) means a program established and maintained by a state under which a person may: (1) prepay tuition benefits on behalf of a beneficiary so that the beneficiary is entitled to a waiver or a payment of qualified higher education expenses, or (2) contribute to an account that is established for paying qualified higher education expenses of the beneficiary. The tax on earnings attributable to prepayments or contributions is deferred until the earnings are distributed from the QSTP. The beneficiary pays tax on the earnings at the time of distribution. If amounts saved through a QSTP are used to pay for college, the student or the student's parents still may be eligible to claim either the Hope Scholarship Credit or the Lifetime Learning Credit.

Q1: How have the prior rules for QSTPs been changed by TRA '97?

A1: (1) QSTPs may now be used to save for room and board expenses, up to a specified level (generally the school's posted room and board charge, or $2,500 per year for students living off-campus and not at home);

(2) QSTPs may now be used to pay expenses not only at public and nonprofit institutions but also at proprietary schools (i.e., any school that is an eligible educational institution for purposes of the Hope Scholarship or Lifetime Learning Credits, see Sec. 1, Q&A4);

(3) Accounts in QSTPs may now be transferred tax-free from the beneficiary to a broader range of family members. (Step-siblings and spouses of family members have been added.)

Q2: May a student using a QSTP to pay for college also benefit from the Hope Scholarship Credit or Lifetime Learning Credit?

A2: Yes. The student or the student's parent may claim a Hope Scholarship Credit or Lifetime Learning Credit for qualified tuition and related expenses covered by a qualified state tuition program, provided the other eligibility requirements for the credits are met.

Q3: When are the changes to the QSTP rules made by TRA '97 effective?

A3: Generally, the new rules go into effect on January 1, 1998. However, the new provision permitting QSTPs to be used to save for room and

board expenses is effective back to August 20, 1996.

Q4: May contributions be made to both a qualified state tuition program and an Education IRA on behalf of the same designated beneficiary in the same taxable year?

A4: No. Any amount contributed to an Education IRA on behalf of a designated beneficiary during any taxable year in which an amount is also contributed to a qualified state tuition program on behalf of the same beneficiary will be treated as an excess contribution to the Education IRA. (See Sec. 3, Q&A6 for the treatment of excess contributions to an Education IRA.)

SECTION 7. EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

TRA '97 extends tax-free treatment to employer-provided educational assistance for undergraduate courses that begin before June 1, 2000. Employers may continue to provide up to $5,250 per year in educational assistance to each employee on a tax-free basis for courses beginning before that date, regardless of whether the education is job-related. This benefit expires for assistance in paying for courses that begin on or after June 1, 2000.

Q1: How does an employee learn whether tax-free educational assistance is available to him/her?

A1: Employers have this information. Employers offering tax- free educational assistance are required to have a written plan describing the benefit and the terms under which it is available.

Q2: Does the employee have to do anything special to avoid being taxed on employer-provided educational assistance, up to the $5,250 limit?

A2: No. The employer will automatically treat the educational assistance as a tax-free benefit and will not include it as wages on the employee's W–2 form.

Q3: May an employee receive tax-free educational assistance from the employer to attend graduate school?

A3: In general, no. However, employers can provide job-related educational assistance for graduate-level education as a tax-free fringe benefit under certain circumstances. Educational assistance would generally qualify as job-related if it maintains or improves skills required for the employee's current job or satisfies certain express employer-imposed conditions for continued employment. Individuals should consult a tax advisor for help in determining the tax treatment of any assistance the individual may be receiving from an employer for graduate-level education.

Q4: If a student is enrolled in undergraduate courses in a particular year and owes $3,000 in qualified tuition and related expenses, and the student's employer pays all of the student's qualified tuition and related expenses, may a Hope Scholarship Credit or a Lifetime Learning Credit be claimed for that student for that year?

A4: No. Neither the Hope Scholarship Credit nor the Lifetime Learning Credit may be claimed for that student for that year.

* * * * *

The IRS will publish additional guidance on the provisions discussed in this notice as well as other provisions included in TRA '97. You may visit the IRS worldwide web site at (http://www.irs.ustreas.gov/prod/hot/index.html) to review this document or for information on additional guidance as it becomes available.

The Department of Education has a worldwide web site (http://www.ed.gov/prog_info/SFA/StudentGuide) you can visit and telephone numbers (1-800-4FED-AID and 1-800-USA-LEARN) you can call to get more information on affording college and obtaining student aid, such as Pell grants and student loans.

Notice 97–61

The Internal Revenue Service has undertaken a large-scale effort to address the year 2000 issue. The Year 2000 Conversion Project's primary goal is to make all current and future IRS information systems year 2000 compliant. That is, ensure that all computer systems function correctly before and after January 1, 2000.

The Internal Revenue Service has adopted a standard for the year representation and date representation. This standard will be used in all data exchanges with external trading partners (ETPs), Federal, state and local governments as well as the private sector. The standard is:

— an 8-position year when using the Gregorian data format; the 8 characters (YYYYMMDD) must be contiguous and the 4-position year field must be at the beginning of the date field;

— a four-position year when using the Julian date format; the date field would be represented as YYYYDDD;

— a four-position year when using the Epock/Offset date format where the Epoch (year field) contains four characters and the Offset is a time element determined by the system owner; and,

— a four-position year will be used in conjunction with all other date formats and the other elements of the date field.

The IRS said it will be contacting its external trading partners to inform them of the date by which data exchanges will be converted. The trading partners will be expected to certify that they will be ready to receive the data and that they will provide any related exchanges to the IRS as specified in the standard.

External Trading Partners who provide data in accord with specifications generally issued in Revenue Procedures will continue to be informed of the date requirements through Revenue Procedures. Others, with whom IRS has agreements for specific exchanges, such as with state revenue departments involved in tax administration, will be contacted individually by the IRS.

Presidentially Declared Disasters in North Dakota and Minnesota

Notice 97–62

PURPOSE

This notice provides immediate additional federal tax relief under §§ 6081, 6161, and 7508A of the Internal Revenue Code for taxpayers located in Grand Forks County, North Dakota, and Polk

County, Minnesota, which were declared major disaster areas by the President on April 7 and 8, 1997. This notice specifically provides up to a 90-day extension of the time to perform any act described in § 7508(a)(1), and generally provides an extension through January 13, 1998 for filing and paying federal income tax. In addition, the Treasury Department intends to issue regulations under § 7508A regarding the postponement of certain tax-related deadlines by reason of a Presidentially declared disaster.

SUMMARY OF RELIEF

As a result of this notice:

(1) Taxpayers located in Grand Forks County, North Dakota, and Polk County, Minnesota, will have an extension to January 13, 1998 to file certain federal tax returns originally due on or after April 15, 1997, and to pay the amount (or any installments) of tax shown or required to be shown on those returns, including — individual income tax returns (Forms 1040, 1040A, 1040EZ, 1040NR, 1040NR–EZ, or 1040PC), gift tax returns (Forms 709 and 709–A), partnership returns (Form 1065), corporate income tax returns (Forms 1120, 1120–A, 1120–H, or 1120S), estate and trust income tax returns (Form 1041), and annual returns filed by tax-exempt organizations (Forms 990, 990–EZ, or 990–T).

(2) For any quarterly estimated tax payment originally due on or after April 15, 1997 for taxpayers located in these two counties, the payment deadline is extended to January 13, 1998 and no estimated tax penalties will be assessed. This extension includes estimated tax payments made by individuals, corporations, estates, or trusts. The deadline for filing or paying employment or excise taxes cannot be extended.

(3) Interest (and penalties relating to the failure to file or pay) will be abated (and waived) through January 13, 1998 with respect to federal individual income tax returns originally due on or after April 15, 1997 for individuals (not including estates and trusts) located in these two counties.

For additional details on the relief provided in this notice, see the portion below headed "GRANT OF RELIEF."

BACKGROUND

Section 6081 provides that the Secretary may grant a reasonable extension of time (generally not to exceed 6 months) for filing any return, declaration, statement, or other document required by the Internal Revenue Code or by regulations thereunder.

Section 6161 provides that the Secretary may grant a reasonable extension of time (generally not to exceed 6 months) for paying the amount (or any installments) of tax shown or required to be shown on any return or declaration required by the Code or by regulations thereunder.

Section 7508A, as added to the Code by section 911 of the Taxpayer Relief Act of 1997 (Act), Pub. L. No. 105–34, 111 Stat. 788 (August 5, 1997), provides the Secretary with authority to postpone the time for performing certain acts under the internal revenue laws (as provided in § 7508(a)(1)) for a taxpayer affected by a Presidentially declared disaster (as defined in § 1033(h)(3)). Pursuant to § 7508A(a), the Secretary may prescribe regulations under which a period of up to 90 days may be disregarded in determining, under the internal revenue laws and in respect of any tax liability (including any penalty, additional amount, or addition to the tax) of such taxpayer,

(1) whether any of the acts described in § 7508(a)(1) (including filing and paying federal taxes) were performed within the time prescribed therefor, and

(2) the amount of any credit or refund.

Section 7508A applies to any period for performing an act that has not expired before August 5, 1997.

Section 915(a) of the Act further provides that under certain circumstances the assessment of interest with respect to income tax must be abated for any individual located in an area designated during 1997 as a Presidentially declared disaster area. This abatement is applicable for any period the Secretary has extended the time for filing income tax returns under § 6081 and the time for paying income tax with respect to such returns under § 6161 (and has waived any penalties relating to the failure to so file or so pay). For this purpose, the term "individual" does not include any estate or trust.

Prior federal tax relief was provided to taxpayers located in North Dakota, South Dakota, and Minnesota in IRS News Release IR–97–21 dated April 8, 1997, and in a News Release dated April 29, 1997 issued by the IRS North Central District Office.

GRANT OF RELIEF

The Secretary, by the exercise of his authority under § 7508A, has granted an extension of time to perform any act described in § 7508(a)(1) to all taxpayers located in Grand Forks County, North Dakota, and Polk County, Minnesota, for which the period for performance of the act (taking extensions into account) had not expired by August 5, 1997 and had commenced no later than November 2, 1997 (affected act). For affected acts for which the period for performance commenced prior to August 5, 1997 (such as the filing of a 1996 income tax return by an individual calendar year taxpayer for which the period for performance commenced on January 1, 1997), this extension is for 90 days. For affected acts for which the period for performance commenced on or after August 5, 1997 and on or before November 2, 1997, this extension is equal to the number of days from that commencement date through November 2, 1997.

In addition, the Secretary, by exercise of his authority under §§ 6081 and 6161, further extends the time for filing and paying federal taxes through January 13, 1998 for those taxpayers located in these two counties for whom the filing and payment date was originally on or after April 15, 1997 and would be before January 13, 1998 even with the applicable § 7508A extension.

Further, pursuant to the authority provided in § 915 of the Act, the Secretary will abate the assessment of any interest prescribed under § 6601 (and waive any penalties relating to the failure to file or pay) through January 13, 1998 with respect to federal individual income tax returns originally due on or after April 15, 1997 for individuals (not including estates and trusts) located in these two counties.

Material Limitation on Surviving Spouse's Right to Income

Notice 97–63

PURPOSE

This notice invites public comment concerning alternatives for proposed regulations that are being considered in light of the opinion of the Supreme Court of the United States in *Commissioner v. Estate of Hubert,* 520 U.S.__ (1997), 1997–32 I.R.B. 8. The proposed regulations would amend § 20.2056(b)–4(a) of the Estate Tax Regulations by providing guidance regarding when there is a "material limitation" on a surviving spouse's right to the income from property when the income is used to pay estate administration expenses.

BACKGROUND

Under § 2056(a) of the Internal Revenue Code, a marital deduction is allowed to a decedent's estate for property passing from the decedent to the surviving spouse. Under § 2056(b)(5) and (b)(7), a marital deduction is allowed for property passing in trust for the benefit of the spouse if the trust satisfies certain requirements, including the requirement that the spouse be entitled to all of the income for life.

Under § 2056(b)(4)(B), where the interest or property passing to the surviving spouse is encumbered, the encumbrance is taken into account in determining the amount of the allowable marital deduction. Section 20.2056(b)–4(a), which implements § 2056(b)(4)(B), provides that the marital deduction may be taken only for the net value of the interest passing to the surviving spouse. In determining the value of the interest, account must be taken of the effect of any material limitations on the spouse's right to the income from the property. The regulation indicates that this rule may apply in the case of a bequest of property in trust for the benefit of the spouse, when income from the property is used to pay estate administration expenses prior to distribution. The same rule applies in the case of a charitable bequest. Section 20.2055–2(e)(1)(i). However, the regulation provides no definitive guidance on when the use of income would rise to the level of a material limitation.

The facts in *Estate of Hubert* are similar to the following common fact pattern. The decedent's will provides for a residuary bequest to a trust for the benefit of the spouse (the marital trust). This bequest qualifies for the marital deduction. The will provides that estate administration expenses are to be paid from the residuary estate. Further, the will (or state law) permits the executor to use income (otherwise payable to the marital trust) to pay administration expenses, and the executor does so. The issue before the Supreme Court in *Estate of Hubert* was whether, for purposes of § 20.2056(b)–4(a), the executor's use of income to pay estate administration expenses was a material limitation on the surviving spouse's right to the income from the bequest, which would reduce the marital deduction.

The Commissioner argued that the payment of administration expenses from income is, per se, a material limitation on the surviving spouse's right to income for purposes of § 20.2056(b)–4(a), and therefore, the value of any marital bequest should be reduced dollar for dollar by the amount of income used to pay administration expenses. The Court agreed that the value of the marital bequest should be reduced if the use of income to pay administration expenses is a material limitation on the spouse's right to income. The Court found, however, that the regulation does not define material limitation and that the Commissioner had not argued that the use of income in this case was a material limitation. Thus, the Court held for the taxpayer.

In the absence of a regulatory definition of material limitation, the plurality opinion suggested a test for materiality that applies present value principles to date of death estimates of income and expenditures. The concurring opinion suggested two additional tests using date of death estimates of income; one of these tests also applies present value principles.

The number of alternatives that exist to define material limitation, as pointed out by the Court in *Estate of Hubert,* underscores the need to provide guidance regarding when the use of income to pay expenses constitutes a material limitation on a spouse's or charity's right to income. The Internal Revenue Service and the Treasury Department intend to promulgate regulations that provide guidance in this area, and this notice solicits comments on the alternative approaches outlined below.

ALTERNATIVE APPROACHES

One test for materiality under consideration would attempt to distinguish between administration expenses that are properly charged to principal and those that are properly charged to income. Under this test, there would be a material limitation on a surviving spouse's right to income from property if income were used to pay an estate administration expense that is properly charged to principal. Expenses that are properly charged to principal would be those expenses described in § 20.2053–3 as well as other expenses commonly incurred in the administration and settlement of a decedent's estate. Such expenses would include, for example, attorneys' fees, appraisers' fees, brokers' commissions on the sale of property, and estate and inheritance taxes.

Expenses that are properly charged to income (and thus not material limitations on income) would be expenses incurred in the production of income during the period of administration including expenses of collecting and disbursing income and current taxes on income.

The regulation's designation of expenses as properly charged to principal or income would be determinative for purposes of § 20.2056(b)–4(a). Therefore, an expense could be characterized as properly charged to principal even though applicable local law or the governing instrument permitted or directed an executor to charge the expense to income. To the extent that income is used to pay an expense that is properly charged to principal, the payment from income would be treated as having the same effect for purposes of the marital deduction as a payment made from principal. That is, in determining the marital deduction, the value of the property interest passing to the spouse would be reduced by an amount equal to the amount of that administration expense paid from income.

This test for materiality is intended to reflect reasonable estate administration practices and would generally be simple to apply.

Another approach under consideration is a test for materiality that provides for a

de minimis safe harbor amount of income that may be used to pay administration expenses without constituting a material limitation on the surviving spouse's right to income. The safe harbor amount could be a cumulative amount determined by a percentage of gross income derived from the property during the period of administration, or a specified dollar amount, or some combination thereof. If more than the safe harbor amount of income were used to pay administration expenses, the marital deduction would be reduced dollar for dollar by the excess over the safe harbor amount of income so used.

The safe harbor approach provides a "bright line" material limitation test. However, if the safe harbor amount were based on the cumulative amount of income derived from the property during administration, the safe harbor amount would have to be recomputed yearly to reflect additional income earned during the year, which might make the test difficult to apply.

An additional approach would be to adopt a regulation stating that any use of income for the payment of administration expenses constitutes a material limitation on the spouse's right to income.

REQUEST FOR COMMENTS

The Service and Treasury invite comments on the tests for materiality described above and also welcome any suggestions for alternative approaches to the issue. In addition, the Service and Treasury are interested in receiving comments on (1) whether the test for materiality under § 20.2056(b)–4(a) should be a quantitative test based on a comparison of the relative size of the income and the expenses charged to income; (2) whether materiality should be determined based on projections as of the date of death rather than on the facts that develop afterwards; and (3) whether present value principles should be applied and, if so, how the practical difficulties of a present value computation can be overcome.

The Service and Treasury are also interested in receiving comments on whether post-death interest accruing on deferred federal estate tax should be treated as properly charged to principal. Rev. Rul. 93–48, 1993–2 C.B. 270, holds that post-death interest accruing on deferred federal estate tax payable from a testamentary transfer does not ordinarily reduce the date of death value of the transfer.

Comments and suggestions are requested by February 4, 1998. An original and eight copies of written comments should be sent to:

Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5431 (P&SI:Br4)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044

or hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5431 (P&SI:Br4)
1111 Constitution Ave., NW
Washington, DC

Alternatively, comments may be submitted electronically via the Service's Internet site at:

http://www.irs.ustreas.gov/prod/tax_regs/comments.html

All comments will be available for public inspection and copying in their entirety.

Temporary Regulations To Be Issued Under Section 1(h) of the Internal Revenue Code (Applying Section 1(h) to Capital Gain Dividends of RICs and REITs)

Notice 97–64

SEC. 1. PURPOSE

This notice describes temporary regulations that will be issued under § 1(h) of the Internal Revenue Code, effective for taxable years ending on or after May 7, 1997, and provides guidance that regulated investment companies ("RICs"), real estate investment trusts ("REITs"), and their shareholders must use in applying § 1(h) until further guidance is issued.

SEC. 2. BACKGROUND

For individuals, estates, and trusts, § 1(h), as amended by the Taxpayer Relief Act of 1997 (the "1997 Act"), Pub. L. No. 105–34, 111 Stat. 788, imposes differing rates of tax on various transactions giving rise to long-term capital gains or losses. For transactions taken into account during taxable years ending on or after May 7, 1997, a taxpayer's long-term capital gains and losses are separated into three tax rate groups: a 20-percent group, a 25-percent group, and a 28-percent group. *See* Notice 97–59, 1997–45 I.R.B. 7.

The Secretary has authority to issue regulations concerning the application of section 1(h) to long-term gains from sales or exchanges by (or of interests in) pass-through entities, including RICs and REITs.

To the extent that a RIC or a REIT has net capital gain for a taxable year, dividends that it pays during the year (or that it is deemed to pay during the year under § 855, § 858, or § 860) may be designated by it as capital gain dividends. In general, a capital gain dividend is treated by the shareholders as a gain from the sale or exchange of a capital asset held for more than one year.

SEC. 3. BASIC DESIGNATION RULE

Subject to the limitations in section 5, if a RIC or REIT designates a dividend as a capital gain dividend for a taxable year ending on or after May 7, 1997, it may also designate the dividend as a 20% rate gain distribution, an unrecaptured section 1250 gain distribution, or a 28% rate gain distribution. If no additional designation is made regarding a capital gain dividend, it is a 28% rate gain distribution. If a dividend was designated as a capital gain dividend in a written notice mailed to shareholders on or before December 31, 1997, the additional designations permitted by this paragraph may be effected by a written notice, mailed to all shareholders not later than February 2, 1998.

If any capital gain dividend is received on or after May 7, 1997, but is treated under § 855, § 858, or § 860 as being paid during a taxable year that ends on or before that date, the dividend is a 28% rate gain distribution.

For purposes of this notice, a designation of undistributed capital gains under § 852(b)(3)(D) or § 857(b)(3)(D) is considered to be the designation of a dividend as a capital gain dividend.

SEC. 4. SHAREHOLDER TREATMENT OF CAPITAL GAIN DIVIDENDS

A capital gain dividend received from a

RIC or REIT in a taxable year of the shareholder ending on or after May 7, 1997, is treated as follows:

.01 A 20% rate gain distribution is an amount of long-term capital gain in the 20-percent group;

.02 An unrecaptured section 1250 gain distribution is an amount of long-term capital gain in the 25-percent group; and

.03 A 28% rate gain distribution is an amount of long-term capital gain in the 28-percent group.

SEC. 5. LIMITATIONS ON DESIGNATIONS OF CAPITAL GAIN DIVIDENDS

Additional designations of capital gain dividends for a taxable year are effective only to the extent that they do not exceed the limitations stated below and only to the extent that they comply with the principles of Rev. Rul. 89–81, 1989–1 C.B. 226, which requires that distributions made to different classes of shares not be composed disproportionately of dividends of a particular type. Designations of capital gain dividends must also comply with § 852(b)(3)(C) or § 857(b)(3)(C) (as appropriate), which make designations ineffective to the extent they exceed the net capital gain for the year.

Subject to a deferral adjustment or bifurcation adjustment discussed in section 6, a RIC or REIT determines the maximum amounts which may be designated in each class of capital gains dividends by performing the computation required by § 1(h) as if the RIC or REIT were an individual whose ordinary income is subject to a marginal tax rate of at least 28 percent. Then, the maximum distributable 20% rate gain is equal to the amount multiplied by 20% in performing that computation and the maximum distributable unrecaptured section 1250 gain is equal to the amount multiplied by 25% in performing that computation. The maximum distributable 28% rate gain is the net capital gain minus the amount of unrecaptured section 1250 gain distributions and 20% rate gain distributions that have been properly designated. For example, if a RIC has net capital gain in the tax year of $100, of which $60 would be multiplied by 20% and $5 would be multiplied by 25% in performing the computations required by § 1(h), then the maximum distributable 20% rate gain is $60 and the maximum unrecaptured section 1250 gain is $5. If the RIC properly designates the maximum permissible unrecaptured section 1250 gain distribution and 20% rate gain distribution, then the RIC's maximum distributable 28% rate gain is $35; *i.e.*, the net capital gain of $100 less the properly designated unrecaptured section 1250 gain distribution of $5 and 20% rate gain distribution of $60.

SEC. 6. DEFERRAL ADJUSTMENT AND BIFURCATION ADJUSTMENT

The adjustment (a deferral adjustment) required by § 852(b)(3)(C) and § 1.852–11(e) for a RIC with post-October capital losses or by § 857(b)(3)(C) for a fiscal year REIT with post-December capital losses must be made before calculating the limitations on the various classes of capital gain dividends for the RIC's or REIT's taxable year. The deferral adjustment is disregarded in determining the group in which any deferred gain or loss belongs, however, if the group depends on whether an item of gain or loss is taken into account before May 7, 1997, after July 28, 1997, or between those dates. For example, if a RIC's sale of a capital asset held for 19 months occurs before May 7, 1997, but is treated under § 852(b)(3)(C) and § 1.852–11(e) as arising after that date, the sale gives rise to capital gain in the 28-percent group.

A RIC or REIT must make the bifurcation adjustment described in the next paragraph if: (1) its taxable year is not the period used to determine capital gain net income for purposes of the excise tax imposed by § 4982 or § 4981 (that is, it is a RIC with a taxable year that does not end on October 31 and that has not made an election under § 4982(e)(4) or it is a REIT whose taxable year is not the calendar year); (2) it has a net capital gain during the pre-November (for a RIC) or pre-January (for a REIT) portion of its taxable year; and (3) it is not required to make the deferral adjustment.

If a RIC or REIT is required to make a bifurcation adjustment, it must calculate the maximum distributable 20% rate gain and the maximum distributable unrecaptured section 1250 gain separately for the pre-November (pre-January for REITs) portion of the year and for the post-October (post-December for REITs) portion of the year, as if the two portions of the year were separate taxable years. Then, the maximum distributable 20% rate gain and the maximum distributable unrecaptured section 1250 gain for the taxable year equals the sum of the maximum distributable amounts for gains in that group determined for each portion of the year.

SEC. 7. EXAMPLES

(1) Example 1. RIC *X*'s taxable year ends on July 31. RIC *X* has only the following capital gains and losses for the periods indicated:

8/1 to 10/31/97	gain	loss	net
Long-term capital gain or loss			
stock held 19 months	300	(150)	150
stock held 13 months	200	(100)	100
Short-term capital gain or loss	100	0	100
11/1 to 7/31/98			
Long-term capital gain or loss			
stock held 19 months	200	(50)	150
stock held 13 months	200	(300)	(100)
Short-term capital gain or loss	0	(100)	(100)

Because *X* has a taxable year ending in July and a post-October net capital loss of $50, it is required by § 852(b)(3)(C) and § 1.852-11(e) to make a deferral adjustment and so does not make a bifurcation adjustment. *X* must disregard the capital gains and losses for the post-October period in computing its net capital gains for purposes of designating capital gain dividends for its taxable year ending July 31, 1998. *X* must also disregard those gains and losses for purposes of calculating the various maximum distributable amounts of gain. For this taxable year, therefore, *X* may designate up to $250 as capital gain dividends, of which up to $150 may be designated as 20% rate gain distributions. The amount that may be designated as 28% rate gain distributions (or is a 28% rate gain distribution if designated only as a capital gain dividend) is $250 minus any amounts properly designated as 20% rate gain distributions. *X* must take the post-October capital gains and losses into account on August 1, 1998 (the first day of the next taxable year), to determine its net capital gain and various maximum distributable amounts of gain for the taxable year beginning on that date.

(2) Example 2. RIC *Y*'s taxable year ends on July 31. RIC *Y* has only the following capital gains and losses for the periods indicated:

8/1 to 10/31/97	gain	loss	net
Long-term capital gain or loss			
stock held 19 months	300	(150)	150
stock held 13 months	200	(100)	100
Short-term capital gain or loss	100	0	100
11/1/97 to 7/31/98			
Long-term capital gain or loss			
stock held 19 months	200	(50)	150
stock held 13 months	200	(300)	(100)
Short-term capital gain or loss	0	0	0

Because *Y* does not have a post-October capital loss for its taxable year ending July 31, 1998, it does not make a deferral adjustment. Because *Y* has a taxable year ending in July and a pre-November net capital gain, it must make a bifurcation adjustment. *Y* must determine the maximum distributable amounts of 20% rate gain and unrecaptured section 1250 gain separately for the pre-November and the post-October portion of its taxable year ending July 31, 1998. The sum of these amounts determines the various maximum distributable amounts of gain for the entire taxable year. For the pre-November period, *Y*'s maximum distributable 20% rate gain is $150. For the post-October portion of the year, *Y*'s maximum distributable 20% rate gain is $50. *Y*'s net capital gain for the entire year is $300. For this taxable year, therefore, *Y* may designate up to $300 of capital gain dividends, of which up to $200 may be designated as 20% rate gain distributions. The amount that may be designated as 28% rate gain distributions (or that will be deemed a 28% rate gain distribution if designated only as a capital gain dividend) is $300 minus any amounts properly designated as 20% rate gain distributions.

SEC. 8. SECTION 1202 GAIN

In the future, RICs may recognize gain from the sale or exchange of qualified small business stock held for more than 5 years that may be distributed to shareholders subject to certain limitations provided by § 1202(g). It is expected that the temporary regulations will provide guidance on how RICs may designate dividends as "section 1202 gain distributions." This guidance is expected to provide that: (1) section 1202 gain distributions will be designated separately for different issuers of qualified small business stock; (2) the exclusion from income permitted by § 1202 will be determined at the shareholder level not the RIC level; and (3) the maximum distributable section 1202 gain for each issuer will be calculated separately from limitations on all other classes of capital gain dividends but in the aggregate will not exceed the RIC's net capital gain.

SEC. 9. USE OF SUBSTITUTE FORMS 1099–DIV FOR 1997

The rules set forth in this section and in section 10 previously have been published in Announcement 97–109, 1997–45 I.R.B. 12.

RICs, REITs, brokers, and others reporting capital gain distributions on the 1997 Form 1099–DIV must provide additional information with their statements to recipients. Payers must continue to report the total capital gain distributions in box 1c. Payers should also advise recipients that they cannot report capital gain distributions on Form 1040, line 13, as stated in the official 1997 Form 1099–DIV. Rather, they must report the distributions on Schedule D (Form 1040), line 13, column (f).

In addition, payers must provide to recipients information sufficient to determine the following:

.01 The amount of 28% rate gain distributions. Payers should advise recipients to report this amount on Schedule D (Form 1040), line 13, column (g).

.02 The amount of unrecaptured section 1250 gain distributions. Payers should advise recipients to report this amount on Schedule D (Form 1040), line 25.

Payers may provide this additional information to recipients on a substitute statement or on a separate statement. Payers are not required to report the additional information to the IRS.

SEC. 10 USE OF SUBSTITUTE FORMS 2439 FOR 1996–1997

RICs and other filers completing the 1996 Form 2439 for fiscal years ending after May 6, 1997, must provide additional information with their notices to shareholders. Filers must continue to report the total undistributed long-term capital gains for the year on line 1 of Form 2439. Filers should also advise individual shareholders that they cannot report the amount on line 1 on Schedule D (Form 1040), Part II, line 12, as stated in the official 1996 Form 2439 instructions. Rather, they must report the amount on line 1 on the 1997 Schedule D (Form 1040), line 11, Column (f).

In addition, filers must provide to shareholders information sufficient to determine the following:

.01 The amount of 28% rate gain included on line 1 of Form 2439. Filers should advise recipients to report this amount on Schedule D (Form 1040), line 11, column (g).

.02 The amount of unrecaptured section 1250 gain included on line 1 of Form 2439. Filers should advise recipients to report this amount on Schedule D (Form 1040), line 25.

Filers may provide this additional information to shareholders on a substitute statement or on a separate statement. Filers are not required to report this additional information on Forms 2439 filed with the IRS.

SEC. 11. SUBMISSION OF COMMENTS

Comment are requested on the subject matter of this notice and, additionally, on the proper treatment of a loss on the sale of a RIC or REIT share held for six months or less that is recharacterized under § 852(b)(4)(A) or § 857(b)(7) as a long-term capital loss. Taxpayers may submit comments to: CC:DOM:CORP:R (OGI–117972–97), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20022. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (OGI–117972–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/ tax_regs/comments.html. Comments will be available for public inspection.

SEC. 12 PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1565.

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.

The collections of information in this notice are in sections 3, 9 and 10. This information is required to permit RIC and REIT shareholders to properly report income following the amendment of § 1(h) by the 1997 Act. The information collected will be used by RIC and REIT shareholders reporting income. The collection of information is mandatory. The likely respondents are businesses and other for-profit institutions.

The burden for the collections of information in section 3 is as follows:

The estimated total annual reporting and/or recordkeeping burden is 1500 hours.

The estimated annual burden per respondent varies from 1/4 hour to 10 hours, depending on individual circumstances, with an estimated average of 1/2 hour. The estimated number of respondents is 3,000.

The estimated annual frequency of responses is annually.

The burden for the collection of information in sections 9 and 10 is reflected in the burden for Form 1099–DIV and Form 2439.

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.

Income Tax Return Preparer Penalties—1997 Federal Income Tax Returns Due Diligence Requirements for Earned Income Credit (EIC)

Notice 97–65

PURPOSE

This notice sets forth due diligence requirements that paid preparers of federal income tax returns or claims for refund (preparers) that involve the Earned Income Tax Credit (EIC) must meet to avoid imposition of the penalty under § 6695(g) of the Internal Revenue Code for 1997 returns and claims for refund. The Treasury Department intends to issue temporary regulations under § 6695(g) that will incorporate the requirements set forth in this notice and that will apply to 1997 returns and claims for refund. However, these regulations may impose different due diligence requirements for returns and claims for taxable years beginning after 1997. Comments are requested regarding possible alternatives for meeting the due diligence requirements in the future.

BACKGROUND

Section 6695(g), as added by section 1085(a)(2) of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788 (August 5, 1997), imposes a $100 penalty on a preparer with respect to any return or claim for refund for each failure to comply with the due diligence requirements imposed by regulations with respect to determining a taxpayer's eligibility for the EIC or the amount of any allowable EIC. This new penalty is effective for taxable years beginning after December 31, 1996, and is in addition to any other penalty imposed under present law.

DUE DILIGENCE REQUIREMENTS FOR 1997

For each 1997 income tax return or claim for refund involving the EIC, a preparer will be liable for the § 6695(g) penalty unless all of the following due diligence requirements are met:

(1) The preparer must either (a) complete the "Earned Income Credit (EIC) Eligibility Checklist" (attached to this notice) or (b) otherwise record in the preparer's paper or electronic files the information that would be necessary to complete the Checklist ("alternate eligibility record"). The preparer's completion of the Checklist or alternate eligibility record must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer. The alternate eligibility record may consist of one or more documents containing the required information.

(2) The preparer must either (a) complete the "Earned Income Credit Worksheet" in the 1997 Form 1040 instructions, or (b) otherwise record in the preparer's paper or electronic files the preparer's EIC computation, including the method and information used to make that computation ("alternate computation record"). The preparer's completion of the Worksheet or alternate computation record must be based on information provided by the taxpayer to the preparer or otherwise reasonably obtained by the preparer. The alternate computation record may consist of one or more documents containing the required information.

(3) The preparer must not know or have reason to know that any information used by the preparer in determining the taxpayer's eligibility for the EIC or in computing the EIC is incorrect. The preparer may not ignore the implications of information furnished to, or known by, the preparer, and must make reasonable inquiries if the information furnished to, or known by, the preparer appears to be incorrect, inconsistent, or incomplete;

(4) The preparer must retain (a) the completed Checklist (or alternate eligibility record); (b) a copy of the Worksheet (or alternate computation record); and (c) a record of how and when the information was obtained by the preparer, including the identity of any person furnishing such information. These items must be retained for three years after the June 30th following the date the return was presented to the taxpayer for signature, and may be retained on magnetic media consistent with Rev. Proc. 81–46, 1981–2 C.B. 621, or in an electronic storage media system consistent with Rev. Proc. 97–22, 1997–13 I.R.B. 9.

The § 6695(g) penalty will not be applied with respect to a particular return or claim for refund if the preparer can demonstrate to the satisfaction of the Service that, considering all the facts and circumstances, the preparer's normal office procedures are reasonably designed and routinely followed to ensure compliance with the 1997 due diligence requirements, and the failure to meet the 1997 due diligence requirements with respect to the return or claim for refund in question was isolated and inadvertent.

REQUEST FOR COMMENTS ON FUTURE GUIDANCE

The Service and Treasury Department invite public comment on the due diligence requirements in § 6695(g) for tax years after 1997. Comments are requested by May 15, 1998. An original and eight copies of written comments should be sent to:

Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5228 (IT&A:Br4)
P.O. Box 7604
Ben Franklin Station
Washington, DC 20044,

or hand delivered between the hours of 8:00 a.m. and 5:00 p.m. to:

Courier's Desk
Internal Revenue Service
Attn: CC:DOM:CORP:R
Room 5228 (IT&A:Br4)
1111 Constitution Ave., NW
Washington, DC

Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to http://www.irs.ustreas.gov./prod/tax_regs/comments.html (the IRS Internet site). All comments will be available for public inspection and copying in their entirety.

PAPERWORK REDUCTION ACT

The collections of information contained in this notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1570.

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

The collections of information in this notice are contained under the heading "DUE DILIGENCE REQUIREMENTS FOR 1997" in this notice. This information is required to implement § 6695(g), and verify that preparers have exercised due diligence in preparing any return or claim for refund for taxable year 1997 that involves the EIC. The likely recordkeepers are preparers.

In 1998, the estimated total annual recordkeeping burden will be 160,000 hours.

The estimated annual burden per recordkeeper will vary from 0 minutes to 16 minutes, depending on individual circumstances, with an estimated average of 8 minutes.

The estimated number of recordkeepers is 1,200,000.

Books or records relating to the collection of information in this notice must be retained for three years after the June 30th following the date the return was presented to the taxpayer for signature. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

EARNED INCOME CREDIT (EIC) ELIGIBILITY CHECKLIST

For use by income tax return preparers in preparing 1997 tax returns and claims for refund

Taxpayer may claim the earned income credit if all the following questions are answered YES:

1. Do the taxpayer, spouse, and qualifying child each have a social security number?
___ YES ___ NO

2. Is the taxpayer's total taxable and nontaxable earned income at least $1 but less than:
* $9,770 if the taxpayer does not have a qualifying child?
* $25,760 if the taxpayer has one qualifying child?
* $29,290 if the taxpayer has more than one qualifying child?

___ YES ___ NO

3. Is the taxpayer's modified AGI less than:
* $9,770 if the taxpayer does not have a qualifying child?
* $25,760 if the taxpayer has one qualifying child?
* $29,290 if the taxpayer has more than one qualifying child?

___ YES ___ NO

4. Is the taxpayer's investment income $2,250 or less?

___ YES ___ NO

5. Is the taxpayer's filing status one of the following: married filing jointly, head of household, qualifying widow(er), or single?

___ YES ___ NO

6. If the taxpayer is a nonresident alien, is the filing status married filing jointly? (If taxpayer is not a nonresident alien, answer YES).

___ YES ___ NO

7. Answer YES if the taxpayer (and spouse if filing a joint return) is not a qualifying child of another person.

___ YES ___ NO

8. Answer YES if the taxpayer (and spouse if filing a joint return) is not filing Form 2555 or Form 2555–EZ to exclude from gross income any income earned in foreign countries or to deduct or exclude a foreign housing amount.

___ YES ___ NO

STOP: If the taxpayer has a qualifying child, answer question 9 and skip 10. If the taxpayer does not have a qualifying child, skip 9 and answer 10.

9. (a) Does the child meet the age, relationship, and residence tests for a qualifying child? See Form 1040 instructions for Line 56a.

___ YES ___ NO

(b) Answer YES if the qualifying child is also a qualifying child for one or more other persons and the taxpayer's modified AGI is higher than each other person's. Answer YES if the child is a qualifying child only for the taxpayer.

___ YES ___ NO

(c) If the qualifying child is married, is the taxpayer claiming the child as a dependent? (If the qualifying child is not married, answer YES.)

___ YES ___ NO

OR

10. (a) Was the taxpayer's main home (and the spouse's if filing a joint return) in the United States for more than half the year? Military personnel on extended active duty outside the United States are considered to be living in the United States.

___ YES ___ NO

(b) Was the taxpayer (or spouse, if filing a joint return) at least age 25 but under 65 at the end of 1997?

___ YES ___ NO

(c) No one can claim the taxpayer (or spouse if filing a joint return) as a dependent on their return. If the taxpayer (and spouse if filing a joint return) is not eligible to be a dependent on anyone else's return, answer YES. If taxpayer (or spouse if filing a joint return) is eligible to be claimed as a dependent on someone else's return, answer NO.

___ YES ___ NO

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*PERSONS WITH A QUALIFYING CHILD: If the taxpayer answered YES to questions 1 through 9(a), (b), and (c), the taxpayer can claim the credit. Remember to fill out Schedule EIC and attach it to the taxpayer's Form 1040 or 1040A.

*PERSONS WITHOUT A QUALIFYING CHILD: If the taxpayer answered YES to questions 1 through 8 and 10(a), (b), and (c), taxpayer can claim the credit.

IF THE TAXPAYER ANSWERED NO TO ANY QUESTION, TAXPAYER IS NOT ELIGIBLE FOR THE CREDIT.

Certain Payments Made Pursuant to a Securities Lending Transaction

Notice 97-66

SECTION 1. SUMMARY

On October 14, 1997, final regulations were published in the Federal Register [T.D. 8735], RIN 1545-AP71, (the "final regulations") which source substitute interest and substitute dividend payments that are made pursuant to a securities lending or sale-repurchase transaction by reference to the income that would be earned with respect to the underlying transferred debt security or stock. The final regulations also provide that substitute interest and dividend payments that are U.S. source under the regulations are also characterized as interest and dividends for purposes of determining the fixed or determinable annual or periodical income of foreign resident individuals and corporations subject to tax under sections 871, 881, 4948(a) and Chapter 3 of the Internal Revenue Code and for purposes of granting tax treaty benefits with respect to interest and dividends. As promulgated, the final regulations were made applicable in all respects for substitute interest (as defined in § 1.861-2(a)(7) of the income tax regulations) and substitute dividend payments (as defined in § 1.861-3(a)(6)) made after November 13, 1997.

This Notice provides guidance on complying with the statement requirement of section 871(h)(5) for substitute interest payments made after November 13, 1997, and before January 1, 1999. In addition, the Treasury and the Service intend to propose new regulations to provide specific guidance on how substitute dividend payments made by one foreign person to another foreign person ("foreign-to-foreign payments") are to be treated. Until the proposed regulations are promulgated, this Notice clarifies how the amount of the tax imposed under §§ 1.871-7(b)(2) and 1.881-2(b)(2) will be determined with respect to foreign-to-foreign payments. The Treasury and the Service request comments on the treatment of foreign-to-foreign payments provided in this Notice.

SECTION 2. SUBSTITUTE INTEREST PAYMENTS

Substitute interest payments made by a foreign person that are U.S. source interest under the final regulations must satisfy the statement requirement of section 871(h)(5) to qualify as portfolio interest. The final regulations refer taxpayers to § 1.871-14(c) for this purpose, but those regulations are not generally applicable until January 1, 1999. Under this Notice, the statement requirement of section 871(h)(5) will be satisfied with respect to substitute interest payments made after November 13, 1997 and before January 1, 1999, if any written, electronic, or oral statement that reasonably establishes that the payee is a foreign person is given or made to the payor prior to, or within a reasonable period of time after, the payment. The statement requirement of the preceding sentence is deemed to be satisfied if the payor is subject to, and satisfies with respect to the payee, the regulatory rules in the jurisdiction in which the payor is operating regarding establishing the identity of a customer (i.e., "know your customer" rules). Also, if a taxpayer makes an election under § 1.1441-1(f)(2)(ii), such election will be effective, pursuant to this Notice, to allow a withholding agent to apply retroactively the documentation requirements of § 1.871-14(c) with respect to one or more substitute interest payments made after November 13, 1997. Treas. Reg. § 1.871-14(c)(3) allows a withholding agent to collect a certificate or documentary evidence at any time until the expiration of the beneficial owner's period of limitation for claiming a refund of tax with respect to portfolio interest.

SECTION 3. SUBSTITUTE DIVIDEND PAYMENTS

The final regulations were adopted to eliminate unjustifiable differences between the taxation of similar economic investments. It has been brought to the attention of the Treasury and the Service, however, that, in certain circumstances, the total U.S. withholding tax paid with respect to a securities loan or sale-repurchase transaction, or series of such transactions, could be excessive due to the application of the final regulations. The Treasury and the Service believe that taxpayers can avoid such excessive withholding taxes in the vast majority of cases by structuring their transactions appropriately. In some circumstances, however, such structuring may be difficult or impossible.

To address these concerns, under this Notice, the amount of U.S. withholding tax to be imposed under §§ 1.871-7(b)(2) and 1.881-2(b)(2) with respect to a foreign-to-foreign payment will be the amount of the underlying dividend multiplied by a rate equal to the excess of the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the recipient of the substitute payment over the rate of U.S. withholding tax that would be applicable to U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. This amount may be reduced or eliminated to the extent that the total U.S. tax actually withheld on the underlying dividend and any previous substitute payments is greater than the amount of U.S. withholding tax that would be imposed on U.S. source dividends paid by a U.S. person directly to the payor of the substitute payment. The recipient of a substitute payment may not, however, disregard the form of its transaction in order to reduce the U.S. withholding tax. Therefore, a recipient of a foreign-to-foreign payment will not be entitled to a refund or tax credit against any other U.S. tax liability to reflect the fact that the rate of U.S. withholding tax that would be applicable to a U.S. source dividend paid by a U.S. person directly to such recipient is less than the rate of U.S. withholding tax that would be applicable to a U.S. source dividend paid by a U.S. person directly to the payor of the substitute payment (or any payor of a previous substitute payment or the underlying dividend).

As a result of this formula, substitute payments with respect to foreign-to-foreign securities loans and sale-repurchase transactions that do not reduce the overall U.S. withholding tax generally will not be subject to withholding tax. For example, no withholding tax is required in situations where transactions are entered into between residents of the same country. The Treasury and the Service

believe that this Notice adequately addresses the concerns of those foreign persons who are required by their local regulators to enter into transactions only with residents of the same country. Conversely, to the extent a foreign-to-foreign securities loan or sale-repurchase transaction would reduce the overall U.S. withholding tax, an incremental amount of U.S. withholding tax is imposed on the substitute payment.

SECTION 4. LIABILITY OF WITHHOLDING AGENTS

Each person who makes a foreign-to-foreign payment shall be treated as a withholding agent under section 1.1441–7 with respect to such payment. If a U.S. withholding agent withholds the highest rate of tax which would be imposed on all foreign recipients of dividends and substitute payments in a chain of such payments, each foreign withholding agent will be treated as having satisfied its withholding obligation under §1.1441–7.

SECTION 5. EXAMPLES

The following examples illustrate the principles of this Notice:

Example 1. *Same Country Securities Loan.* FP, a pension fund resident in Country X, owns stock issued by USCo, a corporation resident in the United States. An income tax treaty between Country X and the United States limits the U.S. withholding tax on gross dividends to 15 percent. USBroker, a U.S. broker-dealer, needs to borrow the stock owned by FP. Under Country X rules intended to safeguard the interests of workers, however, FP is required to deal only with Country X residents in connection with its investment activities. Accordingly, FP enters into a securities loan with FBroker, a broker-dealer also resident in Country X. FBroker then enters into a securities loan with USBroker. USCo pays a dividend of $100 on March 15, 1998. USBroker is the shareholder of record with respect to the dividend. Since USBroker is a U.S. person, USCo does not withhold on the dividend. USBroker makes a substitute payment of $100 to FBroker from which USBroker withholds $15. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to FP is the same as the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to FBroker. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments made by FBroker to FP.

Example 2. *Non-Same Country Securities Loan.* A, a resident of Country X, owns shares of USCo, a U.S. resident corporation. Country X has a treaty with the United States which limits the United States tax on gross dividends to 15 percent. A enters into a securities loan with B, a resident of Country Y, whose treaty with the United States also limits the United States tax on gross dividends to 15 percent. USCo pays a dividend of $100 on March 15, 1998. B is the shareholder of record with respect to the dividend. USCo withholds $15 and pays B a net dividend of $85. B makes a substitute payment of $85 to A. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to A is the same as the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to B. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments made by B to A.

Example 3. *Increased Treaty Benefits.* The facts are the same as in example 2, except that Country X has no treaty with the United States. Since a dividend payment made by a U.S. person directly to A would have been subject to a 30-percent withholding tax, B must withhold an additional $15 ((30 percent - 15 percent) x $100) on the substitute payment it makes to A. Alternatively, USCo could have withheld 30 percent from the dividend payment made to B, thereby satisfying B's withholding liability under § 1.1441–7.

Example 4. *Multiple Country Securities Loans.* A, a resident of Country W, owns shares of USCo, a U.S. resident corporation. Country W has an income tax treaty with the United States that limits the United States tax on gross dividends to 15 percent. B, a resident of Country X, enters into a securities loan with A. Country X does not have an income tax treaty with the United States. C, a resident of Country Y, enters into a securities loan with B. Country Y has an income tax treaty with the United States which limits the United States tax on gross dividends to 10 percent. D, a resident of country Z, enters into a securities loan with C. Country Z has an income tax treaty with the United States which limits the United States tax on gross dividends to 15 percent.

USCo pays a dividend of $100 on March 15, 1998. D is the shareholder of record with respect to the dividend. USCo withholds $15 and pays D a net dividend of $85. D makes a substitute payment of $85 to C. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to C is less than the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to D. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payments received by C. However, C is not entitled to a refund or tax credit against any other U.S. tax liability for the additional 5-percent tax reflected in its substitute payment from D over the amount to which C would have been subject had C received a dividend directly from USCo.

C makes a substitute payment of $85 to B from which C withholds $15. Since a dividend payment made by a U.S. person directly to B would have been subject to a 30-percent withholding tax, C generally would be required to withhold an additional $20 ((30 percent - 10 percent) x $100) on the substitute payment it makes to B. However, because $15 actually was withheld with respect to a $100 gross dividend paid to D, C may reduce by $5 ((15 percent - 10 percent) x $100) the $20 withholding obligation on its substitute payment to B.

B makes a substitute payment of $70 to A. The rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to A is less than the rate of withholding tax that would be applicable to a U.S. source dividend payment made by a U.S. person directly to B. Accordingly, no U.S. withholding tax is imposed under § 1.871–7(b)(2) or § 1.881–2(b)(2) on the substitute payment received by A. However, A is not entitled to a refund or tax credit against any other U.S. tax liability for the additional 15-percent tax reflected in its substitute payment from B over the amount to which A would have been subject had A received a dividend directly from USCo.

Alternatively, USCo could have withheld 30 percent from the dividend payment made to D, thereby satisfying C's withholding obligation under § 1.1441–7.

SECTION 6. EFFECTIVE DATE OF REGULATIONS

The provisions of this Notice are effective for purposes of applying the final regulations as of November 14, 1997, the effective date of those regulations. Because some withholding agents may require additional time to adjust their business practices to implement the provisions of the final regulations and this Notice, a withholding agent can elect to defer the application of the final regulations, other than Treas. Reg. § 1.864–5(b)(2)(ii), and this Notice until January 1, 1998. A withholding agent makes such an election by attaching a statement to such effect to a timely filed tax return (Form 1042) for the period that includes November 14, 1997, or if no such return is otherwise required for the period including that date, on a timely filed return (Form 1042) for the period that includes January 1, 1998. Withholding agents making this election must apply the provisions of the final regulations and this Notice for substitute payments made after December 31, 1997.

SECTION 7. REQUEST FOR COMMENTS

Treasury and the Service invite comments on the guidance provided by this Notice. Written comments should be submitted by January 12, 1998, to the Internal Revenue Service, P.O. Box 7604 Ben Franklin Station, Attention: CC:CORP:T:R: (Notice 97-66) Room 5228, Washington, DC 20044. Alternatively, comments may be submitted via the internet at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The comments submitted will be available for public inspection and copying.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this Notice have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1566.

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

The collections of information contained in this Notice are in Sections 2 and 6. The information is required to qualify substitute interest payments as portfolio interest and to defer, on election by the taxpayer, the effective date of this Notice and the final securities lending regulations (T.D. 8735, 62 FR 53498) for substitute payments made after December 31, 1997. The information will be used for the same purpose described in the preceding sentence. The collections of information are required to obtain a benefit. The likely respondents are businesses or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 61,750 hours.

The estimated annual burden per respondent/recordkeeper varies from 1 minute to 15 minutes, depending on individual circumstances, with an estimated average of 10 minutes. The estimated number of respondents and/or recordkeepers is 377,500.

The estimated frequency of responses (used for reporting requirements only) is once.

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.

Grace Period Interest

Notice 97–67

Many credit card agreements provide for a grace period during which the credit card issuer does not charge interest for a billing cycle if the credit card holder pays off its account balance by a specified date. Under section 1004 of the Taxpayer Relief Act of 1997 (the "Act"), Pub. L. No. 105–34, 111 Stat. 788, 911, if a taxpayer holds a pool of credit card receivables, the taxpayer must accrue interest and original issue discount on the receivables based on a reasonable assumption regarding the timing of the payments by the obligors of the receivables in the pool. Thus, the taxpayer is not permitted to assume that all of its credit card holders will pay their balances by the date specified in the grace period provision of the credit card agreement and, based on this assumption, defer the inclusion of grace period interest. Section 1004 of the Act is effective for taxable years beginning after August 5, 1997. The Internal Revenue Service will issue guidance that provides the procedures for a taxpayer to automatically change its method of accounting to comply with section 1004 for the taxpayer's first taxable year beginning after August 5, 1997.

The Service will process requests by taxpayers to change their methods of accounting for grace period interest that were pending with the Service on August 4, 1997. For any requests filed on or after August 5, 1997 (the date of enactment of the Act), the Service will exercise its discretion to deny requests to change to a method of accounting for grace period interest other than the method required by section 1004 of the Act. *See* § 446(e) of the Internal Revenue Code. *See also* H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 523 (1997); H.R. Rep. No. 148, 105th Cong., 1st Sess. 457 (1997).

Guidance on Making Payments for Charitable Remainder Trusts

Notice 97–68

This notice informs taxpayers that the rules in §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(*e*) of the proposed Income Tax Regulations, published in a Notice of Proposed Rulemaking on April 18, 1997 (62 Fed. Reg. 19072), will not be effective for certain charitable remainder trusts (CRTs) for the 1997 taxable year.

BACKGROUND

Generally, a CRT is a trust that provides for a specified distribution at least annually over a specified period to one or more noncharitable beneficiaries and holds an irrevocable remainder interest in the trust for a charitable organization. Section 664 of the Internal Revenue Code provides for two types of CRTs: a charitable remainder annuity trust (CRAT) and a charitable remainder unitrust (CRUT). A CRAT pays a fixed annuity amount at least annually to the noncharitable beneficiary or beneficiaries. A CRUT pays a fixed percentage of the fair market value of the assets held by the trust as of the annual valuation date (the unitrust amount) at least annually to the noncharitable beneficiary or beneficiaries.

Section 664(d) provides that to qualify as a CRT, the trust must pay the annuity or unitrust amount at least annually to the noncharitable beneficiaries. As an administrative convenience, §§ 1.664–2(a)(1) and 1.664–3(a)(1) of the Income Tax Regulations have allowed CRTs to pay the annuity or unitrust amount within a reasonable time after the close of the tax year in which it is due without the timing of the payment causing the trust to fail to function exclusively as a CRT.

PROPOSED REGULATIONS REGARDING PAYING ANNUITY OR UNITRUST AMOUNT

The proposed amendments to §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(*e*) of the proposed regulations (the proposed timing amendments) would require a CRT to pay the annuity amount or the unitrust amount under the fixed percentage method of § 664(d)(2) by the close of the tax year in which the payment is due in order to function exclusively as a CRT. Under the effective date in the proposed regulations, once final, the proposed timing amendments would apply to taxable years ending after April 18, 1997, the date the proposed regulations were published in the Federal Register.

The Service and Treasury issued the proposed timing amendments in response to abuses associated with the use of accelerated CRTs described in Notice 94–78, 1994–2 C.B. 555. Taxpayers using accelerated CRTs characterize the payment of the annuity or unitrust amount as a distribution of trust corpus that is not subject to tax by delaying the required payment

until after the end of the tax year in which it is due.

Since publishing the proposed regulations, the Service and Treasury have received a significant number of comments expressing concern that the proposed timing amendments will place a significant burden on many trusts that are not engaging in abuses. Some commentators observed that for many CRTs the character of the annuity or unitrust amount is not affected by the time at which the payment is made. Because these trusts have accumulated sufficient income in the ordinary, capital gains, and other income categories of § 664(b)(1), (2), and (3), no portion of the annuity or unitrust amount distributed will be characterized as trust corpus under § 664(b)(4) irrespective of whether the amount is paid before or after the close of the tax year for which it is due. The commentators add that being required to pay the annuity or unitrust amount by the close of the calendar year would create a hardship if the trustee is relying on end-of-the-year dividends and similar income, which may not arrive until January of the following year, to make the annuity or unitrust payment. The commentators also argue that the proposed timing amendments would create a hardship for trustees of CRUTs that have a December 31 valuation date because such a trustee would be forced to value the assets in the trust and make a payment of the unitrust amount after the close of business and before midnight on that date.

In light of the enactment of the Taxpayer Relief Act of 1997 (the Act) on August 5, 1997, other commentators have argued that the proposed timing amendments are no longer necessary to stop the abuses created by accelerated CRTs. The Act amended the definition of a CRT to include a maximum allowable percentage of 50 percent for calculating the annuity amount or unitrust amount and a minimum 10 percent present value for the charitable remainder interest. Taxpayer Relief Act of 1997, Pub. L. No. 105–34, § 1089, 111 Stat. 960, 961. We note that the Senate Finance Committee explicitly stated that it did not intend for the Act to "limit or alter the validity of the regulations proposed by the Treasury Department on April 18, 1997, or the Treasury Department's authority to address this or other abuses of the rules governing the taxation of charitable remainder trusts or their beneficiaries." S. Rep. No. 33, 105th Cong., 1st Sess. 201 (1997).

Several commentators have asked for relief from the effective date for the proposed timing amendments while their comments are considered and before the regulations are finalized.

APPLICATION OF PROPOSED TIMING AMENDMENTS

The Service and Treasury recognize that complying with the proposed timing amendments in 1997 may create an unnecessary burden on those trusts for which the potential for abuse is minimal. Therefore, when the proposed regulations are adopted as final regulations under a Treasury Decision, the Service and Treasury intend to provide that for the taxable year 1997 a CRT created before January 1, 1998, will not be made subject to the rules stated in §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i)(*e*) of the proposed regulations if in 1997 the trust is:

(1) A CRAT under which the sum certain to be paid each year to one or more persons is 15 percent or less of the initial net fair market value of all property placed in the trust, or

(2) A CRUT under which the fixed percentage of the net fair market value of the unitrust's assets to be paid each year to one or more persons is 15 percent or less, or

(3) A CRAT or CRUT from which all of the annuity amounts or unitrust amounts paid for 1997 are characterized in the hands of the beneficiary as income from the categories described in § 664(b)(1), (2), and (3), and not as trust corpus. Thus, a CRT created before January 1, 1998, that meets any one of these three exceptions may pay its annuity amount or unitrust amount for the taxable year 1997 within a reasonable period of time after the close of the tax year under §§ 1.664–2(a)(1)(i) and 1.664–3(a)(1)(i) of the Income Tax Regulations.

The Service and Treasury will continue to consider the comments submitted on the proposed regulations before deciding whether to adopt an amended version of the proposed regulations as final regulations.

Weighted Average Interest Rate Update

Notice 97–69

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for October 1997 is 6.33 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
November	1997	6.81	6.13 to 7.29	6.13 to 7.49

Adoption Assistance
Notice 97-70

This notice modifies Notice 97–9, 1997–2 I.R.B. 35, which provides, in part, general guidance concerning the income tax credit under § 23 of the Internal Revenue Code for qualified adoption expenses paid or incurred by an individual. Notice 97-9 is modified to incorporate the amendment made to § 23(a)(2) (relating to the year(s) in which the credit for certain qualified adoption expenses is allowed) by § 1601(h)(2)(A) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 1092 (1997), effective for taxable years beginning after December 31, 1996. Notice 97-9 will appear in 1997–1 C.B. as modified by this notice.

Section I.E.1 and the first paragraph of section I.E.2 of Notice 97–9 are modified to read as follows:

E. Year of Credit.

1. Domestic adoptions.

The credit for qualified adoption expenses paid or incurred to adopt an eligible child who is a citizen or a resident of the United States at the time the adoption commenced (including such amounts paid or incurred in an unsuccessful effort to adopt such a child) is allowed in the next taxable year unless the expenses are paid or incurred during or after the taxable year the adoption becomes final. The credit for qualified adoption expenses paid or incurred during or after the taxable year in which an adoption becomes final is allowed in the taxable year in which the expenses are paid or incurred.

2. Foreign adoptions.

A special rule applies in the case of the adoption of an eligible child who is not a citizen or resident of the United States at the time the adoption commenced. The credit is only available for adoptions that become final. Qualified adoption expenses paid or incurred in any taxable year before the taxable year in which the adoption becomes final are treated as paid or incurred in the taxable year in which the adoption becomes final. Therefore, the credit for qualified adoption expenses paid or incurred in the taxable year in which the adoption is final, or in any earlier taxable year, is allowed in the taxable year the adoption becomes final. The credit for qualified adoption expenses paid or incurred after the taxable year in which the adoption becomes final is allowed in the taxable year in which the expenses are paid or incurred.

Tables for Figuring Amount Exempt From Levy on Wages, Salary, and Other Income
Notice 97–71

1. Table for Figuring Amount Exempt From Levy on Wages, Salary, and Other Income (Forms 668-W, 668-W(c), & 668-W(c)(DO)) 1998

Publication 1494, shown below, provides tables which show the amount of an individual's income that is exempt from a notice of levy used to collect delinquent tax in 1998.

(Amounts are for each pay period.)

Filing Status: Single							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	26.73	37.12	47.50	57.88	68.27	78.65	16.35 plus 10.38 for each exemption
Weekly	133.65	185.58	237.50	289.42	341.35	393.27	81.73 plus 51.92 for each exemption
Biweekly	267.31	371.15	475.00	578.85	682.69	786.54	163.46 plus 103.85 for each exemption
Semi-monthly	289.58	402.08	514.58	627.08	739.58	852.08	177.08 plus 112.50 for each exemption
Monthly	579.17	804.17	1029.17	1254.17	1479.17	1704.17	354.17 plus 225.00 for each exemption

ments. Until the new regulations are issued, the IRS will not assess penalties for the use of a logo (including the name of the payer in any typeface, font, or stylized fashion and/or a symbolic icon) or slogan on a statement to a recipient if the logo or slogan is used by the payer in the ordinary course of its trade or business. In addition, use of the logo or slogan must not make it less likely that a reasonable payee will recognize the importance of the statement for tax reporting purposes.

(10) With respect to dividend income, a mutual fund family may separately state on one document (*e.g.*, one piece of paper) the dividend income earned by a recipient from each fund within the family of funds as required by Form **1099–DIV.** However, each fund and its earnings must be separately stated. The form must contain an instruction to the recipient that each fund's dividends and name, not the name of the mutual fund family, must be reported on the recipient's tax return. **The form cannot contain an aggregate total of all funds.** Moreover, a mutual fund family may furnish a single statement (as a single filer) for Forms 1099–INT, DIV, and OID information. Each fund and its earnings must be separately stated. The form must contain an instruction to the recipient that each fund's earnings and name, not the name of the mutual fund family, must be reported on the recipient's tax return. The form cannot contain an aggregate total of all funds.

.02 COMPOSITE SUBSTITUTE STATEMENTS – **FORMS 1099–INT (except for interest reportable under section 6041), 1099–DIV (except for section 404(k) dividends)), 1099–OID, AND 1099–PATR ONLY.** – A composite form recipient statement is permitted for reportable payments of interest, dividends, original issue discount, and/or patronage dividends (**Forms 1099–INT, DIV, or PATR**) when one payer is reporting more than one of these payments during a calendar year to the same form recipient. Generally, do not include any other Form 1099 information (*e.g.*, 1098 or 1099–A) on a composite statement with the information required on the forms listed in the preceding sentence. **Exception:** A filer may include Form 1099–B information on a composite form with the forms listed above. Although the composite form recipient statement may be on one sheet, the format of the composite form recipient statement must satisfy the following requirements in addition to the requirements listed in Section 7.01 above.

(1) All information pertaining to a particular type of payment must be located and blocked together on the form and must be separate from any information covering other types of payments included on the form. For example, if you are reporting interest and dividends, the **Form 1099–INT** information must be presented separately from the **Form 1099–DIV** information.

(2) The tax year, form number, and form name of the official IRS form for which the composite form recipient statement substitutes must be prominently displayed together in one area at the beginning of each appropriate block of information.

(3) Any information required by the official IRS forms that would otherwise be repeated in each information block is only required to be listed once in the first information block on the composite form. For example, there is no requirement to report the name of the filer in each information block. This rule does not apply to any money amounts, *e.g.*, Federal income tax withheld, or to any other information that applies to money amounts.

(4) A composite statement shall be considered an acceptable substitute only if the type of payment and the recipient's tax obligation with respect to the payment are no less clear than if each required statement were furnished separately on an official form.

.03 SUBSTITUTE STATEMENTS TO RECIPIENTS – FORMS 1098, 1099–A, 1099–B, 1099–C, 1099–G, 1099–LTC, 1099–MISC, 1099–MSA, 1099–R, 1099–S, 5498, 5498–MSA, W–2G, AND CERTAIN FORMS 1099–INT AND 1099–DIV. Statements to form recipients of payments reportable on **Forms 1098, 1099–A, 1099–B, 1099–C, 1099–G, 1099–LTC, 1099– MISC, 1099–MSA, 1099–R, 1099–S, 5498, 5498–MSA, 1099–DIV only for section 404(k) dividends reportable under section 6047, and 1099–INT only for interest of $600 or more made in the course of a trade or business reportable under section 6041** can be, but are not required to be, copies of the official forms. If you do not use the official form as the form recipient statement, the substitute recipient statement must meet the following requirements:

(1) The tax year, form number, and form name must be the same as the official form, and must be prominently displayed together in one area of the statement. For example, they may be shown in the upper right part of the statement.

(2) The filer's and the form recipient's identifying information required on the official IRS form must be included.

Note: On Copy C, Form 1099–LTC, you may reverse the location of the policyholder's name, street address, city, state, and ZIP code with the location of the insured's name, street address, city, state, and ZIP code for ease in mailing.

(3) Because of new tax law enacted in 1996, the following statements must include the telephone number of a person to contact: W–2G; 1098; 1099–A; 1099–B; 1099–DIV; 1099–G (excluding state and local income tax returns); 1098–INT; 1099–MISC (excluding fishing boat proceeds); 1099–OID; 1099–PATR; and 1099–S. **The telephone number must be conspicuous but may appear anywhere on the recipient statement.** Although not required, payers reporting on other Forms 1099 and 5498 are encouraged to furnish telephone numbers.

(4) All applicable money amounts and information, including box numbers, required to be reported to the form recipient must be titled on the form recipient statement in substantially the same manner as those on the official IRS form. The box

ages all filers including nominees (hereafter collectively referred to as filers) to file information returns on magnetic media or electronically instead of on paper forms.

.02 Any person who is required to file 250 or more information returns (of any one type of form) for one calendar year MUST file on magnetic media unless a hardship waiver is requested and received. To request a one year waiver of the magnetic media filing requirements, for the current tax year only, submit Form 8508, Request for Waiver From Filing Informatin Returns on Magnetic Media. See Publication 1220 Part A, Section 5, for more information. Specifications for filing information returns on magnetic media (or electronically) are contained in Publication 1220, "Specifications for Filing Forms 1098, 1099 Series, 5498, and W–2G Magnetically or Electronically." Copies of this publication may be obtained by calling **1-800-TAX-FORM (1-800-829-3676).** Payers who do not comply with the magnetic media filing requirements and who are not granted a waiver may be subject to penalties. **Note:** Filing electronically will satisfy the magnetic media filing requirements. Refer to Publication 1220, Part C, Bisynchronous (Mainframe) Electronic Filing Specifications and Part D, Asynchronous (IRB–BBS) Electronic Filing Specifications.

SEC. 7. SUBSTITUTE STATEMENTS TO FORM RECIPIENTS AND FORM RECIPIENT COPIES

If you are not use the official IRS form to furnish statements to recipients, your substitute statement must comply with the rules in this section. In general, see Regulations sections 1.6042–4, 1.6044–5, 1.6049–6, and 1.6050N–1 on the manner in which certain statements must be provided to recipients (statement mailing requirements for most Forms 1099–DIV and 1099–INT, all Forms 1099–OID and 1099–PATR, and Form 1099–MISC or 1099–S for royalties). Note: A trustee of a grantor-type trust may choose to file Forms 1099 and furnish a statement to the grantor under Regulations section 1.671–4(b)(2)(iii) and (b)(3)(ii). The statement required by those regulations is not subject to the requirements in this Section 7.

.01 SUBSTITUTE STATEMENTS TO RECIPIENTS – Forms 1099–INT (except for interest reportable under section 6041), 1099–DIV (except for section 404(k) dividends), 1099–OID, and 1099– PATR ONLY. The requirement to furnish Form recipients with an official Form **1099–INT, DIV, OID, or PATR** may be met by furnishing Copy B of the official form or by furnishing a substitute Form 1099 (form recipient statement) if it contains the same language as that of the official IRS form (such as aggregate amounts paid to the form recipient, any backup withholding, the name, address, and TIN of the person making the return, and any other information required by the official form). Information not required by the official form should not be included on the substitute form except state tax withholding information. You may enter a total of the individual accounts listed on the form only if they have been paid by the same payer. For example, if you are listing interest paid on several accounts by one financial institution on **Form 1099–INT**, you may also enter the total interest amount. You may also enter a date next to the corrected box if that box is checked.

The form recipient statement, *i.e.*, Copy B of substitute form for **Forms 1099–INT, 1099–DIV, 1099–OID, or 1099–PATR,** must comply with the following requirements.

(1) Box captions and numbers that are applicable must be clearly identified, using the same wording and numbering as on the official form. However on **Form 1099–INT,** if box 3 is not on your substitute form, you may drop "not included in box 3" from the box 1 caption.

(2) The form recipient statement must contain all applicable form recipient instructions provided on the front and back of the official IRS form. Those instructions may be provided on a separate sheet of paper.

(3) The form recipient statement must contain the following statement in bold and conspicuous type, **"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported."**

(4) The box caption **"Federal income tax withheld"** must be in bold face type on the form recipient statement.

(5) The form recipient statement must contain the Office of Management and Budget (OMB) number as shown on the official IRS form. See Part D, Section 2.

(6) The form recipient statement must contain the tax year (e.g., 1997), form number (e.g., Form 1099–INT), and form name (e.g., Interest Income) of the official IRS Form 1099 for which it substitutes prominently displayed together in one area of the statement. For example, the tax year, form number, and form name could be shown in the upper right part of the statement. Each copy must be appropriately labeled (such as Copy B, For Recipient) (see Part D, Section 1.02 for applicable labels of forms). **NOTE:** DO NOT include the words "Substitute for" or "In lieu of" on the form recipient statement.

(7) Layout and format of the form is at the discretion of the filer. However, IRS encourages the use of statements with boxes so that the statement has the appearance of a form and can be easily distinguished from other nontax statements.

(8) Because of new tax law enacted in 1996, 1099–DIV; 1099–INT; 1099–OID; and 1099–PATR recipient statements must include the telephone number of a person to contact: **The telephone number must be conspicuous but may appear anywhere on the recipient statement.**

(9) No additional enclosures, such as advertising, promotional material, or a quarterly or annual report, are permitted with Forms 1099–DIV, 1099–INT, 1099–OID, 1099–PATR, and forms reporting royalties only (Forms 1099–MISC or 1099–S). **NOTE:** The IRS intends to amend the regulations to allow the use of certain logos and identifying slogans on substitute statements to recipients that are subject to the statement mailing require-

SEC. 4. DEFINITIONS

.01 The term "form recipient" means the person to whom you are required by law to furnish a copy of the official form or information statement: *i.e.,* for Form 1098, the recipient is the "payer/borrower"; Form 1099–A, the "borrower"; Form 1099–C, the "debtor"; Form 1099–LTC, "the policyholder and insured"; Form 1099–S, the "transferor"; other Forms 1099, the payment recipient; Forms 5498 and 5498–MSA, the "participant"; and Form W–2G, the "winner."

.02 The term "filer" means the person or organization required by law to file a form listed in Part A, Section 1.01 with the IRS. Thus, a filer may be a payer, a creditor, a recipient of mortgage interest payments, a broker, a barter exchange, a person reporting real estate transactions, a trustee or issuer of any individual retirement arrangement (including an IRA, SEP, or SIMPLE), a trustee of a medical savings account, or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

.03 The term "substitute form" means a paper substitute of Copy A of an official form listed in Part A, Section 1.01 that totally conforms to the provisions in this revenue procedure.

.04 The term "substitute form recipient statement" means a paper statement of the information reported on a form listed in PART A, Section 1.01 that must be furnished to a person (form recipient), as so defined under the applicable provisions of the Internal Revenue Code and the applicable regulations.

.05 A composite substitute statement is one in which two or more required statements (e.g., Forms 1099–INT and 1099–DIV) are furnished to the recipient on one document. However, each statement must be separately designated and must contain all the requisite Form 1099 information except as provided in Part A, Section 7. A composite statement MAY NOT be filed with the IRS. See Part A, Section 7.02 and 7.04 for more information on composite statements.

SEC. 5. INSTRUCTIONS FOR PREPARING PAPER FORMS THAT WILL BE FILED WITH THE IRS (Copy A)

.01 The form recipient's name, street address, city, state, and Zip Code information should be TYPED OR MACHINE PRINTED IN BLACK INK on separate lines. Although handwritten forms will be accepted, in order for IRS to process the submitted forms in the most economical manner, the IRS prefers that filers TYPE OR MACHINE PRINT data entries. In addition, filers should insert data in the *middle of blocks* well separated from other printing and guidelines, and take other measures to guarantee a clear, dark black, sharp image. Carbon copies and photocopies are not acceptable. The city, state, and Zip Code must be on the same line.

.02 The name of the appropriate form recipient must be shown on the first or second name line in the area on the form provided for the form recipient's name and address. No descriptive information or other name may precede the form recipient's name. Only **ONE** form recipient's name may appear on the first name line of the form. If the names of multiple recipients must be set forth on the form, on the first name line insert the recipient name that corresponds to the recipient taxpayer identification number (TIN) shown on the form. Place the other form recipients' names, on the succeeding name line (up to 2 name lines are allowable). Because certain states require that trust accounts be provided in a different format, *generally* filers should provide information returns reflecting payments to trust accounts with (1) the trust's employer identification number (EIN) in the recipient's TIN area, (2) the trust's name on the recipient's first name line, and (3) the name of the trustee on the recipient's second name line.

.03 You should use the **account number** box for an account number designation. This number must not appear anywhere else on the form, and this box may not be used for any other item. Showing the account number is optional. However, it may be to your benefit to include the recipient's account number or designation on paper documents if your system of records uses the account number or designation in conjunction with, or rather than, the name, social security number, or employer identification number for identification purposes. If you furnish the account number, the IRS will include it in future notices to you about backup withholding. If you use window envelopes and reduced rate mail to mail statements to recipients, be sure the account number does not appear in the window. Otherwise the Postal Service may not accept them for mailing.

.04 Machine printed forms should be printed using a 6 lines/inch option, and should be printed in 10 pitch pica (*i.e.,* 10 print positions per inch) or 12 pitch elite (*i.e.,* 12 print positions per inch). Proportional spaced fonts are unacceptable.

.05 DO NOT use a felt tip marker. The machine used to "read" paper forms generally cannot "read" this ink type.

.06 Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single sheet before they are filed with IRS. The size specified *does not include pinfeed holes.* Pinfeed holes MUST NOT be present on forms filed with the IRS.

.07 Use decimal points to indicate dollars and cents. **DO NOT** use dollar signs ($), ampersands (&), asterisks (*), commas (,), or other special characters in the numbered money boxes. Example: 2000.00 is acceptable.

.08 DO NOT FOLD Forms 1096, 1098, 1099, or 5498 being mailed to IRS. Mail these forms flat in an appropriately sized envelope or box. Folded documents cannot be readily moved through the scanner transport used in IRS processing.

.09 ***DO NOT STAPLE*** Forms 1096 to the returns being transmitted. Staple holes in the vicinity of the return code number reduce the IRS's ability to machine scan the type of documents.

.10 **DO NOT** type other information on Copy A. **DO NOT** cut or separate the individual forms on the sheet of forms of Copy A (except Forms W–2G).

.11 Mail completed paper forms to the IRS service center specified on the back of Form 1096 and in the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G." Specific information needed to complete the forms in this revenue procedure is given in those instructions. A chart is included in those instructions giving a quick guide to which form must be filed to report a particular payment.

SEC. 6. MAGNETIC MEDIA AND ELECTRONIC FILING

.01 All forms listed in Section 1.01 (except Form 1096) may be filed magnetically or electronically. The IRS encour-

cation of Instructions for Forms 1099, 1098, 5498, and W–2G.

.05 Copies of the official forms for the reporting year and the instruction booklet may be obtained by calling our toll-free number **1-800-TAX-FORM (1-800-829-3676).**

.06 The IRS prints and provides the forms on which various payments must be reported. Alternatively, filers may prepare substitute copies of these IRS forms and use such forms to report payments to the IRS.

.07 IRS operates a centralized call site, located in Martinsburg Computing Center (MCC), to answer questions related to information returns, penalties, and backup withholding. The call site phone number is **304-263-8700.** The number for Telecommunications Device for the Deaf (TDD) is **304-267-3367.** These are not toll-free numbers.

.08 IRS has established a personal computer based Information Reporting Program Bulletin Board System (IRP-BBS). This system provides information about forms and publications, including this revenue procedure, news of the latest changes, answers to questions, and other features. The IRP-BBS is available for public use and can be reached by dialing 304-264-7070. The IRP-BBS is compatible with most modems. For more information concerning this system, call MCC at 304-263-8700 Monday through Friday 8:30 A.M. to 4:30 P.M. eastern time.

SEC. 2. NATURE OF CHANGES

.01 The text and exhibits were updated for tax year 1997.

.02 Three new forms were developed for tax year 1997. They are: Form 1099–LTC, Long-Term Care and Accelerated Death Benefits (Exhibit H); Form 1099–MSA, Distributions From Medical Savings Accounts (Exhibit J); and Form 5498–MSA, Medical Savings Account Information (Exhibit Q).

.03 Information about including telephone numbers on recipient statements was added to Part A, Sections 7.01(8) and 7.03(3).

.04 Several existing forms were changed as follows: Form 1099–C (Exhibit D) was changed by eliminating box 4, previously titled "Penalties, fines, admin. costs included in box 2"; Form 1099–MISC (Exhibit I) was changed by deleting the reporting of Excess Golden Parachute Payments (EPP) in box 7 and moving it the reporting to a new box 13; Form 1099–PATR (Exhibit L) was changed by retitling box 7 from "Energy investment credit" to "Investment credit", and retitling box 8 from "Jobs credit" to "Work opportunity credit"; Form 1099–R (Exhibit M) was changed by adding "SIMPLE" to the check box in box 7 to designate a distribution from a SIMPLE retirement account; The title of Form 5498 (Exhibit P) was changed to "IRA, SEP or SIMPLE Retirement Plan Information", the title of box 2 was changed from "Rollover IRA contributions" to "IRA, SEP, or SIMPLE rollover contributions," IRA and SIMPLE check boxes were added to box 5 to designate the type of account, box 6, titled "SEP contributions," was added to report SEP contributions, box 7, titled "SIMPLE contributions," was added to report SIMPLE contributions; and Form 1096 (Exhibit R) was changed to include three new checkboxes for new Forms 1099–LTC, 1099–MSA and 5498–MSA. **NOTE:** REFER TO THE 1997 INSTRUCTIONS FOR FORMS 1099, 1098, 5498, AND W–2G FOR ADDITIONAL INFORMATION REGARDING THESE FORM CHANGES.

.05 The IRS mailing address in Part A, Sec. 3.01 has changed.

.06. A statement regarding the use of logos on substitute statements to recipients was added to Part A, Sec. 7.01 (9).

SEC. 3 REQUIREMENTS FOR ACCEPTABLE SUBSTITUTE FORMS 1096, 1098, 1099, 5498, and W–2G

.01 Paper substitutes for Form 1096 and Copy A of Forms 1098, 1099, 5498, and W–2G that totally conform to the specifications contained in this revenue procedure may be privately printed and filed as returns with the IRS. The reference to the Department of the Treasury - Internal Revenue Service should be included on all such forms. If you are uncertain of any specification set forth herein and want that specification clarified, you may submit a letter citing the specification in question, giving your understanding and interpretation of the specification, and enclosing an example of the form (if appropriate) to:

Internal Revenue Service
ATTN: IRP Coordinator – T:S:P:S
1111 Constitution Avenue, NW
Washington, DC 20224

NOTE: Allow at least 45 days for the IRS to respond.

.02 Copy B (Form 1098 – For Payer, Form 1099–A – For Borrower, Form 1099–C – For Debtor, Form 1099–LTC – For Policyholder, Form 1099–S – For Transferor, Other Forms 1099 – For Recipient, Forms 5498 and 5498–MSA – For Participant, and Forms W–2G and 1099–R – To Be Attached To the Federal Tax Return); and Copy C– (Form 1099–R – For Recipient's Records, Form W–2G – For Winner's Records and, Form 1099–LTC – For Insured) must contain the information specified in Part A, Section 7 in order to constitute a "statement" or "official form" under the applicable provisions of the Internal Revenue Code. The format of this information is at the discretion of the filer with the exception of the location of the tax year, form number and form name specified in Part A, Section 7.01(6) and 7.03(1) and composite Form 1099 statements specified in PART A, Section 7.02.

Note: On Copy C, Form 1099–LTC, you may reverse the location of the policyholder's name, street address, city, state, and ZIP code with the location of the insured's name, street address, city, state, and ZIP code for ease in mailing.

.03 Forms 1096, 1098, 1099, 5498, and W–2G are subject to annual review and possible change. Therefore, filers are cautioned against overstocking supplies of privately printed substitutes. THE SPECIFICATIONS CONTAINED IN THIS REVENUE PROCEDURE APPLY TO 1997 FORMS ONLY.

.04 Proposed substitutes for Copy A that do not conform to the specifications in this revenue procedure are not acceptable. Further, if you file such forms with IRS, you may be subject to a penalty for failure to file an information return under section 6721 of the Internal Revenue Code (IRC). Generally, the penalty is $50 for each failure to file a form (up to $250,000) that the IRS cannot accept as a return because it does not meet the provisions in this revenue procedure. No IRS office is authorized to allow deviations from this revenue procedure.

PART A. GENERAL

SEC. 1. PURPOSE

.01 The purpose of this revenue procedure is to set forth the requirements for:

1. Using official Internal Revenue Service (IRS) forms to file information returns with the IRS,

2. Preparing acceptable substitutes of the official IRS forms to file information returns with the IRS, and

3. Using official or acceptable substitute forms to furnish information to a recipient.

This revenue procedure contains specifications for the following information returns:

(a) Form 1098	Mortgage Interest Statement;
(b) Form 1099–A	Acquisition or Abandonment of Secured Property;
(c) Form 1099–B	Proceeds From Broker and Barter Exchange Transactions;
(d) Form 1099–C	Cancellation of Debt;
(e) Form 1099–DIV	Dividends and Distributions;
(f) Form 1099–G	Certain Government Payments;
(g) Form 1099–INT	Interest Income;
(h) Form 1099–LTC	Long-Term Care and Accelerated Death Benefits;
(i) Form 1099–MISC	Miscellaneous Income;
(j) Form 1099–MSA	Distributions From Medical Savings Accounts;
(k) Form 1099–OID	Original Issue Discount;
(l) Form 1099–PATR	Taxable Distributions Received From Cooperatives;
(m) Form 1099–R	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.;
(n) Form 1099–S	Proceeds From Real Estate Transactions;
(o) Form W–2G	Certain Gambling Winnings;
(p) Form 5498	IRA, SEP, or SIMPLE Retirement Plan Information;
(q) Form 5498–MSA	Medical Savings Account Information; and
(r) Form 1096	Annual Summary and Transmittal of U.S. Information Returns.

.02 For the purpose of this revenue procedure, a substitute form or statement is one that is not printed by the IRS. For a substitute form or statement to be acceptable to the IRS, it must conform to the official form or the specifications outlined in this revenue procedure. **DO NOT SUBMIT ANY SUBSTITUTE FORMS OR STATEMENTS TO IRS FOR APPROVAL.** Private printers may not state "This is an IRS approved form." Further, only those forms that conform to the official form or comply with the specifications set forth herein are acceptable. See Part A, Section 7, for the specifications that apply to form recipient statements (generally Copy B).

.03 Filers who make payments to certain persons (payees) (or in some cases receive payments) during a calendar year are required by the Internal Revenue Code (IRC) to file information returns with the IRS reflecting these payments. Further, as discussed below, these filers must provide this information to their payees.

.04 In general, the manner in which a filer must file an information return is governed by section 6011 of the IRC. A filer must file information returns on magnetic media (including electronic filing) or on paper. Under section 6011 of the IRC, a filer who is required to file 250 or more information returns (of any one type) during a calendar year must file those returns on magnetic media. Filers required to file less than 250 returns during a calendar year may, but are not required to, file such information returns on magnetic media (small volume filers). The IRS explains these legal requirements for filing information returns (and providing a copy to a payee) in the annual publi-

(c) Regardless of whether, pursuant to this Q&A–10, the plan provides for minimum distributions commencing no later than an employee's required beginning date of April 1 of the calendar year following the calendar year the employee attained age 70½, the employee's required beginning date for purposes of § 4974 (excise tax on excess accumulations) and § 402(c) (definition of eligible rollover distribution) is determined in accordance with § 401(a)(9) as amended by the SBJPA. Thus, in the case of an employee who is not a 5-percent owner, no excise tax under § 4974 will apply prior to the calendar year in which the employee retires. However, beginning with that year, the amount that is required to be distributed each year to satisfy § 401(a)(9), as amended by the SBJPA, for purposes of § 4974 and § 402(c), will be determined using the required beginning date under the plan.

IV. COMMENTS

The Treasury and the Service invite comments and suggestions regarding the matters discussed in this notice. Comments can be addressed to CC:DOM:CORP:R (Notice 97–75), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97–75), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Partnership Magnetic Media Filing Requirements

Notice 97–77

PURPOSE

This notice provides guidance to partnerships having more than 100 partners regarding the requirement to file partnership tax returns on magnetic media under § 6011(e) of the Internal Revenue Code, as amended by § 1224 of the Taxpayer Relief Act of 1997 (Act), Pub. L. 105-34, 111 Stat. 788 (August 5, 1997).

BACKGROUND

Section 6011(e)(1) generally provides that the Secretary will prescribe regulations providing standards for determining which returns must be filed on magnetic media or in other machine-readable form.

Section 6011(e)(2) defines the requirements of the regulations, and provides that, in prescribing the regulations under § 6011(e)(1), the Secretary will not require any person to file returns on magnetic media unless such person is required to file at least 250 returns during the calendar year, and will take into account (among other relevant factors) the ability of the taxpayer to comply at reasonable cost with the requirements of such regulations.

Section 1224 of the Act amended § 6011(e)(2) to provide that the Secretary will require partnerships having more than 100 partners to file returns on magnetic media. Section 1226 of the Act provides that § 1224 is effective for tax years ending on or after December 31, 1997. However, the legislative history of the Act, as provided in H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 675 (1997), indicates that § 1224 is effective for tax years beginning after December 31, 1997. The Tax Technical Corrections Act of 1997, which is currently pending in Congress, provides that the effective date in § 1226 of the Act is for partnership tax years beginning after December 31, 1997. H.R. 2645, 105th Cong., 1st Sess. § 11(c) (1997).

TAX YEARS BEGINNING AFTER DECEMBER 31, 1997

The Service intends to implement § 1224 of the Act by issuing regulations as required by § 6011(e). The regulations will address the mandatory magnetic media filing requirements for Form 1065, U.S. Partnership Return of Income, for Schedules K-1, Shareholder's Share of Income, Credits, Deductions, etc., and for all other related forms and schedules. These regulations, however, will only address the requirements for tax years beginning after December 31, 1997.

TAX YEARS BEGINNING BEFORE JANUARY 1, 1998

The Service will not require magnetic media filing of partnership tax returns for partnership tax years beginning before January 1, 1998. Therefore, a partnership with more than 100 partners will not be required to file its partnership tax return on magnetic media for a tax year ending December 31, 1997, and no penalties will be imposed on the partnership for not filing such partnership tax return on magnetic media.

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26 CFR 601.602: Forms and instructions. (Also Part I, Sections 220, 408, 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N, 6050P, 6050Q, 1.408–5, 1.408–7, 1.6041–1, 7.6041–1, 1.6042–2, 1.6042–4, 1.6044–2, 1.6044–5, 1.6045–1, 5f.6045–1, 1.6045–2, 1.6045–4, 1.6047–1, 1.6049–4, 1.6049–6, 1.6049–7, 1.6050A–1, 1.6050B–1, 1.6050D–1, 1.6050E–1, 1.6050H–1, 1.6050H–2, 1.6050J–1T, 1.6050N–1, 1.6050P–1)

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distributions are being paid in the form of a qualified joint and survivor annuity (QJSA) within the meaning of § 417(b). Where such distributions are being paid in the form of a QJSA, in order to comply with this paragraph (c), the person who was the employee's spouse on the original annuity starting date must consent to the election to stop distributions under Q&A–7(a) and the spouse's consent must acknowledge the effect of the election. Because there is a new annuity starting date upon recommencement of benefits, the plan, in order to satisfy this paragraph (c), must comply with all of the requirements of § 417 upon such recommencement, including payment of a qualified preretirement survivor annuity (QPSA) if the employee dies before the new annuity starting date.

(4) *ISSUES RELATING TO ELIGIBILITY FOR ROLLOVERS*

Q–9: If distributions are made under a plan to an employee (other than a 5-percent owner) who did not retire before January 1, 1997 from employment with the employer maintaining the plan, is any portion of a distribution made after attainment of age 70½ a required distribution under § 401(a)(9) for purposes of § 402(c)(4)(B)?

A–9: (a) *General rule.* Section 402(c)–(4)(B) provides that a distribution is not an eligible rollover distribution to the extent that it is required under § 401(a)(9). As noted in Q&A–6, for purposes of determining the amount of minimum distributions that are required after December 31, 1996, the required beginning date for an employee who did not retire before January 1, 1997 from employment with the employer maintaining the plan is redetermined under § 401(a)(9)(C), as amended by the SBJPA. Therefore, whether or not a plan allows an employee who attained age 70½ before January 1, 1997, but did not retire from employment with the employer maintaining the plan before that date, to stop receiving distributions in accordance with Q&A–7, a distribution to such an employee prior to the year the employee retires is not a required distribution under § 401(a)(9). Such a distribution is an eligible rollover distribution unless it is excepted for some other reason. An exception is provided under § 402(c)(4)(A) for a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and the employee's designated beneficiary, or for a specified period of 10 years or more. If an employee's benefit is being distributed in a series of annual payments that would equal the required minimum distribution determined in accordance with Q&A F–1 of § 1.401(a)(9)–1 of the proposed Income Tax Regulations, then the series of payments will be considered a series of substantially equal payments over the life (or life expectancy) of the employee or the joint lives (or joint life expectancy) of the employee and the employee's designated beneficiary, or for a specified period of 10 years or more, in accordance with Q&A–5 of § 1.402(c)–2 of the Income Tax Regulations. Therefore, payments under such a series of payments are not eligible rollover distributions.

(b) *Treatment of 1996 distributions for employees who attained age 70½ in 1996.* As provided in Q&A–3 of Notice 96–67, if a distribution is made during 1996 to an employee who attained age 70½ in 1996, whether that distribution is a required distribution under § 401(a)(9) is determined by applying § 401(a)(9) as in effect prior to amendment by the SBJPA.

(c) *Transition rule for 1997 distributions.* A plan will not fail to satisfy § 401(a)(31) merely because the plan administrator or payor did not offer an employee (other than a 5-percent owner), who has attained age 70½ but has not retired from employment with the employer maintaining the plan, a direct rollover option with respect to the eligible rollover distributions described in this paragraph (c). A distribution is described in this paragraph (c) if it is paid in calendar year 1997 and, under pre-SBJPA § 401(a)(9), the distribution would not have been an eligible rollover distribution because it would have been a required minimum distribution. In addition, with respect to such a distribution, a plan will not be required to satisfy the written explanation requirement under § 402(f) or the mandatory 20-percent withholding requirement under § 3405(c).

(5) *PLANS MAINTAINING PRE-SBJPA REQUIRED BEGINNING DATE*

Q–10: Will a plan satisfy § 401(a)(9) as amended by SBJPA if it provides for minimum required distributions for an employee commencing no later than an employee's required beginning date of April 1 of the calendar year following the calendar year the employee attained age 70½, regardless of whether the employee is a 5-percent owner?

A–10: (a) A plan will not fail to satisfy § 401(a)(9) as amended by SBJPA merely because it provides for minimum distributions commencing no later than an employee's pre-SBJPA required beginning date of April 1 of the calendar year following the calendar year the employee attained age 70½, regardless of whether the employee is a 5-percent owner. For example, a plan may provide, in the case of all employees who attained age 70½ before 1999, that minimum required distributions will commence by the pre-SBJPA required beginning date of April 1 of the calendar year following the calendar year the employee attained age 70½.

(b) If, pursuant to this Q&A–10, the plan provides for minimum distributions commencing no later than an employee's required beginning date of April 1 of the calendar year following the calendar year in which the employee attained age 70½, both the employee's designated beneficiary and whether recalculation of life expectancy applies will be determined based on any elections in effect as of that date. Furthermore, an employee who dies after the required beginning date determined under the plan terms is treated as dying after the required beginning date within the meaning of § 401(a)(9)(C). Thus, to determine the distributions after such a death, § 401(a)-(9)(B)(i) (and not § 401(a)(9)(B)(ii)) applies, requiring the remaining portion of the employee's interest to be distributed at least as rapidly as under the method being used under § 401(a)(9)(A)(ii) as of the employee's date of death. See Q&As B–4 and F–3A of § 1.401(a)(9)–1 of the proposed Income Tax Regulations for guidance on satisfying the requirements of § 401(a)(9)(B)(i).

are not 5-percent owners for purposes of section 401(a)(9).

(3) *ISSUES RELATING TO EMPLOYEES WHO ATTAINED AGE 70½ BEFORE JANUARY 1, 1997*

Q–6: For purposes of § 401(a)(9)(C) after amendment by the SBJPA, what is the required beginning date for an employee (other than a 5-percent owner) who attained age 70½ before 1997, but did not retire from employment with the employer maintaining the plan before January 1, 1997?

A–6: For purposes of determining the amount of minimum distributions required after December 31, 1996, the required beginning date for an employee who did not retire from employment with the employer maintaining the plan before January 1, 1997 is determined under § 401(a)(9)(C), as amended by the SBJPA. Accordingly, as described in Q&A–2 of Notice 96–67, in the case of an employee (other than a 5-percent owner) who attained age 70½ in 1996 and retired from employment with the employer maintaining the plan on or after January 1, 1997, the required beginning date is April 1 of the calendar year following the year in which the employee retires from employment with the employer maintaining the plan. Furthermore, an employee (other than a 5-percent owner) who attained age 70½ prior to 1996, and retires from employment with the employer maintaining the plan on or after January 1, 1997, has a required beginning date for purposes of determining minimum distributions that are required on or after January 1, 1997 that is different from the required beginning date for the employee for purposes of determining minimum distributions that were required prior to January 1, 1997. Thus, for example, an employee (other than a 5-percent owner) who attained age 70½ in 1995, and retired from employment with the employer maintaining the plan in 1997, has a required beginning date of April 1, 1998. See Q&A–10 of this notice for a special rule permitting an employee's required beginning date determined without regard to the SBJPA amendments to be treated as the required beginning date for purposes of determining the minimum distributions required after January 1, 1997.

Q–7: May a plan permit an employee who attained age 70½ before 1997 but did not retire from employment with the employer maintaining the plan before January 1, 1997 to elect to stop current distributions?

A–7: (a) *Election to stop permitted.* An employee who attained age 70½ before 1997, but did not retire from employment with the employer maintaining the plan before January 1, 1997 has a new required beginning date as described in Q&A–6. Accordingly, distributions are not required to be made to that employee after December 31, 1996 and prior to the employee's new required beginning date in order to satisfy § 401(a)(9). A plan may provide that such an employee may affirmatively elect to stop distributions at any time until the employee retires, subject to the terms of an applicable qualified domestic relations order (QDRO), within the meaning of § 414(p).

(b) *Compliance with sections 401(a)(11) and 417.* An employee's election to stop and recommence distributions under paragraph (a) of this Q&A–7 is subject to the requirements of §§ 401(a)(11) and 417, if the plan is otherwise subject to those rules. However, a plan that permits an employee to stop distributions in accordance with paragraph (a) of this Q&A–7 and that complies with either of the alternatives set forth in Q&A–8, will not violate § 401(a)(11) and § 417 on account of the employee's cessation and recommencement of those distributions.

Q–8: What special alternatives are available for a plan that is subject to § 401(a)(11) and § 417 in order to satisfy those sections with respect to an employee who, pursuant to Q&A–7, elects to stop and recommence distributions?

A–8 (a): *In general.* A plan will not violate § 401(a)(11) and § 417 on account of an employee's cessation and recommencement of distributions in accordance with Q&A–7(a) if the plan operationally complies with either paragraph (b) or (c) of this Q&A–8, the plan is amended within the remedial amendment period for the plan for SBJPA changes to reflect that operational compliance, and the distributions stop prior to the end of that remedial amendment period.

(b) *No new annuity starting date upon recommencement.*

(i) Under this alternative, the plan provides that there is no new annuity starting date under § 417 upon recommencement of benefits. In such case, no spousal consent is required for an employee to elect to stop distributions pursuant to Q&A–7(a). Moreover, no spousal consent is required when payments recommence to the employee if:

(A) payments recommence to the employee with the same beneficiary and in a form of benefit that is the same but for the cessation of distributions,

(B) the individual who was the employee's spouse on the annuity starting date executed a general consent within the meaning of § 1.401(a)–20, A–31 of the Income Tax Regulations, or

(C) the individual who was the employee's spouse on the annuity starting date executed a specific consent to waive a QJSA within the meaning of § 1.401(a)–20, A–31, and the employee is not married to that individual when benefits recommence.

(ii) However, in order to comply with this paragraph (b), consent of the individual who was the employee's spouse on the annuity starting date is required prior to recommencement if the employee chooses to recommence benefits either in a different form than the form in which they were being distributed prior to the cessation of distributions or with a different beneficiary and if:

(A) the original form was a qualified joint and survivor annuity (QJSA) within the meaning of § 417(b), or

(B) the individual who was the employee's spouse on the annuity starting date originally executed a specific consent to waive a QJSA within the meaning of § 1.401(a)–20, A–31, of the Income Tax Regulations, and the employee is still married to that individual when benefits recommence.

(c) *New annuity starting date upon recommencement.* Under this alternative, the plan provides that there is a new annuity starting date under § 417 upon recommencement of benefits. In such case, no spousal consent is required for an employee to elect to stop distributions pursuant to Q&A–7(a), except where such

(d) *Nonapplication to defined contribution plans.* The actuarial increase required under this Q&A–1 does not apply to defined contribution plans.

Q–2: What amount of actuarial increase is required under § 401(a)(9)(C)(iii)?

A–2: In order to satisfy § 401(a)(9)(C)(iii), the retirement benefits payable with respect to an employee as of the end of the period for actuarial increases (described in Q&A–1) must be no less than: the actuarial equivalent of the employee's retirement benefits that would have been payable as of the date the actuarial increase must commence under Q&A–1 (i.e., the later of the April 1 following the calendar year in which the employee attained 70½ or January 1, 1997) if benefits had commenced on that date; plus the actuarial equivalent of any additional benefits accrued after that date; reduced by the actuarial equivalent of any distributions made with respect to the employee's retirement benefits after that date. Actuarial equivalence is determined using the plan's assumptions for determining actuarial equivalence for purposes of satisfying § 411.

Q–3: How does the actuarial increase required under § 401(a)(9)(C)(iii) relate to the actuarial increase required under § 411?

A–3: As reflected in § 1.411(c)–1(f)(2) of the proposed Income Tax Regulations, in order for an employee's accrued benefit to be nonforfeitable as required by § 411, a defined benefit plan must make an actuarial adjustment to an accrued benefit the payment of which is deferred past normal retirement age. The only exception to this rule is that generally no actuarial adjustment is required to reflect the period during which a benefit is suspended as permitted under section 203(a)(3)(B) of the Employee Retirement Income Security Act of 1974 (ERISA). The actuarial increase required under § 401(a)(9) of the Code for the period described in Q&A–1 is generally the same as, and not in addition to, the actuarial increase required for that same period under § 411 to reflect any delay in the payment of retirement benefits after normal retirement age. However, unlike the actuarial increase required under § 411, the actuarial increase required under § 401(a)(9)(C) must be provided even during the period during which an employee is in section 203(a)(3)(B) service.

Q–4: To what extent may additional accruals required under § 411(b)(1)(H) be reduced by actuarial increases required under § 401(a)(9)(C)(iii)?

A–4: For purposes of § 411(b)(1)(H)–(iii)(II), the actuarial increase required under § 401(a)(9)(C)(iii) will be treated as an adjustment attributable to the delay in distribution of benefits after the attainment of normal retirement age. Accordingly, to the extent permitted under § 411(b)(1)(H), the actuarial increase required under § 401(a)(9)(C)(iii) may reduce the benefit accrual otherwise required under § 411(b)–(1)(H)(i). However, the rule in the last sentence of § 1.411(b)–2(b)(4)(iii)(B) of the proposed Income Tax Regulations regarding the actuarial adjustment in the case of a plan that suspends benefits in accordance with § 203(a)(3)(B) of ERISA and the regulations thereunder is not applicable to the calculation of additional accruals for the period of time for which actuarial increases are required under § 401(a)(9)(C)(iii).

(2) *COORDINATION OF SECTION 401(a)(4) AND SECTION 401(a)(9) FOR CERTAIN PRERETIREMENT AGE 70½ DISTRIBUTION OPTIONS*

Q–5: Are there special rules that coordinate the implementation of the SBJPA changes to § 401(a)(9) with the nondiscriminatory current and effective availability requirements of § 1.401(a)(4)–4 of the Income Tax Regulations?

A–5: (a) *Aggregation of optional forms of benefit.* Solely for purposes of determining whether a plan satisfies the nondiscriminatory current and effective availability requirements of § 1.401(a)(4)–4, a preretirement age 70½ distribution option that is only available to required group members is permitted to be aggregated with another optional form of benefit that provides for commencement in the retirement period and the two optional forms of benefit may be treated as a single optional form of benefit. This aggregation treatment is permitted only if the other optional form of benefit is the same optional form of benefit as the preretirement age 70½ distribution option except for the difference in the timing of the commencement of payments.

(b) *Interim minimum distributions.* In the case of a defined contribution plan, if a preretirement age 70½ distribution option is available only to required group members and provides for payment of installment payments equal to the minimum amount (calculated in accordance with a method specified in the plan) necessary to satisfy § 401(a)(9) (before or after amendment by the SBJPA) with payment commencing during the 70½ period and ending by the end of the retirement period, and this form of payment does not apply to benefit payments after the end of the retirement period, this preretirement distribution option is treated as satisfying the requirements of § 1.401(a)(4)–4.

(c) *Definitions.* The following definitions apply only for purposes of this Q&A–5:

(i) *70½ period.* The 70½ period is the period beginning on January 1 of the year in which the employee attains age 70½ and ending on the April 1 of the following year.

(ii) *Retirement period.* The retirement period is the period beginning on January 1 of the year in which the employee retires from employment with the employer maintaining the plan and ending on April 1 of the following year.

(iii) *Preretirement age 70½ distribution option.* A preretirement age 70½ distribution option is an optional form of benefit under which benefits payable in a particular distribution form (including any modifications that may be elected after benefit commencement) commence during the 70½ period prior to the employee's retirement from employment with the employer maintaining the plan.

(iv) *Required group member.* An employee who is a 5-percent owner for purposes of section 401(a)(9) is a required group member. If a plan is amended to eliminate a preretirement age 70½ distribution option with respect to all employees (other than 5-percent owners) who attain age 70½ after a specified calendar year, and the plan satisfied § 1.401(a)(4)–4 with respect to availability of the preretirement age 70½ distribution option immediately before the amendment, then employees who attained age 70½ in or before the specified calendar year are also required group members with respect to the preretirement age 70½ distribution option under the plan even if the employees

explanation requirement under § 402(f) and the mandatory 20-percent withholding requirement under § 3405(c) for certain distributions made in 1997.

• Provides an optional rule under which an employee's required beginning date under pre-SBJPA § 401(a)(9) may be retained.

II. BACKGROUND

Section 401(a)(9) provides that, in order for a plan to be qualified under § 401(a), distributions of each employee's interest in the plan must commence no later than the "required beginning date" for the employee. Prior to the amendments made by the SBJPA, § 401(a)(9)(C) generally defined the required beginning date for an employee as the April 1 of the calendar year following the calendar year in which the employee attained age 70½. This meant that an employee who attained age 70½ was required to commence receiving distributions from the plan during the following year, even if the employee had not retired from employment with the employer maintaining the plan.

Section 1404(a) of the SBJPA amended § 401(a)(9) of the Code to provide that, in the case of an employee who is not a 5-percent owner, the required beginning date for minimum distributions from a qualified plan is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. In the case of an employee who is a 5-percent owner, the required beginning date continues to be the April 1 of the calendar year following the calendar year in which the employee attains age 70½. An employee is treated as a 5-percent owner for purposes of § 401(a)(9) as amended by the SBJPA if such employee is a 5-percent owner (as defined in § 416) with respect to the plan year ending with or within the calendar year in which such owner attains age 70½. Once an employee is a 5-percent owner described in the preceding sentence, distributions must continue to such employee even if such employee ceases to own more than 5 percent of the employer in a subsequent year.

Section 1404(a) of the SBJPA also amended § 401(a)(9) of the Code to provide that an employee's accrued benefit shall be actuarially increased to take into account the period after age 70½ in which the employee was not receiving any benefits under the plan. The amendments to § 401(a)(9) of the Code apply to years beginning after December 31, 1996.

The amendments retain the existing rules relating to the determination of the required beginning date for distributions from an individual retirement account or individual retirement annuity under § 408, and the determination of the required beginning date for church plans and government plans.

Notice 96–67, 1996–2 C.B. 235, provides guidance on the application of the amendments to § 401(a)(9)(C) made by the SBJPA to employees who attained age 70½ in 1996 but did not retire by the end of 1996.

Announcement 97–24, 1997–11 I.R.B. 24, provides that an employer may offer employees (other than 5-percent owners) who attain age 70½ after 1995 and have not retired, an option to defer commencement of benefit distributions under a qualified plan rather than to begin receiving benefits from the plan by April 1, 1997, even if the plan has not yet been amended to provide for the option.

Announcement 97–70, 1997–29 I.R.B. 14, provides transition relief for a plan under which certain distributions required under the terms of the plan were not made to an employee (other than a 5-percent owner) who attained age 70½ in 1996 and who did not retire from employment with the employer maintaining the plan by the end of 1996.

Section 1.411(d)–4, Q&A 10, of the proposed Income Tax Regulations, 62 F.R. 35752 (July 2, 1997), would provide relief from § 411(d)(6) for certain plan amendments that eliminate preretirement distributions commencing at age 70½.

Rev. Proc. 97–41, 1997–33 I.R.B. 51, provides guidance to sponsors of plans that are qualified under § 401(a) with respect to the date by which they must adopt amendments to comply with changes in the law, including a remedial amendment period for amendments to reflect changes to the qualification requirements made by the SBJPA.

This notice provides guidance on additional issues relating to the amendments to § 401(a)(9)(C) made by the SBJPA.

III. QUESTIONS AND ANSWERS

(1) *ACTUARIAL INCREASE FOR DEFINED BENEFIT PLANS*

Q–1: If an employee retires in a calendar year after the calendar year in which the employee attains age 70½, for what period must the employee's accrued benefit under a defined benefit plan be actuarially increased?

A–1: (a) *Actuarial increase starting date.* Under § 401(a)(9)(C)(iii), in the case of an employee (other than a 5-percent owner) who retires in a calendar year after the calendar year in which the employee attains age 70½, the employee's accrued benefit under a defined benefit plan must be actuarially increased in order to take into account the period after age 70½ in which the employee is not receiving benefits under the plan. If an employee retires at age 70½, then, in order to satisfy § 401(a)(9), the distribution of the employee's benefits is required to begin no later than the April 1 following the calendar year in which the employee attains age 70½. Thus, if an employee retires after the calendar year in which the employee attains age 70½, the actuarial increase required to satisfy § 401(a)(9) to reflect the delay in payment must be provided for the period starting on the April 1 following the calendar year in which the employee attains age 70½. In the case of an employee who attained age 70½ prior to 1996, the starting date for the period of actuarial increase is January 1, 1997.

(b) *Actuarial increase ending date.* The period for which the actuarial increase must be provided ends on the date on which benefits commence after retirement in an amount sufficient to satisfy § 401(a)(9).

(c) *Nonapplication to defined benefit plans using optional rule.* If, pursuant to the optional rule of Q&A–10, minimum distributions under a plan to an employee commence no later than April 1 of the calendar year following the calendar year in which the employee attains age 70½, in an amount sufficient to satisfy § 401(a)(9) as in effect prior to amendment by the SBJPA, no actuarial increase is required under § 401(a)(9)(C)(iii).

how to file returns by magnetic media. In addition, the Service is exploring electronic filing options and will issue further guidance when such options become available.

E. *Statements To Be Provided to Students*

Each eligible educational institution must provide each student with respect to whom an information return is filed a statement containing the same information that is provided to the Service on the information return required by § 6050S. In addition, the statement provided to the student must contain the phone number of the individual serving as information contact at the eligible educational institution that made the return. The statement with respect to qualified tuition and related expenses paid in 1998 must be provided to the student by February 1, 1999. The statement may be a copy of Form 1098–T or an acceptable substitute statement.

F. *Collecting Information*

The Service is developing an optional Form W–9S for use in collecting information for the purpose of complying with § 6050S. Eligible educational institutions will be able to use the form to collect a student's name, address, and TIN. The form is being designed so that it can also be used to collect any information necessary to meet the information reporting requirements associated with the student loan interest deduction provided by new § 221. Eligible educational institutions will be able to collect information from students for 1998 information reporting purposes on a paper or an electronic version of Form W–9S (or an acceptable substitute). The eligible educational institution also may collect the necessary information by using its own forms and procedures.

Eligible educational institutions that are also federal, state or local government agencies are required to provide certain disclosures under the Privacy Act when collecting social security numbers from individuals. *See* 5 U.S.C. § 552a. The Form W–9S will contain a Privacy Act disclosure statement.

G. *Waiver of Penalties.*

The Treasury Department intends to issue regulations under § 6050S providing guidance on how institutions are to comply with the requirements of the statute. Until the regulations are adopted, no penalties will be imposed under §§ 6721 and 6722 for failure to file correct information returns with the Service or to furnish correct statements to the individuals with respect to whom information reporting is required under § 6050S. Furthermore, even after the regulations are adopted, no penalties will be imposed under §§ 6721 and 6722 for failure to file correct information returns or furnish correct written statements for 1998 as required by § 6050S if the institution made a good faith effort to file information returns and furnish statements in accordance with this notice.

Weighted Average Interest Rate Update

Notice 97–74

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for November 1997 is 6.11 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 107% Permissible Range	90% to 110% Permissible Range
December	1997	6.79	6.11 to 7.26	6.11 to 7.47

Minimum Distribution Requirements

Notice 97–75

I. PURPOSE

This notice provides guidance relating to the amendments to the minimum distribution requirements of § 401(a)(9) of the Internal Revenue Code ("Code") made by § 1404 of the Small Business Job Protection Act of 1996, Pub. L. 104–188 ("SBJPA"). Specifically, this notice:

- Answers questions regarding the actuarial increase that must be provided under a defined benefit plan for an employee who retires after age 70½, and the interaction of this actuarial increase with § 411.
- Coordinates the § 401(a)(4) nondiscrimination requirements with the § 401(a)(9) requirement that certain preretirement distribution options be available to an employee at age 70½.
- Permits plans to allow participants who commenced distributions under pre-SBJPA § 401(a)(9) to stop receiving those distributions, and provides guidance on the applicable notice and spousal consent requirements.
- Clarifies the extent to which distributions made after 1996 to an employee who has attained age 70½ will be considered eligible rollover distributions under § 402(c)(4)(B).
- Gives relief from the direct rollover requirements of § 401(a)(31), the written

or the reimbursements or refunds are made. Section 6050S(a) also requires each person engaged in a trade or business who makes a reimbursement or refund of qualified tuition and related expenses to submit an annual information report to the Service with respect to each student on whose behalf the reimbursements or refunds are paid. The terms "eligible educational institution" and "qualified tuition and related expenses" have the same meanings for purposes of § 6050S as they do for purposes of the Hope Scholarship Credit and the Lifetime Learning Credit.

Section 6050S(b) provides that the return of information must be in the form prescribed by the Secretary and contain:

(1) the name, address, and taxpayer identification number (TIN) of the individual with respect to whom the qualified tuition and related expenses were received or the reimbursement or refund was paid,

(2) the name, address, and TIN of any individual certified by the individual named in the first item as the taxpayer who will claim that individual as a dependent for purposes of the deduction under § 151 for any taxable year ending with or within the year for which the information return is filed,

(3) the aggregate amount of payments of qualified tuition and related expenses received by the eligible educational institution or the aggregate amount of reimbursements or refunds (or similar amounts) paid during the calendar year with respect to the individual named in the first item, and

(4) such other information as the Secretary may prescribe.

Section 6050S(d) provides that every person required to make an information return under § 6050S(a) shall furnish to each individual whose name is required to be included in the return a written statement showing the name, address, and phone number of the reporting person's information contact, and the aggregate amounts required to be included in the return.

DISCUSSION

A. *Who Must File for 1998.*

For 1998, an eligible educational institution that receives payments of qualified tuition and related expenses in 1998 must file an information return with the Service with respect to each student on whose behalf payments were received. An eligible educational institution that makes reimbursements or refunds of tuition or related expenses to a student during 1998, that equal or exceed payments of qualified tuition or related expenses received on behalf of that student during 1998, is not required to file an information return or furnish a statement with respect to that student for 1998.

An institution is not required to provide a report with respect to a student whose tuition and related expenses were waived in their entirety or paid entirely with scholarships because it will have received no payments of qualified tuition and related expenses on behalf of such a student.

Persons, other than eligible educational institutions, engaged in a trade or business and making reimbursements or refunds of qualified tuition and related expenses will not be required to file information returns or furnish statements of reimbursements or refunds for 1998.

For purposes of providing these information reports, an eligible educational institution should provide reports on students who are enrolled in the institution for any academic term beginning in 1998. An institution should determine its enrollment for each term as of any of the following three dates:

(a) 30 days after the first day of the academic term;

(b) a date during the term on which enrollment data must be collected for purposes of the Integrated Postsecondary Education Data System administered by the Department of Education; or

(c) a date during the term on which the institution must report enrollment data to the State, the institution's governing board or some other external governing body.

An institution should provide a single information report for each student on whose behalf qualified tuition and related expenses have been received in 1998 even if the institution receives more than one payment on that student's behalf during 1998.

B. *Information Required for 1998.*

Eligible educational institutions required under this notice to file information returns for 1998 must properly complete Form 1098–T, Tuition Payments, for each student with respect to whom information reporting is required. For 1998, a properly completed Form 1098–T filed with the Service must include:

(1) the name, address, and TIN of the eligible educational institution,

(2) the name, address, and TIN of the individual with respect to whom payments of qualified tuition and related expenses were received during 1998,

(3) an indication as to whether the individual named in the second item was enrolled for at least half the full-time academic workload during any academic period commencing in 1998, and

(4) an indication as to whether the individual named in the second item was enrolled exclusively in a program or programs leading to a graduate-level degree, graduate-level certificate, or other recognized graduate-level educational credential.

For purposes of section 25A and the reporting required under § 6050S, a student will be considered to be enrolled at least half-time if the student is enrolled for at least half the full-time academic workload for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. The institution's standard for a full-time workload must equal or exceed the standards established by the Department of Education under the Higher Education Act and set forth in 34 C.F.R. § 674.2(b).

Although in the future institutions will be required to provide the additional information specified in § 6050S *(e.g.,* the amount of qualified tuition and related expenses received and/or reimbursed), the IRS will not impose penalties on an institution that does not provide this information for 1998.

C. *When To File*

The information returns required under § 6050S for 1998 must be sent to the Service by March 1, 1999.

D. *Manner of Filing*

Eligible educational institutions may file the information returns required by § 6050S for 1998 on paper or by magnetic media. Additional guidance will be issued providing further information on

quently, commentators have expressed concern that a refinancing of indebtedness incurred to acquire property that is the subject of a rental agreement entered into prior to the effective date of the § 467 regulations will result in a substantial modification of the rental agreement. This treatment may occur because, even though the lessee is not directly obligated to pay the principal of, or interest on, such indebtedness, in many leases, the rent paid by the lessee is affected by the lessor's debt service costs. Thus, the concern of the commentators is that a refinancing of the lessor's indebtedness after June 3, 1996, will cause a change in rental payments that will constitute a substantial modification of the rental agreement and may cause the remaining portion of the rental agreement to be treated as a disqualified leaseback or long-term agreement under the § 467 regulations (and therefore subject to constant rental accrual).

EFFECT OF REFINANCING

In response to the concerns of commentators, the final regulations under § 467 will provide that the refinancing of any indebtedness incurred by the lessor to acquire the property subject to a rental agreement and secured by the property, together with any corresponding changes in the rights or obligations of the lessee under the rental agreement, will not be treated as a substantial modification of the rental agreement if all of the following conditions are met:

(a) Neither the amount, nor the time for payment, of the principal amount of the new indebtedness differs from the amount and time for payment of the principal amount of the refinanced indebtedness, except for de minimis changes;

(b) For each of the remaining rental periods, the rent allocation schedule, the payments of rent and interest, and the amount accrued under § 467 are changed only as necessary to take into account the change in financing costs, and such changes are made pursuant to the terms of the rental agreement;

(c) The lessor and the lessee are not related persons (as defined in § 1.467–1(h)(7) of the proposed regulations) to each other or to any lender to the lessor with respect to the property (whether under the refinanced indebtedness or the new indebtedness); and

(d) The lessor has a unilateral option (within the meaning of § 1.1001–3(c)(3)), with or without the consent of the lessee, to repay the refinanced indebtedness.

Returns Relating to Higher Education Tuition and Related Expenses

Notice 97–73

PURPOSE

This notice describes the information reporting requirements for 1998 under § 6050S of the Internal Revenue Code (as enacted by the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, § 201(c), 111 Stat. 804 (the Act)) that apply to certain educational institutions in connection with the Hope Scholarship Credit and the Lifetime Learning Credit. The Treasury Department intends to issue regulations on the information reporting required under § 6050S. Pending the issuance of those regulations, this notice describes who must report information, and the nature of the information that will be required to be reported under § 6050S for 1998.

BACKGROUND

A. *The Hope Scholarship and Lifetime Learning Credits.*

Section 201(a) of the Act, 111 Stat. 799, added § 25A to the Code. Section 25A allows certain taxpayers who pay qualified tuition and related expenses to an eligible educational institution to claim a Hope Scholarship Credit or a Lifetime Learning Credit against their federal income tax liability. The Hope Scholarship Credit is available for qualified tuition and related expenses paid after December 31, 1997, in taxable years ending after that date for education furnished in academic periods beginning after December 31, 1997. The Lifetime Learning Credit is available for qualified tuition and related expenses paid after June 30, 1998, in taxable years ending after that date for education furnished in academic periods beginning after June 30, 1998. The term "academic period" includes a semester, trimester, quarter, or any other period designated as a period of instructional time by the educational institution. For this purpose, an academic period begins on the first day of classes, and does not include periods of student orientation, counseling, or vacation.

For a taxpayer to be eligible for the Hope Scholarship Credit or the Lifetime Learning Credit, qualified tuition and related expenses must be paid by the taxpayer to an eligible educational institution for the taxpayer, the taxpayer's spouse or any dependents. Payments by a taxpayer's dependents are to be treated as having been made by the taxpayer. The Hope Scholarship Credit is available only for the qualified tuition and related expenses of students enrolled at least half-time in the first two years of postsecondary education and can be claimed in no more than two years for each student.

Qualified tuition and related expenses are the tuition and fees an individual is required to pay in order to be enrolled at or attend an eligible educational institution. Amounts paid for any course or other education involving sports, games, or hobbies are not eligible for the credit, unless the course or other education is part of the student's degree program. Charges and fees associated with room, board, student activities, athletics, insurance, books, equipment, transportation, and similar personal, living, or family expenses are not qualified tuition and related expenses.

An eligible educational institution is a college, university, vocational school, or other postsecondary educational institution that is described in section 481 of the Higher Education Act of 1965 (20 U.S.C. 1088) and, therefore, is eligible to participate in the student aid programs administered by the Department of Education. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

Notice 97–60, 1997–46 I.R.B. 8, provides additional information about the Hope Scholarship Credit and the Lifetime Learning Credit.

B. *Information Reporting Relating to Qualified Tuition and Related Expenses.*

Section 6050S(a) requires eligible educational institutions that receive payments of qualified tuition and related expenses or make reimbursements or refunds of qualified tuition and related expenses to submit an annual information report to the Service with respect to each student on whose behalf the payments are received

2. Table for Figuring Additional Exempt Amount for Taxpayers at Least 65 Years Old and/or Blind

Additional Exempt Amount

Filing Status	*	Daily	Wkly	Bi-Wkly	Semi-Mo	Monthly
Single or Head of Household	1	4.04	20.19	40.38	43.75	87.50
	2	8.08	40.38	80.77	87.50	175.00
Any Other Filing Status	1	3.27	16.35	32.69	35.42	70.83
	2	6.54	32.69	65.38	70.83	141.67
	3	9.81	49.04	98.08	106.25	212.50
	4	13.08	65.38	130.77	141.67	283.33

* ADDITIONAL STANDARD DEDUCTION claimed on Parts 3, 4, & 5 of levy.

Examples

These tables show the amount exempt from a levy on wages, salary, and other income.

For example:

1. A single taxpayer who is paid weekly and claims three exemptions (including one for the taxpayer) has $237.50 exempt from levy.

2. If the taxpayer in number 1 is over 65 and writes 1 in the ADDITIONAL STANDARD DEDUCTION space on Parts 3, 4, & 5 of the levy, $257.69 is exempt from this levy ($237.50 plus $20.19).

3. A taxpayer who is married, files jointly, is paid bi-weekly, and claims two exemptions (including one for the taxpayer) has $480.77 exempt from levy.

4. If the taxpayer in number 3 is over 65 and has a spouse who is blind, this taxpayer should write 2 in the ADDITIONAL STANDARD DEDUCTION space on Parts 3, 4, & 5 of the levy. Then, $546.15 is exempt from this levy ($480.77 plus $65.38).

Substantial Modification of Rental Agreements

Notice 97-72

PURPOSE

This notice informs taxpayers of certain conditions under which changes in rental payment terms resulting from a refinancing of indebtedness incurred by a lessor to acquire property that is the subject of a rental agreement will not be a substantial modification of the rental agreement for purposes of § 467 of the Internal Revenue Code. The Treasury Department intends to issue final regulations under § 467 that will incorporate these conditions.

BACKGROUND

On June 3, 1996, the Internal Revenue Service and Treasury issued proposed Income Tax Regulations under § 467, published in a Notice of Proposed Rulemaking (61 Fed. Reg. 27834). The regulations provide that, if a rental agreement is a § 467 rental agreement, the lessor and lessee must take into account for a taxable year the § 467 rent and the § 467 interest for that year. The proposed regulations provide that a rental agreement is a § 467 rental agreement if it has increasing or decreasing rent, or deferred or prepaid rent, and the aggregate rental payments and other consideration to be received for the use of the property exceed $250,000.

Under § 1.467–3 of the proposed regulations, if a § 467 rental agreement is a leaseback or long-term agreement that provides for increases or decreases in rent that have a principal purpose of Federal income tax avoidance (a disqualified leaseback or long-term agreement), the Commissioner may require the lessor and lessee to use constant rental accrual. Section 467(e)(1) provides that the "constant rental amount" is an amount that, if paid at the close of each lease period under the agreement, would result in an aggregate present value equal to the present value of the aggregate payments required under the agreement. Section 467(b)(5) and the § 467 proposed regulations provide certain safe harbor exceptions to the application of constant rental accrual.

The regulations are proposed to be effective for (1) disqualified leasebacks and long-term agreements entered into after June 3, 1996, and (2) all other rental agreements entered into after the date on which final § 467 regulations are published.

Under § 1.467–1(f) of the proposed regulations, if, after the lease term begins, the lessor and lessee agree to a substantial modification of the terms of the lease, the remaining portion of the rental agreement, as modified, is treated as a new rental agreement for purposes of § 467 and the regulations thereunder, including the effective date provisions. Thus, for example, such a rental agreement must be retested to determine whether increases or decreases in rent were motivated by Federal income tax avoidance, or whether a safe harbor exception to constant rental accrual applies.

The proposed regulations provide no guidance regarding whether a substantial modification has occurred. Conse-

Filing Status: Unmarried Head of Household							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	34.42	44.81	55.19	65.58	75.96	86.35	24.04 plus 10.38 for each exemption
Weekly	172.12	224.04	275.96	327.88	379.81	431.73	120.19 plus 51.92 for each exemption
Biweekly	344.23	448.08	551.92	655.77	759.62	863.46	240.38 plus 103.85 for each exemption
Semi-monthly	372.92	485.42	597.92	710.42	822.92	935.42	260.42 plus 112.50 for each exemption
Monthly	745.83	970.83	1195.83	1420.83	1645.83	1870.83	520.83 plus 225.00 for each exemption

Filing Status: Married Filing Joint (and Qualifying Widow(er)s)							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	37.69	48.08	58.46	68.85	79.23	89.62	27.31 plus 10.38 for each exemption
Weekly	188.46	240.38	292.31	344.23	396.15	448.08	136.54 plus 51.92 for each exemption
Biweekly	376.92	480.77	584.62	688.46	792.31	896.15	273.08 plus 103.85 for each exemption
Semi-monthly	408.33	520.83	633.33	745.83	858.33	970.83	295.83 plus 112.50 for each exemption
Monthly	816.67	1041.67	1266.67	1491.67	1716.67	1941.67	591.67 plus 225.00 for each exemption

Filing Status: Married Filing Separate							
Pay Period	Number of Exemptions Claimed on Statement						
	1	2	3	4	5	6	More Than 6
Daily	24.04	34.42	44.81	55.19	65.58	75.96	13.65 plus 10.38 for each exemption
Weekly	120.19	172.12	224.04	275.96	327.88	379.81	68.27 plus 51.92 for each exemption
Biweekly	240.38	344.23	448.08	551.92	655.77	759.62	136.54 plus 103.85 for each exemption
Semi-monthly	260.42	372.92	485.42	597.92	710.42	822.92	147.92 plus 112.50 for each exemption
Monthly	520.83	745.83	970.83	1195.83	1420.83	1645.83	295.83 plus 225.00 for each exemption

Accounts, Magnetically/Electronically.

.07 This revenue procedure supersedes Rev. Proc. 96–36 published as Publication 1220 (Rev. 7–96), Specifications for Filing Forms 1098, 1099 series, 5498, and W–2G Magnetically or Electronically.

.08 Refer to Part A, Sec. 17, for definitions of terms used in this publication.

Sec. 2. Nature of Changes—Current Year (Tax Year 1997)

.01 In this publication, all pertinent changes for Tax Year *1997* have been emphasized by using italics. This has been done to assist filers in identifying new information. Filers are still advised to read the publication in its entirety.

.02 Programming Changes

a. Payer/Transmitter "A" Record Changes:

(1) For all forms, Payment Year, Field Positions 2-3 must be incremented by one (from *96* to *97*) unless reporting prior year data.

(2) In Part B, Sec. 6, the Type of Return Codes, Field Position 22 of the Payer "A" Record, have been expanded to include new forms 1099–LTC, 1099–MSA, and 5498–MSA. The Type of Return Codes are T for Form 1099–LTC, M for 1099–MSA, and K for Form 5498–MSA.

(3) In Part B, Sec. 6, for Form 1099–C, Amount Code 4 (Penalties, fines, or administrative costs included in Amount Code 2) has been deleted from Field Positions 23–31 of the Payer "A" Record.

(4) In Part B, Sec. 6, for the new Form 1099–LTC (Type of Return Code T), Amount Codes 1 (Gross long-term care benefits paid) and 2 (Accelerated death benefits paid) have been added to Field Positions 23–31 of the Payer "A" Record.

(5) In Part B, Sec. 6, for the new Form 1099–MSA (Type of Return Code M), Amount Codes 1 (Gross distribution) and 2 (Earnings on excess contributions) have been added to Field Positions 23–31 of the Payer "A" Record.

(6) In Part B, Sec. 6, for Form 5498, Two Amount Codes have been added, Amount Code 6 (SEP contributions) and Amount Code 7 (SIMPLE contributions) in Field Positions 23–31 of the Payer "A" Record.

(7) In Part B, Sec. 6, for the new Form 5498–MSA (Type of Return Code K), Amount Codes 1 (Employee MSA contributions made in 1997 and 1998 for 1997), 2 (Total MSA contributions made in 1997), and 3 (Total MSA contributions made in 1998 for 1997), 4 (MSA rollover contributions not included in Amount Code 1, 2, or 3) and 5 (Fair market value of account) have been added to Field Positions 23–31 of the Payer "A" Record.

(8) In Part B, Sec. 6, the Payer City, State, and Zip Code field in Positions 171–210 of the Payer "A" Record have been broken down into three separate fields.

(9) In Part B, Sec. 6, for the convenience of the filer, an optional field has been added for the Payer's Phone Number and Extension in Field Positions 371–385 of the Payer "A" Record.

b. Payee "B" Record Changes:

(1) For all forms, Payment Year, Field Positions 2–3 must be incremented by one (from 96 to 97) unless reporting prior year data.

(2) In Part B, Sec. 8, for the Form 1099–MSA, Distribution Codes 1 (Normal distribution), 2 (Excess contributions), 3 (Disability), 4 (Death), and 5 (Prohibited transaction) have been added to Field Positions 4 and 5 of the Payee "B" Record.

(3) In Part B, Sec. 8, for the Form 1099–R, Distribution Codes L (Loans treated as deemed distributions under section 72(p)) and S (Early distribution from a SIMPLE IRA in first 2 years, no known exception) have been added to Field Positions 4 and 5 of the Payee "B" Record.

(4) In Part B, Sec. 8, for the Form 1099–R, the IRA/SEP Indicator in Field Position 44 of the Payee "B" Record has been expanded from IRA/SEP to IRA/SEP/SIMPLE. This field will be used exclusively for the Form 1099–R.

(5) In Part B, Sec. 8, for the Form 5498, IRA, SEP, and SIMPLE Indicators have been added in Field Positions 141–143.

(6) In Part B, Sec. 8(1), Form 1099-MSA and Form 5498–MSA have been added to the standard Record Layout Positions 322–420.

(7) In Part B, Sec. 8(5), the Record Layout Positions 322–420 of the Payee "B" Record are given for Form 1099–LTC to include the following fields:

- **(a)** A Type of Payment Indicator has been added to Field Position 322 of the Payee "B" Record with indicators of 1 (Per diem) and 2 (Reimbursed amount).
- **(b)** The Social Security Number of the Insured has been added to Field Positions 323–331 of the Payee "B" Record.
- **(c)** The Name of the Insured has been added to Field Positions 332–371 of the Payee "B" Record.
- **(d)** The Address of the Insured has been added to Field Positions 372–411 of the Payee "B" Record.
- **(e)** A Status of Illness Indicator has been added for Field Position 412 of the Payee "B" Record with indicators of 1 (Chronically ill) and 2 (Terminally ill).
- **(f)** A Date of Doctor's Certification has been added in Field Positions 413–418 of the Payee "B" Record.

.03 Other Programming Changes

(a) In Part E, Sec. 3, in the record layout for the Magnetic/Electronic Specifications for Extensions of Time, the Document Indicators in Field Position 175 have been expanded to include Forms 1099–LTC, 1099–MSA, and 5498–MSA.

.04 Editorial Changes—General

(a) A note has been added advising filers that date fields will be expanded in Tax Year 1998 in preparation for Year 2000.

(b) The title of the Form 5498 has been changed from Individual Retirement Arrangement Information to IRA, SEP, or SIMPLE Retirement Plan Information. The new title appears in the list of forms in Part A, Sec. 1.01 and throughout the publication.

(c) Three new forms have been added for TY97 processing: Form 1099–LTC, Long-Term Care and Accelerated Death Benefits, Form 1099–MSA, Distributions From Medical Savings Accounts, and Form 5498–MSA, Medical Savings Account Information. The new forms are included in the list of forms in Part A, Sec. 1.1 and throughout the publication. Filers

Part E. Magnetic/Electronic Specification for Extensions of Time

Part F. Miscellaneous Information

Part A. General

Revenue procedures are generally revised annually to reflect legislative and form changes. Comments concerning this revenue procedure, or suggestions for making it more helpful, can be addressed to:

Internal Revenue Service
Martinsburg Computing Center
Attn: IRB, Information Support Section
P. O. Box 1359, MS-360
Martinsburg, WV *25402*

Sec. 1. Purpose

.01 The purpose of this revenue procedure is to provide the specifications for filing Forms 1098, 1099 series, 5498, 5498–MSA, and W–2G electronically or on magnetic media, which includes 1/2-inch magnetic tape; IBM 3480, 3490 or AS400 compatible tape cartridges (including 8mm); or 5 1/4- and 3 1/2-inch diskettes with IRS. **IRS/MCC has discontinued processing 8-inch diskettes.** This revenue procedure must be used for the preparation of Tax Year *1997* information returns and information returns for years prior to 1997 that are required to be filed. This revenue procedure must be used to prepare current and prior year information returns filed between January 1, *1998*, and December 31, *1998*. Specifications for filing the following forms are contained in this revenue procedure.

(a) Form 1098, Mortgage Interest Statement.
(b) Form 1099–A, Acquisition or Abandonment of Secured Property.
(c) Form 1099–B, Proceeds From Broker and Barter Exchange Transactions.
(d) Form 1099–C, Cancellation of Debt.
(e) Form 1099–DIV, Dividends and Distributions.
(f) Form 1099–G, Certain Government Payments.
(g) Form 1099–INT, Interest Income.
(h) *Form 1099–LTC, Long-Term Care and Accelerated Death Benefits.*
(i) Form 1099–MISC, Miscellaneous Income.
(j) *Form 1099–MSA, Distributions From Medical Savings Accounts.*
(k) Form 1099–OID, Original Issue Discount.
(l) Form 1099–PATR, Taxable Distributions Received From Cooperatives.
(m) Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
(n) Form 1099–S, Proceeds From Real Estate Transactions.
(o) Form 5498, *IRA, SEP, or SIMPLE Retirement Plan Information.*
(p) *Form 5498–MSA, Medical Savings Account Information.*
(q) Form W–2G, Certain Gambling Winnings.

.02 Specifications for filing Forms W-2 on magnetic media are available from the Social Security Administration (SSA) **only**. Filers can call 1-800-SSA-1213 to obtain the phone number of the SSA Magnetic Media Coordinator for their area.

.03 The Internal Revenue Service, Martinsburg Computing Center (IRS/MCC) has the responsibility for processing Forms 1098, 1099 series, 5498, *5498–MSA*, and W–2G filed magnetically or electronically. IRS/MCC does **not** process Forms W–2. Paper **and/or** magnetic media for Forms W–2 must be sent to SSA. IRS/MCC does, however, process waiver requests (Form 8508), extension of time to file requests (Form 8809) for Forms W–2 and requests for extension of time to file the employee copies of W–2G.

.04 Generally, the box numbers on the paper forms correspond with the amount codes used to file magnetically/electronically; however, if discrepancies occur, the instructions in this revenue procedure govern.

.05 This revenue procedure also provides the requirements and specifications for magnetic media or electronic filing under the Combined Federal/State Filing Program.

.06 The following revenue procedures and publications provide more detailed filing procedures for certain other information returns.

(a) 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" provides specific instructions on completing and submitting information returns to IRS.
(b) Rev. Proc. 84–33, 1984–1 C.B. 502, regarding the optional method for agents to report and deposit backup withholding.
(c) Publication 1179, Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 Series, 5498, and W–2G.
(d) Publication 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape and 5 1/4- or 3 1/2-inch Diskettes.
(e) Publication 1187, Specifications for Filing Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, Electronically or on Magnetic Tape, and 5 1/4- or 3 1/2-inch Diskettes.
(f) Publication 1245, Specifications for Filing Form W-4, Employee's Withholding Allowance Certificate, on Magnetic Tape, and 5 1/4- or 3 1/2-inch Diskette.
(g) Rev. Proc. 97–25, specifications set forth for the magnetic or electronic filing of 1997 Form 8851, Summary of Medical Savings

tax return information are confidential, as required by 26 U.S.C. 6103.

NOTE:

Following is a list of related instructions and forms for filing Information Returns Magnetically/Electronically:

- ▶ 1997 Instructions for Forms 1099, 1098, 5498, and W–2G
- ▶ Form 4419 — Application for Filing Information Returns Magnetically/ Electronically
- ▶ Form 4804 — Transmittal of Information Returns Reported Magnetically/Electronically
- ▶ Form 4802 — Transmittal of Information Returns Reported Magnetically/Electronically *(Continuation)*
- ▶ Form 8508 — Request for Waiver From Filing Information Returns on Magnetic Media (Forms W–2, W–2G, 1042–S, 1099 Series, 5498, and 8027)
- ▶ Form 8809 – Request for Extension of Time To File Information Returns (For Forms W–2, W–2G, 1042–S, 1098, 1099, and 5498)
- ▶ Notice 210 — Preparation Instructions for Media Label

Rev. Proc. 97–34

Use this revenue procedure to prepare Tax Year *1997* information returns for submission to Internal Revenue Service (IRS) using any of the following:

- — Magnetic Tape
- — Tape Cartridge
- — 8mm, *4mm, and Quarter Inch Cartridges*
- — 5 1/4-inch Diskette
- — 3 1/2-inch Diskette
- — Electronic Filing
  - — (Bisynchronous)
  - — (Asynchronous)

Caution to filers:

Format changes to accommodate Year 2000 will occur for TY98 in calendar year 1999.

Treasury has mandated that all electronic year dates exchanged with non-IRS organizations, both government and private, both input and output, shall adhere to the following:

- — All Gregorian date formats will be in the format 'YYYYMMDD'.
- — All other year date formats (e.g., Julian, Tax Period, Cycle Dates) will expand representations from 2-digit year to 4-digit year: 'YYYY'.

In compliance with Year 2000 changes, the current bisynchronous electronic filing communications package will be changed in the future.

Please read this publication carefully. Persons or businesses required to file information returns may be subject to penalties for failure to file or include correct information if they do not follow the instructions in this revenue procedure.

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match, the Financial Agent will send the FTD or FTP information to the Service for posting to the taxpayer's account(s).

.08 If the Financial Agent cannot identify the taxpayer, the ACH credit entry will be returned to the originating financial institution.

.09 Failure to provide correct, complete, and properly formatted information may cause an ACH credit entry to be returned. In the event of a return, a taxpayer may instruct the financial institution to submit a corrected ACH credit entry at the next opportunity or use ETA. The taxpayer may also initiate an ACH debit entry if enrolled for that payment option. A taxpayer that is not required to use EFT may also use the paper FTD coupon system.

.10 An ACH credit entry that is not returned or reversed will be deemed made at the time that the funds are paid into the appropriate Treasury account.

.11 The ACH Rules will govern ACH credit entry returns and reversals.

SECTION 9. ELECTRONIC TAX APPLICATION (ETA)

.01 Taxpayers may use ETA (as defined in section 3.07) to make a timely FTD or FTP. Taxpayers should contact their financial institution to determine if the financial institution is capable of making an ETA payment.

.02 After the EFTPS enrollment process is completed, the Financial Agent will send the taxpayer an EFTPS Payment Instruction Booklet that includes additional ETA information under the heading "Same Day Payments."

.03 The Service generally will deem an ETA payment to have been made on the date the payment is received by the FRB. Taxpayers should contact their financial institutions to determine their deadline for initiating ETA payments for a particular day. ETA payments received by the FRB after the deadline set forth in the Treasury Financial Manual, Volume IV (IV TFM), will be recorded as received the following business day. Currently, the deadline in IV TFM is 2:00 p.m. FRB Head Office Local Zone Time. If a payment is not accepted, the payment must be re-originated using ETA or any other permissible payment method.

SECTION 10. PROOF OF PAYMENT

.01 For an ACH debit or credit entry, a statement prepared by the taxpayer's financial institution showing a transfer (that is, a decrease to the taxpayer's account balance) will be accepted as proof of payment if the statement:

(1) shows the amount and the date of the transfer; and

(2) identifies the U.S. Government as the payee.

.02 For an ETA payment, taxpayers may request that their financial institution obtain a statement from the FRB that executed the transfer. This statement will be accepted as proof of payment if the statement:

(1) shows the amount and the date of the transfer; and

(2) identifies the U.S. Government as the payee.

.03 For purposes of this section, statements prepared by a financial institution include statements prepared by a third party that is contractually obligated to prepare statements for the financial institution.

SECTION 11. REFUNDS

No refunds of FTDs or FTPs will be made through EFTPS. However, a refund request may be made using existing tax refund procedures. If a taxpayer's error results in a significant hardship, the taxpayer may contact the Service at (800) 829-1040 for assistance.

SECTION 12. ENROLLMENT FORMS AND ADDITIONAL INFORMATION ABOUT EFTPS

.01 Taxpayers may obtain enrollment forms and additional information by calling EFTPS Customer Service at (800) 945-8400 (First Chicago) or (800) 555-4477 (NationsBank). Taxpayers may also request enrollment forms by calling the IRS Distribution Center at (800) TAX-FORM ((800) 829-3676).

.02 Financial institutions that would like additional information about EFTPS may write to:

Financial Services Division
Financial Management Service
401 14th Street, SW, 3rd Floor
Washington, DC 20227

or may call (202) 874–6580 (not a toll–free number).

SECTION 13. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94–48 is obsoleted for FTDs or FTPs made after July 15, 1997.

SECTION 14. EFFECTIVE DATE

This revenue procedure is effective on July 11,1997.

SECTION 15. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1546.

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

The collections of information in this revenue procedure are in section 10 of this revenue procedure. This information is required to implement EFTPS, and verify that taxpayers have met their obligations to pay their taxes and make FTDs by EFT. This information will be used to credit taxpayers' accounts for FTDs and FTPs made through EFTPS. The collections of information in section 10 of this revenue procedure are mandatory. The likely respondents are individuals, state or local governments, farms, business or other for–profit institutions, federal agencies or employees, nonprofit institutions, and small businesses or organizations.

In 1999, the estimated total annual reporting and recordkeeping burden will be 690,000 hours.

The estimated annual burden per respondent and recordkeeper will vary from 15 minutes to 45 minutes, depending on individual circumstances, with an estimated average of 30 minutes. The estimated number of respondents and recordkeepers is 1,380,000.

The estimated annual frequency of responses is on occasion.

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

NationsBank (800) 555-4477	*First Chicago (800) 945-8400*
Riverside, San Diego, and Imperial counties only)	Connecticut
Commonwealth of the Northern Mariana Islands	Hawaii
Commonwealth of Puerto Rico	Idaho
Delaware	Illinois
District of Columbia	Indiana
Florida	Iowa
Georgia	Kansas
Guam	Maine
Kentucky	Massachusetts
Louisiana	Michigan
Maryland	Minnesota
Mississippi	Missouri
Nevada	Montana
New Mexico	Nebraska
North Carolina	New Hampshire
Ohio	New Jersey
Oklahoma	New York
Pennsylvania	North Dakota
South Carolina	Oregon
Tennessee	Rhode Island
Texas	South Dakota
Virgin Islands	Utah
Virginia	Vermont
West Virginia	Washington
	Wisconsin
	Wyoming
	Foreign countries

SECTION 6. TIMELY INITIATION OF FTD OR FTP

.01 A taxpayer must ensure that the FTD or FTP is timely made. Publication 509, Tax Calendars, lists the due dates for FTDs and FTPs.

.02 A taxpayer choosing the ACH debit entry payment option may access the EFTPS Voice Response System 24 hours a day, seven days a week, or use the PC Tax Payment software application. However, the taxpayer must initiate its ACH debit entry payment before 8:00 p.m. Eastern Time of the last business day prior to the FTD or FTP due date.

.03 A taxpayer choosing the ACH credit entry payment option must determine whether its financial institution offers the ACH credit entry payment option and when the taxpayer must initiate an ACH credit entry that will settle on or before the FTD or FTP due date.

SECTION 7. ACH DEBIT ENTRY

.01 To initiate a timely ACH debit entry, a taxpayer must contact the Financial Agent by 8:00 p.m. Eastern time of the last business day prior to the FTD or FTP due date. A business taxpayer may arrange an ACH debit entry up to 30 calendar days in advance of the due date. An individual taxpayer may arrange an ACH debit entry up to 105 calendar days in advance of the due date.

.02 In order to initiate an ACH debit entry, a taxpayer must furnish the Financial Agent with the taxpayer's TIN and PIN. The Service does not have access to the taxpayer's PIN and, therefore, cannot initiate an ACH debit entry from the taxpayer's account.

.03 After a taxpayer initiates an ACH debit entry, the Financial Agent will validate the payment information and issue an acknowledgment number to the taxpayer. The acknowledgment number verifies when the necessary payment information was received by a Financial Agent but does not constitute proof of payment. See section 10 of this revenue procedure regarding proof of payment.

.04 Pursuant to the taxpayer's instructions, the Financial Agent, on the date designated by the taxpayer, will instruct the taxpayer's financial institution to originate the transfer of funds from the taxpayer's account to the appropriate Treasury account. The Financial Agent also will transmit the related payment data, supplied by the taxpayer, to the Service for posting to the taxpayer's account(s).

.05 The Service will deem an ACH debit entry to have been made at the time of the debit (*i.e.*, when the amount is withdrawn from the taxpayer's account and not returned or reversed).

.06 When a timely ACH debit entry cannot be made, a taxpayer may instruct the Financial Agent to complete the transaction at the next opportunity to submit an ACH debit entry. The taxpayer may also use the ACH credit entry payment option or ETA. See section 8 of this revenue procedure regarding the use of an ACH credit entry and section 9 regarding the use of ETA. A taxpayer that is not required to use EFT for FTDs may use the paper FTD coupon system. To avoid penalties, the FTD or FTP must be received by an appropriate means on or before the FTD or FTP due date.

.07 The ACH Rules will govern ACH debit entry returns and reversals.

SECTION 8. ACH CREDIT ENTRY

.01 If a taxpayer chooses the ACH credit entry payment option to make an FTD or FTP, the taxpayer may use any financial institution capable of originating an ACH credit entry.

.02 For each TIN used by a taxpayer in making an FTD or FTP by an ACH credit entry, the taxpayer should request that its financial institution originate a prenotification ACH credit. See section 3.13 of this revenue procedure. The taxpayer's financial institution should not originate an ACH credit entry until the financial institution has successfully completed the prenotification process. A prenotification ACH credit will verify the taxpayer information in the TXP addenda record, thereby minimizing the possibility that an ACH credit entry will be rejected.

.03 If the prenotification ACH credit is rejected, the financial institution should not originate an ACH credit entry for the taxpayer until the financial institution has successfully completed the prenotification process.

.04 To initiate a timely ACH credit entry, a taxpayer must take into account its financial institution's deadline for originating an ACH credit entry.

.05 If the taxpayer timely and accurately requests an ACH credit entry, the taxpayer's financial institution is responsible for the timely origination of the ACH credit entry with the appropriate Treasury account number and the correct format.

.06 When a timely ACH credit entry cannot be made, a taxpayer may instruct the financial institution to complete the transaction at the next opportunity to submit an ACH credit entry or use ETA. The taxpayer may also initiate an ACH debit entry if enrolled for that payment option. See section 7 of this revenue procedure regarding the use of an ACH debit entry and section 9 regarding the use of ETA. A taxpayer that is not required to use EFT for FTDs may use the paper FTD coupon system. To avoid penalties, the FTD or FTP must be received by an appropriate means on or before the FTD or FTP due date.

.07 The Financial Agent will receive and process the ACH credit entry information. The Financial Agent will compare the transaction's remittance detail in the CCD+ TXP addenda with the taxpayer's enrollment record data. If they

electronic funds transfer transaction and an addenda record for tax payments identified by the three characters, "TXP". The ACH TXP addenda record includes the Taxpayer Identification Number (TIN) (*i.e.*, Employer Identification Number (EIN), IRS Individual Taxpayer Identification Number (ITIN), or Social Security Number (SSN)), the tax type code, the tax period end date, and the FTD or FTP amount.

.06 ELECTRONIC FUNDS TRANSFER (EFT). An "EFT" is any transfer of funds, other than a transaction originated by check, draft, or similar paper instrument, which is initiated through an electronic terminal, telephonic instrument, computer, or magnetic tape so as to order, instruct, or authorize a financial institution or other financial intermediary to debit or credit an account.

.07 ELECTRONIC TAX APPLICATION (ETA). "ETA" (also referred to as "Same Day Payment") is a subsystem of EFTPS that receives, processes, and transmits an FTD or an FTP and the related tax payment information for taxpayers that make same day payments through Fedwire value transfers, Fedwire non–value transactions, and Direct Access transactions. See section 9 of this revenue procedure for information on the ETA process. For more information about ETA payments, taxpayers should contact their financial institutions.

.08 EMPLOYER IDENTIFICATION NUMBER (EIN). An "EIN" is a unique nine digit taxpayer identifying number issued by the Internal Revenue Service to business taxpayers for the purpose of reporting tax related information.

.09 FEDERAL RESERVE BANK (FRB). The "FRB" is the U.S. Government's fiscal agent. The FRB also processes ACH transactions to a commercial financial institution account or to a Treasury account.

.10 FRB HEAD OFFICE LOCAL ZONE TIME. "FRB Head Office Local Zone Time" is the local zone time of the FRB head office through which a financial institution, or its authorized correspondent bank, sends a same–day payment.

.11 FINANCIAL AGENT. For purposes of EFTPS, a "Financial Agent" (also referred to as a "Treasury Financial Agent") is a financial institution that is designated as an agent of Treasury. The Secretary has designated NationsBank and First National Bank of Chicago (First Chicago) to be the Financial Agents for EFTPS. A Financial Agent processes EFTPS enrollments, receives FTD and FTP information, originates ACH debit entries upon instructions from taxpayers, and provides customer service assistance for EFTPS enrollment and payment information.

.12 IRS INDIVIDUAL TAXPAYER IDENTIFICATION NUMBER (ITIN). An "ITIN" is a taxpayer identifying number issued by the Service to an alien individual who is ineligible to receive an SSN for the purpose of reporting tax related information.

.13 PRENOTIFICATION ACH CREDIT. "Prenotification ACH credit" is a process whereby a taxpayer's financial institution originates a zero dollar entry to the appropriate Treasury Routing Transit Number (RTN) to verify the Treasury RTN, the Treasury's account number, and the taxpayer's TIN. See section 8.02 of this revenue procedure.

.14 PRENOTIFICATION ACH DEBIT. "Prenotification ACH debit" is a process whereby the appropriate Financial Agent originates a zero dollar entry to the taxpayer's financial institution to verify the RTN of the taxpayer's financial institution, the taxpayer's account number, and the account type. See section 4.03 of this revenue procedure.

.15 TAXPAYER IDENTIFICATION NUMBER (TIN). A "TIN" is a taxpayer identifying number assigned to a taxpayer for the purpose of reporting tax related information. A TIN includes an EIN, ITIN, or SSN.

SECTION 4. ENROLLMENT

.01 An EFTPS applicant should submit its completed Form 9779, EFTPS Business Enrollment Form, or Form 9783, EFTPS Individual Enrollment Form, to the EFTPS Enrollment Processing Center at the address provided in the applicable form instructions at least ten weeks in advance of the first FTD or FTP due date for which it intends to use EFTPS. As part of completing the enrollment form, the taxpayer may choose to use the ACH debit entry and/or ACH credit entry payment option(s). See section 7 of this revenue procedure for information on the ACH debit entry payment option, and section 8 for information on the ACH credit entry payment option.

.02 A taxpayer may request an enrollment form by calling a Financial Agent at one of the numbers listed in section 12.01 of this revenue procedure or the IRS Distribution Center at (800) TAX–FORM ((800) 829–3676). A taxpayer should request an enrollment form at least four weeks in advance of the time the form needs to be submitted.

.03 The Financial Agent will verify the accuracy of the enrollment information and enter the verified enrollment information in its enrollment record database. As part of the verification process for those taxpayers who choose the ACH debit entry, the Financial Agent will originate a prenotification ACH debit.

.04 When the enrollment process is completed, the Financial Agent will notify the taxpayer that it is enrolled in EFTPS by sending the taxpayer a Form 9787, Business Confirmation/Update Form, or Form 9789, Individual Confirmation/Update Form and an EFTPS Payment Instruction Booklet that will contain information on ACH credit and debit transactions, and information on ETA under the heading "Same Day Payments." A Personal Identification Number (PIN) will be mailed to the taxpayer separately from the enrollment confirmation package.

.05 If a taxpayer attempts to make an FTD or FTP through EFTPS before the taxpayer receives Form 9787 or Form 9789, the FTD or FTP generally will be rejected and the taxpayer may be subject to a penalty for a late FTD or FTP. Further, a taxpayer cannot make an FTD or FTP using an ACH debit transaction without a PIN.

SECTION 5. ASSIGNMENT TO A FINANCIAL AGENT

Each Financial Agent has responsibility for certain geographic locations as listed below. A taxpayer's assignment to a Financial Agent is based on the location of the principal financial institution that will be electronically transmitting FTDs and/or FTPs for the taxpayer.

NationsBank *(800) 555-4477*	*First Chicago* *(800) 945-8400*
Alabama	Alaska
American Samoa	California (except Los Angeles, Orange, San Bernardino, Riverside, San Diego, and Imperial counties)
Arizona	
Arkansas	
California (Los Angeles, Orange, San Bernardino,	
Colorado	

26 CFR 601.602: Tax Forms and Instructions. (Also Part I, § 6302; 31.6302–1.)

Rev. Proc. 97–33

CONTENTS

SECTION 1. PURPOSE

This revenue procedure provides taxpayers with information about the Electronic Federal Tax Payment System (EFTPS). EFTPS is an electronic remittance processing system for making federal tax deposits (FTDs) and federal tax payments (FTPs). EFTPS is the successor electronic funds transfer (EFT) system to TAXLINK described in Rev. Proc. 94–48, 1994–2 C.B. 694.

SECTION 2. BACKGROUND

.01 Section 6302(c) of the Internal Revenue Code provides that the Secretary of the Treasury (Secretary) may authorize Federal Reserve banks, and incorporated banks and other financial institutions that are depositories or financial agents of the United States, to receive any tax imposed under the internal revenue laws, in such manner, at such times, and under such conditions as the Secretary may prescribe. Section 6302(c) also provides that the Secretary shall prescribe the manner, times, and conditions under which the receipt of such tax by such banks and other financial institutions is to be treated as a payment of such tax to the Secretary.

.02 Section 6302(h) requires the Secretary to establish an EFT system to collect the FTDs of certain taxpayers. TAXLINK and its successor, EFTPS, are the EFT systems developed by the Secretary to collect federal taxes. The TAXLINK system will terminate on July 15, 1997. All taxpayers making FTDs or FTPs by EFT must use EFTPS after July 15, 1997.

.03 Some taxpayers are required by regulations issued under § 6302(h) to make FTDs using an EFT system. *See* § 31.6302–1(h)(2)(i)(A) of the Employment Taxes and Collection of Income Tax at Source Regulations. Taxpayers not required to make FTDs using an EFT system may choose to do so voluntarily. Taxpayers also may choose to make FTPs using EFTPS.

.04 All taxpayers participating in EFTPS must comply with this revenue procedure.

.05 The two primary payment options in EFTPS are an Automated Clearing House (ACH) debit entry and an ACH credit entry. Taxpayers may also use the Electronic Tax Application (ETA) to accommodate their business requirements and meet their FTD and FTP obligations. These payment options are described in sections 7, 8, and 9 of this revenue procedure.

.06 Taxpayers participating in EFTPS must ensure that their funds are remitted on a timely basis. See § 31.6302–1(h)(8) for rules regarding when an FTD remitted by EFT is deemed made. In the case of FTPs remitted by EFT, see § 31.6302–1-(h)(9) for rules regarding when the tax is deemed paid.

.07 A taxpayer required by regulations to make an FTD by EFT may not use Form 8109, Federal Tax Deposit Coupon, to make an FTD. If the taxpayer is unable to make a timely FTD using an ACH debit entry or an ACH credit entry, the taxpayer may use ETA to make a timely FTD. If a taxpayer is a voluntary participant in EFTPS (*i.e.*, a participant not required by regulations to make an FTD by EFT) and is unable, for any reason, to make an FTD using EFTPS or chooses not to use EFTPS to make an FTD, the taxpayer may make a timely FTD by using Form 8109.

.08 If an FTD is late, the taxpayer is subject to the penalty for failure to timely deposit unless the taxpayer establishes reasonable cause for that failure. See Rev. Rul. 94–46, 1994–2 C.B. 278.

.09 EFTPS does not change the computation of tax liability, interest or penalties, or FTD or FTP due dates.

SECTION 3. DEFINITIONS

.01The definitions provided in this section will be used for EFTPS.

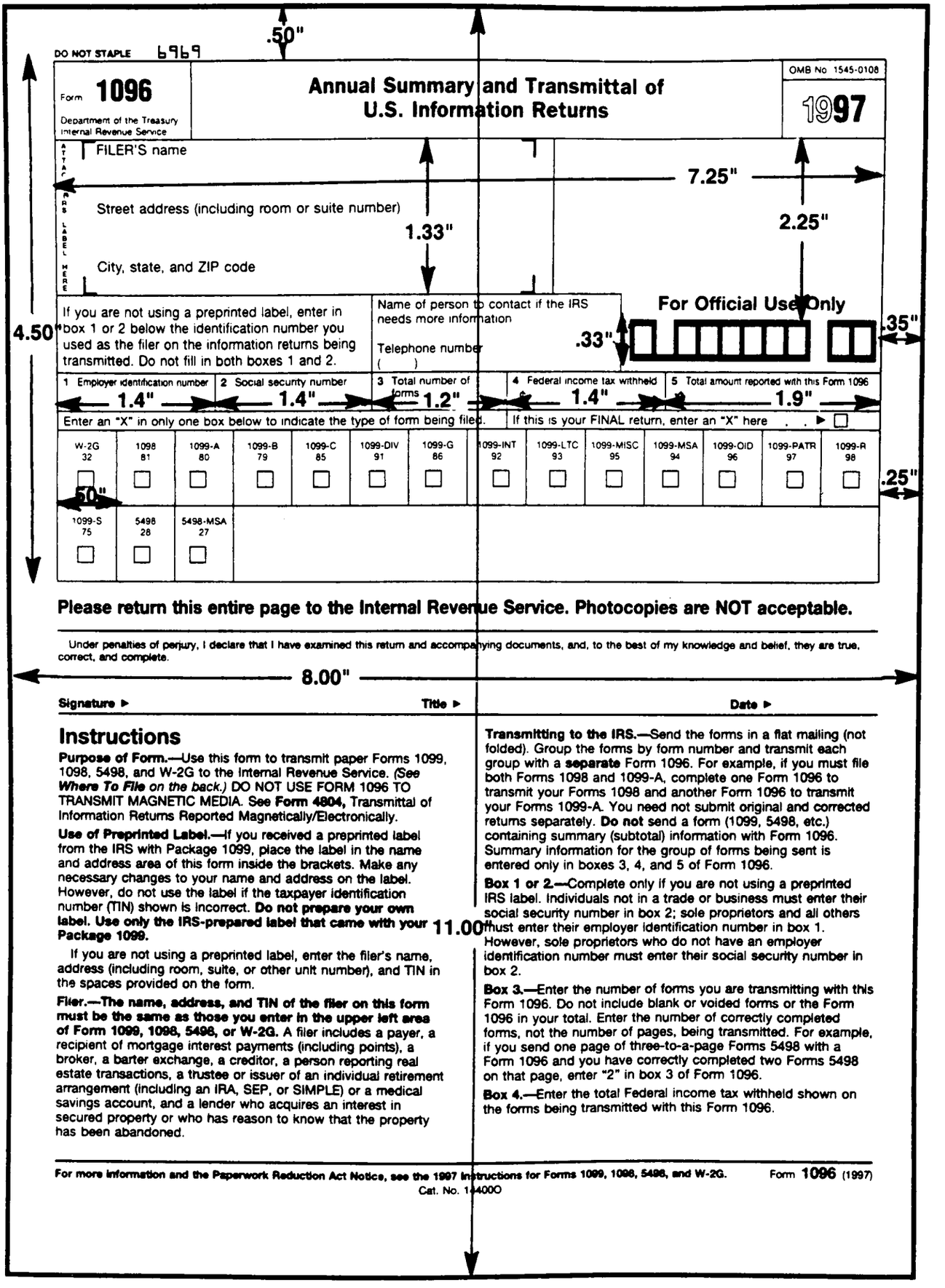
.02 AUTOMATED CLEARING HOUSE (ACH). "Automated Clearing House" is a funds transfer system, governed by the ACH Rules (the Operating Rules and the Operating Guidelines published by National Automated Clearing House Association (NACHA)), that provides for the interbank clearing of electronic entries for participating financial institutions.

.03 ACH CREDIT ENTRY. An "ACH credit entry" is a transaction in which a financial institution, upon instructions from a taxpayer, originates an FTD or FTP to the appropriate Department of the Treasury (Treasury) account through the ACH system. See section 8 of this revenue procedure for a description of an ACH credit entry.

.04 ACH DEBIT ENTRY. An "ACH debit entry" is a transaction in which one of the Treasury Financial Agents, upon instructions from a taxpayer, instructs the taxpayer's financial institution to withdraw funds from the taxpayer's account for an FTD or FTP and to route the FTD or FTP to the appropriate Treasury account through the ACH system. See section 7 of this revenue procedure for a description of an ACH debit entry.

.05 CASH CONCENTRATION OR DISBURSEMENT+ TAX PAYMENT ADDENDA RECORD (CCD+ TXP). The "CCD+ TXP" is NACHA's tax payment convention that will be used to facilitate the transmission of the tax payment information associated with an ACH credit entry to the appropriate Financial Agent. This convention consists of the CCD+

Exhibit R



DO NOT STAPLE 6969

Form **1096**
Department of the Treasury
Internal Revenue Service

Annual Summary and Transmittal of U.S. Information Returns

OMB No 1545-0108
1997

ATTACH ARS LABEL HERE
FILER'S name
Street address (including room or suite number)
City, state, and ZIP code

If you are not using a preprinted label, enter in box 1 or 2 below the identification number you used as the filer on the information returns being transmitted. Do not fill in both boxes 1 and 2.

Name of person to contact if the IRS needs more information
Telephone number
( )

For Official Use Only

1 Employer identification number	2 Social security number	3 Total number of forms	4 Federal income tax withheld	5 Total amount reported with this Form 1096
			$	

Enter an "X" in only one box below to indicate the type of form being filed.

If this is your FINAL return, enter an "X" here . . ▶ ☐

W-2G 32	1098 81	1099-A 80	1099-B 79	1099-C 85	1099-DIV 91	1099-G 86	1099-INT 92	1099-LTC 93	1099-MISC 95	1099-MSA 94	1099-OID 96	1099-PATR 97	1099-R 98
☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐	☐

1099-S 75	5498 28	5498-MSA 27
☐	☐	☐

Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable.

Under penalties of perjury, I declare that I have examined this return and accompanying documents, and, to the best of my knowledge and belief, they are true, correct, and complete.

Signature ▶ **Title ▶** **Date ▶**

Instructions

Purpose of Form.—Use this form to transmit paper Forms 1099, 1098, 5498, and W-2G to the Internal Revenue Service. *(See **Where To File** on the back.)* DO NOT USE FORM 1096 TO TRANSMIT MAGNETIC MEDIA. See **Form 4804,** Transmittal of Information Returns Reported Magnetically/Electronically.

Use of Preprinted Label.—If you received a preprinted label from the IRS with Package 1099, place the label in the name and address area of this form inside the brackets. Make any necessary changes to your name and address on the label. However, do not use the label if the taxpayer identification number (TIN) shown is incorrect. **Do not prepare your own label. Use only the IRS-prepared label that came with your Package 1099.**

If you are not using a preprinted label, enter the filer's name, address (including room, suite, or other unit number), and TIN in the spaces provided on the form.

Filer.—The name, address, and TIN of the filer on this form must be the same as those you enter in the upper left area of Form 1099, 1098, 5498, or W-2G. A filer includes a payer, a recipient of mortgage interest payments (including points), a broker, a barter exchange, a creditor, a person reporting real estate transactions, a trustee or issuer of an individual retirement arrangement (including an IRA, SEP, or SIMPLE) or a medical savings account, and a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned.

Transmitting to the IRS.—Send the forms in a flat mailing (not folded). Group the forms by form number and transmit each group with a **separate** Form 1096. For example, if you must file both Forms 1098 and 1099-A, complete one Form 1096 to transmit your Forms 1098 and another Form 1096 to transmit your Forms 1099-A. You need not submit original and corrected returns separately. **Do not** send a form (1099, 5498, etc.) containing summary (subtotal) information with Form 1096. Summary information for the group of forms being sent is entered only in boxes 3, 4, and 5 of Form 1096.

Box 1 or 2.—Complete only if you are not using a preprinted IRS label. Individuals not in a trade or business must enter their social security number in box 2; sole proprietors and all others must enter their employer identification number in box 1. However, sole proprietors who do not have an employer identification number must enter their social security number in box 2.

Box 3.—Enter the number of forms you are transmitting with this Form 1096. Do not include blank or voided forms or the Form 1096 in your total. Enter the number of correctly completed forms, not the number of pages, being transmitted. For example, if you send one page of three-to-a-page Forms 5498 with a Form 1096 and you have correctly completed two Forms 5498 on that page, enter "2" in box 3 of Form 1096.

Box 4.—Enter the total Federal income tax withheld shown on the forms being transmitted with this Form 1096.

For more information and the Paperwork Reduction Act Notice, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G. Form **1096** (1997)
Cat. No. 14400O

Exhibit Q

0527 ☐ VOID ☐ CORRECTED

TRUSTEE'S name, street address, city, state, and ZIP code	1 Employee MSA contributions made in 1997 and 1998 for 1997 ←1.4"→	OMB No. 1545-1518	Medical Savings Account Information
	2 Total MSA contributions made in 1997 $	1997 Form 5498-MSA	

TRUSTEE'S Federal identification number	PARTICIPANT'S social security number	3 Total MSA contributions made in 1998 for 1997 $	Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name ←3.40"→		4 MSA rollover contributions (not included in boxes 1, 2, or 3) $	5 Fair market value of account $
Street address (including apt. no.)			For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code			
Account number (optional)			

Form 5498-MSA Cat. No. 23097L Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

0527 ☐ VOID ☐ CORRECTED

TRUSTEE'S name, street address, city, state, and ZIP code	1 Employee MSA contributions made in 1997 and 1998 for 1997 $	OMB No. 1545-1518	Medical Savings Account Information
	2 Total MSA contributions made in 1997 $	1997 Form 5498-MSA	

TRUSTEE'S Federal identification number	PARTICIPANT'S social security number	3 Total MSA contributions made in 1998 for 1997 $	Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name		4 MSA rollover contributions (not included in boxes 1, 2, or 3) $	5 Fair market value of account $
Street address (including apt. no.)			For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code			
Account number (optional)			

Form 5498-MSA Cat. No. 23097L Department of the Treasury - Internal Revenue Service

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0527 ☐ VOID ☐ CORRECTED

TRUSTEE'S name, street address, city, state, and ZIP code	1 Employee MSA contributions made in 1997 and 1998 for 1997 $	OMB No. 1545-1518	Medical Savings Account Information
	2 Total MSA contributions made in 1997 $	1997 Form 5498-MSA	

TRUSTEE'S Federal identification number	PARTICIPANT'S social security number	3 Total MSA contributions made in 1998 for 1997 $	Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name		4 MSA rollover contributions (not included in boxes 1, 2, or 3) $	5 Fair market value of account $
Street address (including apt. no.)			For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
City, state, and ZIP code			
Account number (optional)			

Form 5498-MSA Cat. No. 23097L Department of the Treasury - Internal Revenue Service

Exhibit P

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Regular IRA contributions made in 1997 and 1998 for 1997 $ (1.4")	OMB No. 1545-0747 1997 Form 5498	IRA, SEP, or SIMPLE Retirement Plan Information
	2 IRA, SEP, or SIMPLE rollover contributions $		
TRUSTEE'S or ISSUER'S Federal identification no. / PARTICIPANT'S social security number	3 Life insurance cost included in box 1 $		Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name	4 Fair market value of account $		For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	5 Check for IRA ☐ SEP ☐ SIMPLE ☐		
City, state, and ZIP code	6 SEP contributions $ (1.4")	7 SIMPLE contributions $ (1.4")	
Account number (optional)			

Form **5498** Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Regular IRA contributions made in 1997 and 1998 for 1997 $	OMB No. 1545-0747 1997 Form 5498	IRA, SEP, or SIMPLE Retirement Plan Information
	2 IRA, SEP, or SIMPLE rollover contributions $		
TRUSTEE'S or ISSUER'S Federal identification no. / PARTICIPANT'S social security number	3 Life insurance cost included in box 1 $		Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name	4 Fair market value of account $		For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	5 Check for IRA ☐ SEP ☐ SIMPLE ☐		
City, state, and ZIP code	6 SEP contributions $	7 SIMPLE contributions $	
Account number (optional)			

Form **5498** Cat. No. 50010C Department of the Treasury - Internal Revenue Service

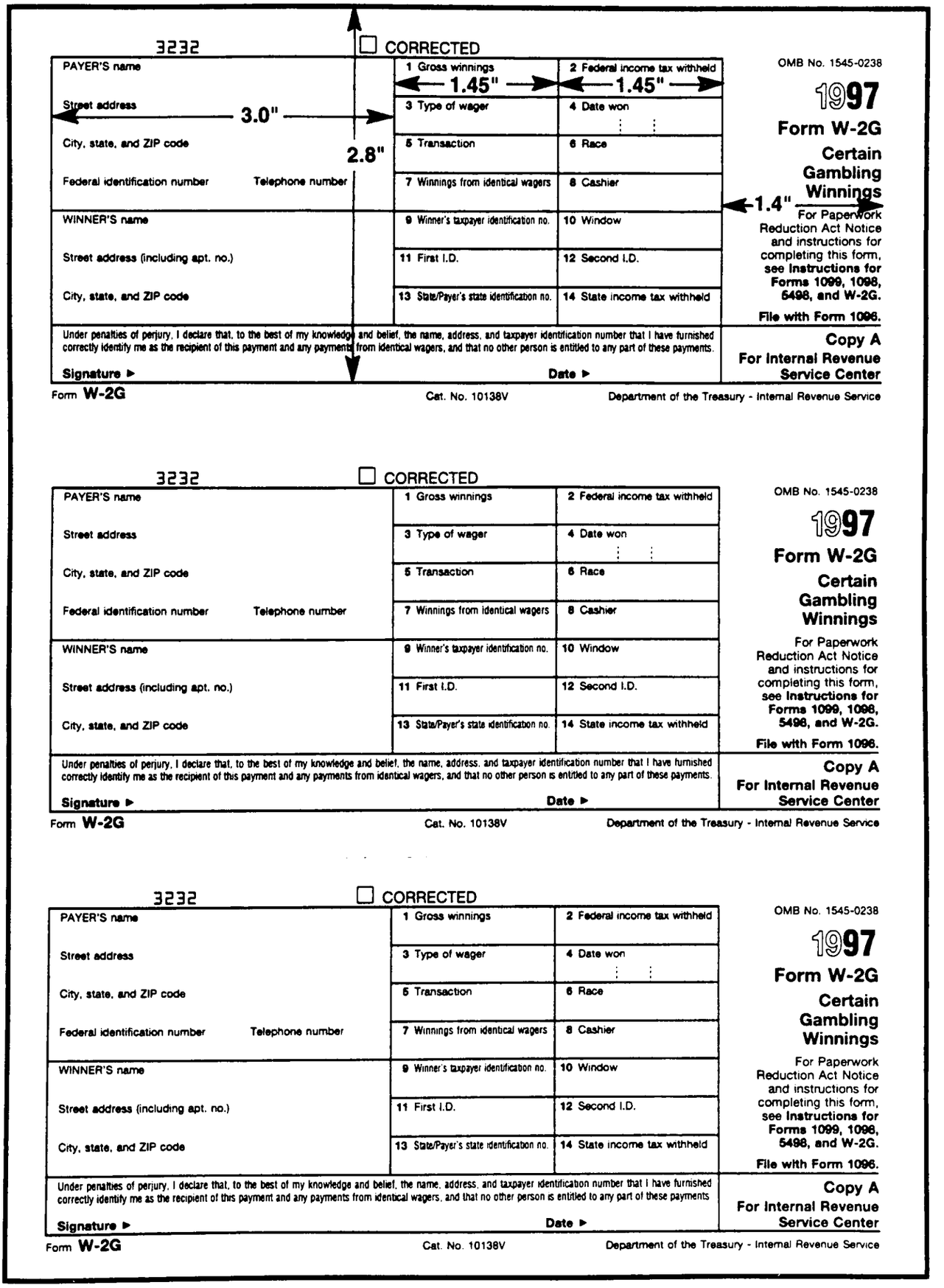
Do NOT Cut or Separate Forms on This Page

2828 ☐ VOID ☐ CORRECTED

TRUSTEE'S or ISSUER'S name, street address, city, state, and ZIP code	1 Regular IRA contributions made in 1997 and 1998 for 1997 $	OMB No. 1545-0747 1997 Form 5498	IRA, SEP, or SIMPLE Retirement Plan Information
	2 IRA, SEP, or SIMPLE rollover contributions $		
TRUSTEE'S or ISSUER'S Federal identification no. / PARTICIPANT'S social security number	3 Life insurance cost included in box 1 $		Copy A For Internal Revenue Service Center File with Form 1096.
PARTICIPANT'S name	4 Fair market value of account $		For Paperwork Reduction Act Notice and instructions for completing this form, see the 1997 Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	5 Check for IRA ☐ SEP ☐ SIMPLE ☐		
City, state, and ZIP code	6 SEP contributions $	7 SIMPLE contributions $	
Account number (optional)			

Form **5498** Cat. No. 50010C Department of the Treasury - Internal Revenue Service

Exhibit O



3232
CORRECTED
PAYER'S name
Street address
City, state, and ZIP code
Federal identification number
Telephone number
1 Gross winnings
2 Federal income tax withheld
3 Type of wager
4 Date won
5 Transaction
6 Race
7 Winnings from identical wagers
8 Cashier
WINNER'S name
Street address (including apt. no.)
City, state, and ZIP code
9 Winner's taxpayer identification no.
10 Window
11 First I.D.
12 Second I.D.
13 State/Payer's state identification no.
14 State income tax withheld
Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.
Signature ▶
Date ▶
Form W-2G
Cat. No. 10138V
Department of the Treasury - Internal Revenue Service
OMB No. 1545-0238
1997
Form W-2G
Certain Gambling Winnings
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
File with Form 1096.
Copy A
For Internal Revenue Service Center

3232
CORRECTED
PAYER'S name
Street address
City, state, and ZIP code
Federal identification number
Telephone number
1 Gross winnings
2 Federal income tax withheld
3 Type of wager
4 Date won
5 Transaction
6 Race
7 Winnings from identical wagers
8 Cashier
WINNER'S name
Street address (including apt. no.)
City, state, and ZIP code
9 Winner's taxpayer identification no.
10 Window
11 First I.D.
12 Second I.D.
13 State/Payer's state identification no.
14 State income tax withheld
Under penalties of perjury, I declare that, to the best of my knowledge and belief, the name, address, and taxpayer identification number that I have furnished correctly identify me as the recipient of this payment and any payments from identical wagers, and that no other person is entitled to any part of these payments.
Signature ▶
Date ▶
Form W-2G
Cat. No. 10138V
Department of the Treasury - Internal Revenue Service
OMB No. 1545-0238
1997
Form W-2G
Certain Gambling Winnings
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
File with Form 1096.
Copy A
For Internal Revenue Service Center

Exhibit N

7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone no.	1 Date of closing (MMDDYY)	OMB No. 1545-0997	
	← 1.4" →	1997	**Proceeds From Real Estate Transactions**
	2 Gross proceeds $	Form 1099-S	

FILER'S Federal identification number ←1.7"→	TRANSFEROR'S identification number ←1.7"→	3 Address or legal description (including city, state, and ZIP code) ←2.8"→	**Copy A For Internal Revenue Service Center** File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1096, 5498, and W-2G. ←1.15"→
TRANSFEROR'S name			
Street address (including apt. no.)			
City, state, and ZIP code		4 Check here if the transferor received or will receive property or services as part of the consideration. ▶ ☐	
Account number (optional)		5 Buyer's part of real estate tax $	

Form 1099-S Cat. No. 64292E Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone no.	1 Date of closing (MMDDYY)	OMB No. 1545-0997	
		1997	**Proceeds From Real Estate Transactions**
	2 Gross proceeds $	Form 1099-S	

FILER'S Federal identification number	TRANSFEROR'S identification number	3 Address or legal description (including city, state, and ZIP code)	**Copy A For Internal Revenue Service Center** File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1096, 5498, and W-2G.
TRANSFEROR'S name			
Street address (including apt. no.)			
City, state, and ZIP code		4 Check here if the transferor received or will receive property or services as part of the consideration. ▶ ☐	
Account number (optional)		5 Buyer's part of real estate tax $	

Form 1099-S Cat. No. 64292E Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7575 ☐ VOID ☐ CORRECTED

FILER'S name, street address, city, state, ZIP code, and telephone no.	1 Date of closing (MMDDYY)	OMB No. 1545-0997	
		1997	**Proceeds From Real Estate Transactions**
	2 Gross proceeds $	Form 1099-S	

FILER'S Federal identification number	TRANSFEROR'S identification number	3 Address or legal description (including city, state, and ZIP code)	**Copy A For Internal Revenue Service Center** File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1096, 5498, and W-2G.
TRANSFEROR'S name			
Street address (including apt. no.)			
City, state, and ZIP code		4 Check here if the transferor received or will receive property or services as part of the consideration. ▶ ☐	
Account number (optional)		5 Buyer's part of real estate tax $	

Form 1099-S Cat. No. 64292E Department of the Treasury - Internal Revenue Service

Exhibit M

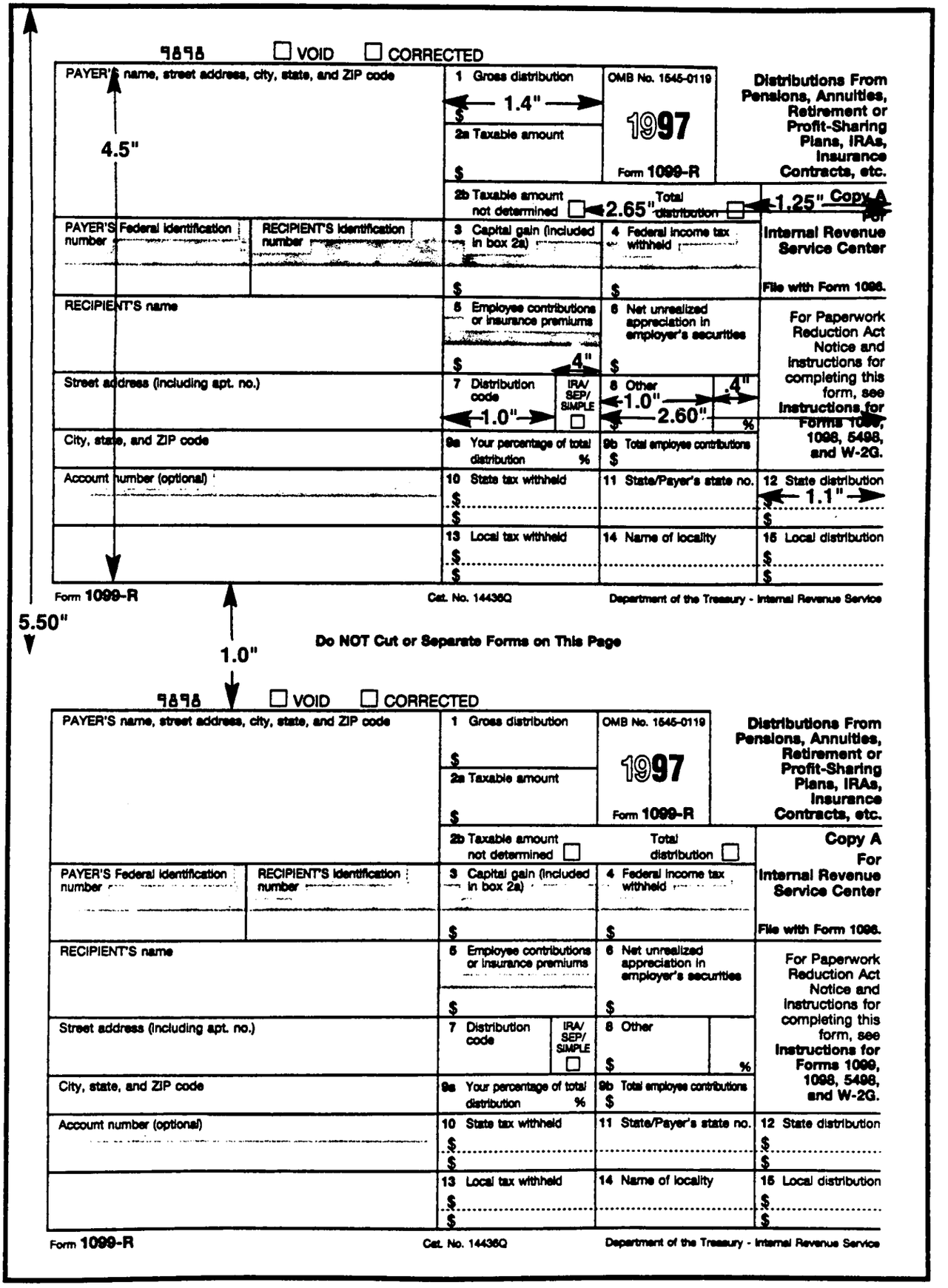

9898
VOID
CORRECTED
PAYER's name, street address, city, state, and ZIP code
1 Gross distribution
$
1.4"
OMB No. 1545-0119
1997
Form 1099-R
Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
4.5"
2a Taxable amount
$
2b Taxable amount not determined
Total distribution
2.65"
1.25"
Copy A For Internal Revenue Service Center
PAYER'S Federal identification number
RECIPIENT'S identification number
3 Capital gain (included in box 2a)
4 Federal income tax withheld
$
$
File with Form 1096.
RECIPIENT'S name
5 Employee contributions or insurance premiums
6 Net unrealized appreciation in employer's securities
$
.4"
$
For Paperwork Reduction Act Notice and Instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)
7 Distribution code
IRA/ SEP/ SIMPLE
1.0"
8 Other
1.0"
.4"
2.60"
%
City, state, and ZIP code
9a Your percentage of total distribution
%
9b Total employee contributions
$
Account number (optional)
10 State tax withheld
$
$
11 State/Payer's state no.
12 State distribution
1.1"
$
$
13 Local tax withheld
$
$
14 Name of locality
15 Local distribution
$
$
Form 1099-R
Cat. No. 14436Q
Department of the Treasury - Internal Revenue Service
5.50"
1.0"
Do NOT Cut or Separate Forms on This Page
9898
VOID
CORRECTED
PAYER'S name, street address, city, state, and ZIP code
1 Gross distribution
$
OMB No. 1545-0119
1997
Form 1099-R
Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
2a Taxable amount
$
2b Taxable amount not determined
Total distribution
Copy A For Internal Revenue Service Center
PAYER'S Federal identification number
RECIPIENT'S identification number
3 Capital gain (included in box 2a)
4 Federal income tax withheld
$
$
File with Form 1096.
RECIPIENT'S name
5 Employee contributions or insurance premiums
6 Net unrealized appreciation in employer's securities
$
$
For Paperwork Reduction Act Notice and Instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)
7 Distribution code
IRA/ SEP/ SIMPLE
8 Other
$
%
City, state, and ZIP code
9a Your percentage of total distribution
%
9b Total employee contributions
$
Account number (optional)
10 State tax withheld
$
$
11 State/Payer's state no.
12 State distribution
$
$
13 Local tax withheld
$
$
14 Name of locality
15 Local distribution
$
$
Form 1099-R
Cat. No. 14436Q
Department of the Treasury - Internal Revenue Service

Exhibit L

9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Patronage dividends $ ←1.4"→	OMB No 1545-0118	**Taxable Distributions Received From Cooperatives**
	2 Nonpatronage distributions $	1997	
	3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		**Copy A For Internal Revenue Service Center File with Form 1096.**
RECIPIENT'S name	5 Redemption of nonqualified notices and retain allocations $		For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	6 $	7 Investment credit $	
City, state, and ZIP code	8 Work opportunity credit $	9 Patron's AMT adjustment $	
Account number (optional) ←2.8"→	2nd TIN Not. ☐	←4.1"→	

Form **1099-PATR** Cat. No. 14435F Department of the Treasury - Internal Revenue Service

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9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Patronage dividends $	OMB No. 1545-0118	**Taxable Distributions Received From Cooperatives**
	2 Nonpatronage distributions $	1997	
	3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		**Copy A For Internal Revenue Service Center File with Form 1096.**
RECIPIENT'S name	5 Redemption of nonqualified notices and retain allocations $		For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	6 $	7 Investment credit $	
City, state, and ZIP code	8 Work opportunity credit $	9 Patron's AMT adjustment $	
Account number (optional)	2nd TIN Not. ☐		

Form **1099-PATR** Cat. No. 14435F Department of the Treasury - Internal Revenue Service

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9797 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Patronage dividends $	OMB No. 1545-0118	**Taxable Distributions Received From Cooperatives**
	2 Nonpatronage distributions $	1997	
	3 Per-unit retain allocations $	Form 1099-PATR	
PAYER'S Federal identification number / RECIPIENT'S identification number	4 Federal income tax withheld $		**Copy A For Internal Revenue Service Center File with Form 1096.**
RECIPIENT'S name	5 Redemption of nonqualified notices and retain allocations $		For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	6 $	7 Investment credit $	
City, state, and ZIP code	8 Work opportunity credit $	9 Patron's AMT adjustment $	
Account number (optional)	2nd TIN Not. ☐		

Form **1099-PATR** Cat. No. 14435F Department of the Treasury - Internal Revenue Service

Exhibit K

9696 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Original issue discount for 1997 $ ←1.4"→	OMB No. 1545-0117	Original Issue Discount
	2 Other periodic interest $	1997 Form 1099-OID	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name	5 Description		
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional) ←2.8"→ / 2nd TIN Not. ☐	←4.1"→		

Form **1099-OID** Cat. No. 14421R Department of the Treasury - Internal Revenue Service

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9696 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Original issue discount for 1997 $	OMB No. 1545-0117	Original Issue Discount
	2 Other periodic interest $	1997 Form 1099-OID	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name	5 Description		
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional) / 2nd TIN Not. ☐			

Form **1099-OID** Cat. No. 14421R Department of the Treasury - Internal Revenue Service

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9696 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Original issue discount for 1997 $	OMB No. 1545-0117	Original Issue Discount
	2 Other periodic interest $	1997 Form 1099-OID	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Early withdrawal penalty $	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name	5 Description		
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional) / 2nd TIN Not. ☐			

Form **1099-OID** Cat. No. 14421R Department of the Treasury - Internal Revenue Service

Exhibit J

0594 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		OMB No. 1545-1517 **1997** Form **1099-MSA**	**Distributions From Medical Savings Accounts**
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $ 1.40"	2 Earnings on excess contributions $ 1.40"
RECIPIENT'S name 3.40"		3 Distribution code	
Street address (including apt. no.)		3.85"	
City, state, and ZIP code			
Account number (optional)			

Copy A For Internal Revenue Service Center
File with Form 1096.
For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1096, 5498, and W-2G.**

Form **1099-MSA** Cat. No. 23114L Department of the Treasury - Internal Revenue Service

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0594 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		OMB No. 1545-1517 **1997** Form **1099-MSA**	**Distributions From Medical Savings Accounts**
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $	2 Earnings on excess contributions $
RECIPIENT'S name		3 Distribution code	
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional)			

Copy A For Internal Revenue Service Center
File with Form 1096.
For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1096, 5498, and W-2G.**

Form **1099-MSA** Cat. No. 23114L Department of the Treasury - Internal Revenue Service

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0594 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code		OMB No. 1545-1517 **1997** Form **1099-MSA**	**Distributions From Medical Savings Accounts**
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Gross distribution $	2 Earnings on excess contributions $
RECIPIENT'S name		3 Distribution code	
Street address (including apt. no.)			
City, state, and ZIP code			
Account number (optional)			

Copy A For Internal Revenue Service Center
File with Form 1096.
For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1096, 5498, and W-2G.**

Form **1099-MSA** Cat. No. 23114L Department of the Treasury - Internal Revenue Service

Exhibit I

9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Rents $	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1997	
	3 Other income $	Form 1099-MISC	

PAYER'S Federal identification number	RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name		6 Medical and health care payments $	7 Nonemployee compensation $	
		8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐	
Street address (including apt. no.)				
City, state, and ZIP code		10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional)	2nd TIN Not. ☐	12 State/Payer's state number	13 $	

1.4" 1.15" 2.8" 4.1" .60"

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

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9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Rents $	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1997	
	3 Other income $	Form 1099-MISC	

PAYER'S Federal identification number	RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name		6 Medical and health care payments $	7 Nonemployee compensation $	
		8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐	
Street address (including apt. no.)				
City, state, and ZIP code		10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional)	2nd TIN Not. ☐	12 State/Payer's state number	13 $	

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

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9595 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Rents $	OMB No. 1545-0115	Miscellaneous Income
	2 Royalties $	1997	
	3 Other income $	Form 1099-MISC	

PAYER'S Federal identification number	RECIPIENT'S identification number	4 Federal income tax withheld $	5 Fishing boat proceeds $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name		6 Medical and health care payments $	7 Nonemployee compensation $	
		8 Substitute payments in lieu of dividends or interest $	9 Payer made direct sales of $5,000 or more of consumer products to a buyer (recipient) for resale ▶ ☐	
Street address (including apt. no.)				
City, state, and ZIP code		10 Crop insurance proceeds $	11 State income tax withheld $	
Account number (optional)	2nd TIN Not. ☐	12 State/Payer's state number	13 $	

Form 1099-MISC Cat. No. 14425J Department of the Treasury - Internal Revenue Service

Exhibit H

0593 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Gross long-term care benefits paid $ 2 Accelerated death benefits paid $	OMB No. 1545-1519 1997 Form 1099-LTC	**Long-Term Care and Accelerated Death Benefits**
PAYER'S Federal identification number / POLICYHOLDER'S identification number	3 Check one: ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no. 1.40"	**Copy A For Internal Revenue Service Center** **File with Form 1096.**
POLICYHOLDER'S name 3.40"	INSURED'S name		For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	Street address (including apt. no.) 2.80"		
City, state, and ZIP code	City, state, and ZIP code		
Account number (optional)	4 (optional) ☐ Chronically ill ☐ Terminally ill	Date certified 1.0"	

Form **1099-LTC** Cat. No. 23021Z Department of the Treasury - Internal Revenue Service

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0593 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Gross long-term care benefits paid $ 2 Accelerated death benefits paid $	OMB No. 1545-1519 1997 Form 1099-LTC	**Long-Term Care and Accelerated Death Benefits**
PAYER'S Federal identification number / POLICYHOLDER'S identification number	3 Check one: ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no.	**Copy A For Internal Revenue Service Center** **File with Form 1096.**
POLICYHOLDER'S name	INSURED'S name		For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	Street address (including apt. no.)		
City, state, and ZIP code	City, state, and ZIP code		
Account number (optional)	4 (optional) ☐ Chronically ill ☐ Terminally ill	Date certified	

Form **1099-LTC** Cat. No. 23021Z Department of the Treasury - Internal Revenue Service

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0593 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code	1 Gross long-term care benefits paid $ 2 Accelerated death benefits paid $	OMB No. 1545-1519 1997 Form 1099-LTC	**Long-Term Care and Accelerated Death Benefits**
PAYER'S Federal identification number / POLICYHOLDER'S identification number	3 Check one: ☐ Per diem ☐ Reimbursed amount	INSURED'S social security no.	**Copy A For Internal Revenue Service Center** **File with Form 1096.**
POLICYHOLDER'S name	INSURED'S name		For Paperwork Reduction Act Notice and instructions for completing this form, see the **1997 Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	Street address (including apt. no.)		
City, state, and ZIP code	City, state, and ZIP code		
Account number (optional)	4 (optional) ☐ Chronically ill ☐ Terminally ill	Date certified	

Form **1099-LTC** Cat. No. 23021Z Department of the Treasury - Internal Revenue Service

Exhibit G

9292 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	Payer's RTN (optional)	OMB No. 1545-0112 **1997** Form **1099-INT**	**Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $		**Copy A For Internal Revenue Service Center File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name	2 Early withdrawal penalty $ (1.4")	3 Interest on U.S. Savings Bonds and Treas. obligations $	
Street address (including apt. no.)	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid $	6 Foreign country or U.S. possession (4.1")	
Account number (optional) (2.8")	2nd TIN Not. ☐ (.60")		

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

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9292 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	Payer's RTN (optional)	OMB No. 1545-0112 **1997** Form **1099-INT**	**Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $		**Copy A For Internal Revenue Service Center File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name	2 Early withdrawal penalty $	3 Interest on U.S. Savings Bonds and Treas. obligations $	
Street address (including apt. no.)	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid	6 Foreign country or U.S. possession	
Account number (optional)	2nd TIN Not. ☐ $		

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

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9292 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	Payer's RTN (optional)	OMB No. 1545-0112 **1997** Form **1099-INT**	**Interest Income**
PAYER'S Federal identification number / RECIPIENT'S identification number	1 Interest income not included in box 3 $		**Copy A For Internal Revenue Service Center File with Form 1096.** For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
RECIPIENT'S name	2 Early withdrawal penalty $	3 Interest on U.S. Savings Bonds and Treas. obligations $	
Street address (including apt. no.)	4 Federal income tax withheld $		
City, state, and ZIP code	5 Foreign tax paid	6 Foreign country or U.S. possession	
Account number (optional)	2nd TIN Not. ☐ $		

Form **1099-INT** Cat. No. 14410K Department of the Treasury - Internal Revenue Service

Exhibit F

8686 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Unemployment compensation $ ← 1.4" →	OMB No. 1545-0120 1997 Form 1099-G	Certain Government Payments
	2 State or local income tax refunds, credits, or offsets $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5	6 Taxable grants $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Agriculture payments $	8 The amount in box 2 applies to income from a trade or business ▶ ☐ ← 1.15" →	
City, state, and ZIP code			
Account number (optional)			

Form 1099-G Cat. No. 14438M Department of the Treasury - Internal Revenue Service

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8686 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Unemployment compensation $	OMB No. 1545-0120 1997 Form 1099-G	Certain Government Payments
	2 State or local income tax refunds, credits, or offsets $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5	6 Taxable grants $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Agriculture payments $	8 The amount in box 2 applies to income from a trade or business ▶ ☐	
City, state, and ZIP code			
Account number (optional)			

Form 1099-G Cat. No. 14438M Department of the Treasury - Internal Revenue Service

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8686 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1 Unemployment compensation $	OMB No. 1545-0120 1997 Form 1099-G	Certain Government Payments
	2 State or local income tax refunds, credits, or offsets $		
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Box 2 amount is for tax year	4 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096.
RECIPIENT'S name	5	6 Taxable grants $	For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Street address (including apt. no.)	7 Agriculture payments $	8 The amount in box 2 applies to income from a trade or business ▶ ☐	
City, state, and ZIP code			
Account number (optional)			

Form 1099-G Cat. No. 14438M Department of the Treasury - Internal Revenue Service

Exhibit E

9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 1997 Form 1099-DIV	Dividends and Distributions
		1b Ordinary dividends $ ← 1.4" →		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $	
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession	
City, state, and ZIP code		Liquidation Distributions		
Account number (optional) ← 2.8" →	2nd TIN Not. ☐ .60"	5 Cash $	6 Noncash (Fair market value) $ ← 4.1" →	

Form 1099-DIV Cat. No. 14415N Department of the Treasury - Internal Revenue Service

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9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 1997 Form 1099-DIV	Dividends and Distributions
		1b Ordinary dividends $		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $	
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession	
City, state, and ZIP code		Liquidation Distributions		
Account number (optional)	2nd TIN Not. ☐	5 Cash $	6 Noncash (Fair market value) $	

Form 1099-DIV Cat. No. 14415N Department of the Treasury - Internal Revenue Service

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9191 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) $	OMB No. 1545-0110 1997 Form 1099-DIV	Dividends and Distributions
		1b Ordinary dividends $		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions $	2 Federal income tax withheld $	Copy A For Internal Revenue Service Center File with Form 1096. For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
RECIPIENT'S name		1d Nontaxable distributions $	3 Foreign tax paid $	
Street address (including apt. no.)		1e Investment expenses $	4 Foreign country or U.S. possession	
City, state, and ZIP code		Liquidation Distributions		
Account number (optional)	2nd TIN Not. ☐	5 Cash $	6 Noncash (Fair market value) $	

Form 1099-DIV Cat. No. 14415N Department of the Treasury - Internal Revenue Service

Exhibit D

8585 ☐ VOID ☐ CORRECTED

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424 1997 Form 1099-C	Cancellation of Debt
CREDITOR'S Federal identification number	DEBTOR'S identification number	1 Date canceled ← 1.40" →	2 Amount of debt canceled $ ← 1.40" →
DEBTOR'S name ← 3.40" →		3 Interest if included in box 2 $	4
Street address (including apt. no.)		5 Debt description	
City, state, and ZIP code			
Account number (optional)		6 Check for bankruptcy ☐	7 Fair market value of property $

Copy A For Internal Revenue Service Center File with Form 1096.

For Paperwork Reduction Act ←1.40" Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-C** Cat. No. 26280W Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

8585 ☐ VOID ☐ CORRECTED

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424 1997 Form 1099-C	Cancellation of Debt
CREDITOR'S Federal identification number	DEBTOR'S identification number	1 Date canceled	2 Amount of debt canceled $
DEBTOR'S name		3 Interest if included in box 2 $	4
Street address (including apt. no.)		5 Debt description	
City, state, and ZIP code			
Account number (optional)		6 Check for bankruptcy ☐	7 Fair market value of property $

Copy A For Internal Revenue Service Center File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-C** Cat. No. 26280W Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

8585 ☐ VOID ☐ CORRECTED

CREDITOR'S name, street address, city, state, and ZIP code		OMB No. 1545-1424 1997 Form 1099-C	Cancellation of Debt
CREDITOR'S Federal identification number	DEBTOR'S identification number	1 Date canceled	2 Amount of debt canceled $
DEBTOR'S name		3 Interest if included in box 2 $	4
Street address (including apt. no.)		5 Debt description	
City, state, and ZIP code			
Account number (optional)		6 Check for bankruptcy ☐	7 Fair market value of property $

Copy A For Internal Revenue Service Center File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-C** Cat. No. 26280W Department of the Treasury - Internal Revenue Service

Exhibit C

7979 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1a Date of sale (MMDDYY)	OMB No. 1545-0715	**Proceeds From Broker and Barter Exchange Transactions**
	1b CUSIP No.	1997 Form 1099-B	
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums — 1.9"	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Bartering $	4 Federal income tax withheld $ — 3.9"	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name	5 Description		**File with Form 1096.**
	Regulated Futures Contracts		For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	6 Profit or (loss) realized in 1997 $ — 1.4"	7 Unrealized profit or (loss) on open contracts—12/31/96 $ — 1.4"	
City, state, and ZIP code	8 Unrealized profit or (loss) on open contracts—12/31/97 $	9 Aggregate profit or (loss) $ — 4.1"	
Account number (optional) — 2.8" / 2nd TIN Not. ☐ — .60"			

Form **1099-B** Cat. No. 14411V Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7979 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1a Date of sale (MMDDYY)	OMB No. 1545-0715	**Proceeds From Broker and Barter Exchange Transactions**
	1b CUSIP No.	1997 Form 1099-B	
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Bartering $	4 Federal income tax withheld $	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name	5 Description		**File with Form 1096.**
	Regulated Futures Contracts		For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	6 Profit or (loss) realized in 1997 $	7 Unrealized profit or (loss) on open contracts—12/31/96 $	
City, state, and ZIP code	8 Unrealized profit or (loss) on open contracts—12/31/97 $	9 Aggregate profit or (loss) $	
Account number (optional)	2nd TIN Not. ☐		

Form **1099-B** Cat. No. 14411V Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

7979 ☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, ZIP code, and telephone no.	1a Date of sale (MMDDYY)	OMB No. 1545-0715	**Proceeds From Broker and Barter Exchange Transactions**
	1b CUSIP No.	1997 Form 1099-B	
	2 Stocks, bonds, etc. $	Reported to IRS ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S Federal identification number / RECIPIENT'S identification number	3 Bartering $	4 Federal income tax withheld $	**Copy A For Internal Revenue Service Center**
RECIPIENT'S name	5 Description		**File with Form 1096.**
	Regulated Futures Contracts		For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**
Street address (including apt. no.)	6 Profit or (loss) realized in 1997 $	7 Unrealized profit or (loss) on open contracts—12/31/96 $	
City, state, and ZIP code	8 Unrealized profit or (loss) on open contracts—12/31/97 $	9 Aggregate profit or (loss) $	
Account number (optional)	2nd TIN Not. ☐		

Form **1099-B** Cat. No. 14411V Department of the Treasury - Internal Revenue Service

Exhibit B

8080 ☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, ZIP code, and telephone no.		OMB No. 1545-0877 **1997** Form **1099-A**
LENDER'S Federal identification number / BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)	2 Balance of principal outstanding $
BORROWER'S name	3	4 Fair market value of property $
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No	
City, state, and ZIP code	6 Description of property	
Account number (optional)		

Acquisition or Abandonment of Secured Property

Copy A
For Internal Revenue Service Center
File with Form 1096.

1.4" 1.4" For Paperwork Reduction Act
1.8" Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-A** Cat. No. 14412G Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

8080 ☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, ZIP code, and telephone no.		OMB No. 1545-0877 **1997** Form **1099-A**
LENDER'S Federal identification number / BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)	2 Balance of principal outstanding $
BORROWER'S name	3	4 Fair market value of property $
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No	
City, state, and ZIP code	6 Description of property	
Account number (optional)		

Acquisition or Abandonment of Secured Property

Copy A
For Internal Revenue Service Center
File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-A** Cat. No. 14412G Department of the Treasury - Internal Revenue Service

Do NOT Cut or Separate Forms on This Page

8080 ☐ VOID ☐ CORRECTED

LENDER'S name, street address, city, state, ZIP code, and telephone no.		OMB No. 1545-0877 **1997** Form **1099-A**
LENDER'S Federal identification number / BORROWER'S identification number	1 Date of lender's acquisition or knowledge of abandonment (MMDDYY)	2 Balance of principal outstanding $
BORROWER'S name	3	4 Fair market value of property $
Street address (including apt. no.)	5 Was borrower personally liable for repayment of the debt? ☐ Yes ☐ No	
City, state, and ZIP code	6 Description of property	
Account number (optional)		

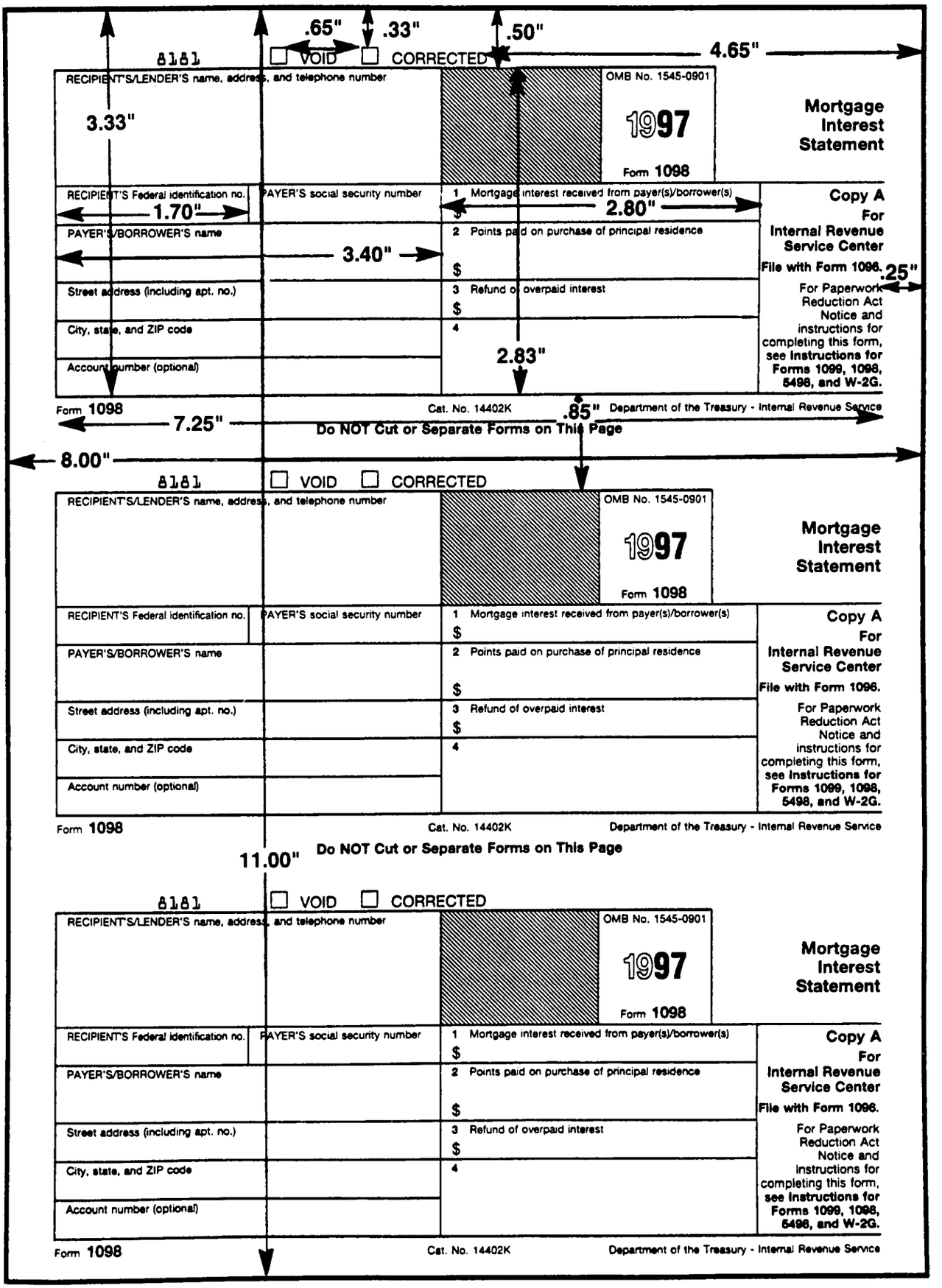
Acquisition or Abandonment of Secured Property

Copy A
For Internal Revenue Service Center
File with Form 1096.

For Paperwork Reduction Act Notice and instructions for completing this form, see **Instructions for Forms 1099, 1098, 5498, and W-2G.**

Form **1099-A** Cat. No. 14412G Department of the Treasury - Internal Revenue Service

Exhibit A


.65"
.33"
.50"
4.65"
3.33"
8181
VOID
CORRECTED
RECIPIENT'S/LENDER'S name, address, and telephone number
OMB No. 1545-0901
1997
Form 1098
Mortgage Interest Statement
RECIPIENT'S Federal identification no.
PAYER'S social security number
1 Mortgage interest received from payer(s)/borrower(s)
$
1.70"
2.80"
PAYER'S/BORROWER'S name
2 Points paid on purchase of principal residence
3.40"
$
Street address (including apt. no.)
3 Refund of overpaid interest
$
City, state, and ZIP code
4
Account number (optional)
2.83"
Copy A For Internal Revenue Service Center
File with Form 1096.
.25"
For Paperwork Reduction Act Notice and instructions for completing this form, see Instructions for Forms 1099, 1098, 5498, and W-2G.
Form 1098
Cat. No. 14402K
.85"
Department of the Treasury - Internal Revenue Service
7.25"
Do NOT Cut or Separate Forms on This Page
8.00"
11.00"

.03 The official OMB numbers may be obtained from the official IRS printed forms, and are also shown on the forms in the exhibits.

SEC 3. REPRODUCIBLE COPIES

.01 As of April 30, 1996, IRS discontinued taking orders for reproducible and information copies of federal tax materials. However, there are several new options available to obtain federal tax material. The new options are:

(1) **Internal Revenue Information Services (IRIS)**—IRIS is housed within FedWorld, known also as the Electronic Marketplace of U.S. Government Information. IRIS at FedWorld can be reached by:
   (a) Modem (dial up) at 703-321-8020,
   (b) by Internet – Telnet to iris.irs.ustreas.gov
   (c) by File Transfer Protocol (FTP) connect to – ftp.irs.ustreas.gov
   (d) or by World Wide Web – http://www.irs.ustreas.gov

(2) **IRS Federal Tax Forms CD-ROM**—The IRS also offers an alternative to downloading electronic files from IRIS and provides prior-year access to tax forms and instructions through it's Federal Tax Forms CD-ROM. First offered during 1994, the CD will again be available for the upcoming filing season. For system requirements and to order the 1997 Federal Tax Forms CD-ROM contact the Government Printing Office's (GPO's) Superintendent of Documents either:
   (a) by telephone 202-521-1800; or
   (b) electronically through GPO's Federal Bulletin Board on 202–512–1387.

(3) **Government Printing Office Superintendent of Documents Bookstores**—The Government Printing Office Superintendent of Documents Bookstores also sell individual copies of tax forms, instructions and publications. Call 202-521-1800 to find the bookstore nearest to you.

.02 Forms 1096, 1098, 1099 series, and 5498 are provided electronically on the IRS home page, IRIS bulletin board system, and on the Federal Tax Forms CD-ROM, but **CANNOT** be used for filing with IRS when printed from a conventional printer. These forms contain drop-out ink requirements as described in Part B, Section 2 of this publication.

SEC. 4. EFFECT ON OTHER REVENUE PROCEDURES

Revenue Procedure 96–42, 1996–32 I.R.B. 14, covering paper returns and statements for payments made during the 1996 calendar year is hereby superseded.

SEC. 2. SPECIFICATIONS FOR COPY A OF FORMS W–2G

.01 Color and Quality of Paper—Paper for Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 × 22–500), plus or minus 5 percent. The paper must consist substantially of bleached chemical wood pulp and be free from unbleached or ground wood pulp or recycled printed paper. It also must be suitably sized to accept ink without feathering.

.02 Color and Quality of Ink—All printing must be in a high quality non-gloss black ink. Bar codes should be free from picks and voids.

.03 Typography—The type must be substantially identical in size and shape with that on the official form. All rules on the document are either ½ point (.007 inch), 1 point (0.015 inch), or 3 point (0.045). Vertical rules must be parallel to the left edge of the document; horizontal rules, to the top edge.

.04 Dimensions—The official form is 8 inches wide × 3-⅔ inches deep, exclusive of a ⅔ inch snap stub on the left side of the form. The snap feature is not required on substitutes. The top and right margins must be ¼ inch plus or minus .0313. If the top and right margins are properly aligned, the left margin for all forms will be correct. All margins must be free of any printing. If the substitute forms are in continuous or strip form, they must be burst and stripped to conform to the size specified for a single form.

(1) The width of a substitute Copy A must be 8 inches. The left margin must be free of all printing other than that shown on the official form.

(2) The depth of a substitute Copy A must be 3-⅔ inches.

.05 Hot wax and cold carbon spots are not permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply. Interleaved carbons, if used, should be black and of good quality to preclude smudging.

.06 Printer's Symbol—The Government Printing Office (GPO) symbol must not be printed on substitute Forms W–2G. Instead the employer identification number (EIN) of the forms printer must be printed in the bottom margin on the face of each individual form of Copy A of such substitute forms. The form must not contain the statement "IRS approved."

.07 The Catalog Number (Cat. No.) shown on the 1997 Form W–2G is used for IRS distribution purposes and need not be printed on any substitute forms.

PART D. ADDITIONAL INSTRUCTIONS FOR FORMS 1098, 1099, 5498, AND W–2G

SEC. 1. OTHER COPIES

.01 Copies B, C, and in some cases D, 1, and 2, are included in the official assembly for the convenience of the filer. There is no legal requirement that privately printed substitute forms include all these copies. Copies B, and in some cases Copies C, will satisfy the requirement of the law and regulations concerning the statement of information that is required to be furnished to the form recipient. **NOTE:** If Federal income tax withheld is shown on **Form W–2G or 1099–R,** Copy B (to be attached to the tax return) and Copy C **must** be furnished to the recipient. Copy D (**Forms 1099–R and W–2G**) may be desired as a filer record copy. Only Copy A should be filed with the IRS.

.02 Arrangement of Assembly – The parts of the assembly must be arranged, from top to bottom, as follows: (a) All forms-Copy A "For Internal Revenue Service Center." (b) Form 1098 – Copy B "For Payer"; Copy C "For Recipient." (c) Form 1099–A – Copy B "For Borrower"; Copy C "For Lender." (d) Form 1099–C Copy B "For Debtor"; Copy C "For Creditor"; (e) Form 1099–LTC Copy B "For Policyholder"; Copy C "For Insured" and Copy D "For Payer." (f) Form 1099–B, 1099–DIV, 1099–G, 1099–INT, 1099–MSA, 1099–OID, and 1099–PATR – Copy B "For Recipient"; Copy C "For Payer.: (g) Form 1099–MISC – Xopy 1 "For State Tax Department"; Copy B "For Recipient"; Copy 2 "To be filed with recipient's state income tax return, when required."; Copy C "For Payer." (h) Form 1099–R – Copy 1 "For State, City, or Local Tax Department"; Copy B "Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return."; Copy C "For Recipient's Records"; Copy 2 "File this copy with your state, city, or local income tax return, when required."; Copy D "For Payer." (i) Form 1099–S – Copy B "For Transferor"; Copy C "For Filer." (j) Form 5498 – Copy B "For Participant"; Copy C "For trustee or Issuer." (k) Form 5498–MSA – Copy B "For Participant"; Copy C "For Trustee." (l) Form W–2G – Copy 1 "For State Tax Department"; Copy 1 "For State Tax Department"; Copy B "Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 2, attach this copy to your return." Copy C "For Winner's Records"; Copy 2 "Attach this copy to your state income tax return, if required."; Copy D "For Payer."

.03 Perforations are required between forms on all copies except Copy A to enable the separation of individual forms. Copy A of Form W–2G may be perforated.

SEC. 2. OMB REQUIREMENTS

.01 Office of Management and Budget (OMB) Requirements for Substitute Forms—Public Law 96–511 requires that: (1) OMB approve Internal Revenue Service tax forms, (2) each form show (in the upper right corner) the OMB approval number, and (3) the form (or its instructions) state why IRS is collecting the information, how it will be used and whether it must be given to IRS. The official IRS forms or instructions contain this information and any substitute must contain it also.

.02 The OMB requirements for substitute IRS forms are:

(1) All substitute forms, **including substitute statements to recipients,** must show the OMB number as it appears on the official IRS form;

(2) For Copy A, the OMB number must appear exactly as shown on the official IRS form;

(3) For any copy other than Copy A, the OMB number must use one of the following formats:

(a) OMB No. XXXX–XXXX

(preferred) or;

(b) OMB # XXXX–XXXX.

(4) All substitute forms (Copy A only) must state "For Paperwork Reduction Act Notice, see the 1997 Instructions for Forms 1099, 1098, 5498, and W–2G."

color or tone. Separation between fields must be 0.1 inch. Other than the Form 1099–R, the numbered captions are printed as a solid with no shaded background. Other printing requirements are discussed below.

OCR Specifications

The contractor must have or initiate a quality control program to assure OCR ink density. In addition, the contractor must have access to either a MacBeth PCM-II tester or a Kidder 082A tester to evaluate the ink at regular intervals throughout a shift.

Paper and Ink

Readings will be made when printed on approved 20 lb. white OCR bond with a reflectance of not less than 80%. Black ink used must not have a reflectance greater than 15%. These readings are based on requirements of the "REI Input 80 Model C1 & D" Optical Scanner using Flint Ink (Formerly known as Sinclair – Valentine J–6983 red ink) or equal.

MacBeth PCM II Tester

The tested Print Contrast Signal (PCS) values when using the MacBeth PCM-II tester on the "C" scale must range from .01 minimum to .06 maximum.

Kidder 082A Tester

The tested Print Contrast Signal (PCS) values when using the Kidder 082A tester on the Infra Red (IR) scale must range from .12 minimum to .21 maximum. White calibration disc must be 100%, sensitivity must be set at one (1).

Alternative Tester

If an alternative tester is used it must be approved by the Government so that tested (PCS) values can be established with this equipment. Approval may be obtained by writing to the following address:

Commissioner of Internal Revenue
Attn: HR:F:P:P Room 1237
Tax Forms Procurement Analyst
1111 Constitution Avenue, NW
Washington, DC 20224

.04 Typography – Type must be substantially identical in size and shape with corresponding type on the official form. All rules are either ½-point or ¾-point. Rules must be identical to that on the official IRS form. NOTE: The form identifying number must be nonreflective carbon-based black ink in OCR A Font.

.05 Dimension – Three Forms 1098, 1099, or 5498 (Copy A) are contained on a single page, except Form 1099–R, which contains two documents per page, which is 8 inches wide (exclusive of any snap-stubs and/or pinfeed holes) by 11 inches deep. There is a .33 inch top margin from the top of the corrected box, and there is a .25 inch right margin. There is a 1/32″ (0.0313″) tolerance for the right margin. These measurements are constant for all **Forms 1098, 1099 and 5498.** The measurements will be shown only once in the exhibit section of this publication, on the **Form 1098.** Exceptions to these measurements will be shown on the remainder of exhibits. If the right and top margins are properly aligned, the left margin for all forms will be correct. All margins must be free of all printing. See Exhibits A through R in this publication for the correct form measurements.

.06 The depth of the individual trim size of each form on a page must be the same as that of the official form (3 ⅔ inches, except 5 ½ inches for Form 1099–R).

.07 The words "For Paperwork Reduction Act Notice and instructions for completing this form, see the *Instructions for Forms 1099, 1098, 5498, and W–2G*" ***must*** be printed on Copy A. The words "For more information and the Paperwork Reduction Act Notice, see the 1997 Instructions for Forms 1099, 1098, 5498, and W–2G" ***must*** be printed on Form 1096.

.08 The OMB Number *must* be printed on Copies A and Form 1096 in the same location as that on the official form.

.09 *Privately printed continuous substitute forms (Copy A) must be perforated at each 11″ (3 per page, or 2 per page for 1099–R) page depth. No perforations are allowed between the 3-⅔″ forms (or 5-½″ for Form 1099–R) on a single copy page of Copy A.*

.10 The words *"Do NOT Cut or Separate Forms on This Page"* must be printed in red dropout ink (as required by form specifications) between the three forms, or two forms for **Forms 1099–R.** NOTE: Perforations are required between all the other individual copies (Copies B and C, and Copies 1 and 2 for **Form 1099–R and Form 1099–MISC,** and Copy D for **Form 1099–R**) **included in the set.**

.11 Chemical transfer paper is permitted for Copy A only if the following standards are met:

(1) Only chemically backed paper is acceptable for Copy A.

(2) Carbon coated forms are not permitted. Front and back chemically treated paper cannot be processed properly by machine.

(3) Chemically transferred images must be black in color.

.12 Hot wax and cold carbon spots are NOT permitted for Copy A. Interleaved carbon should be black and must be of good quality to assure legibility of information on all copies to preclude smudging. All copies must be CLEARLY LEGIBLE. Fading must not be of such a degree as to preclude legibility.

.13 Printer's symbol—The GPO symbol must not be printed on substitute Copy A. Instead, the employer identification number (EIN) of the forms printer must be entered in the bottom margin on the face of each individual form of Copy A, or the bottom margin on the reverse side of each Form 1096. **THE FORM MUST NOT CONTAIN THE STATEMENT "IRS APPROVED."**

.14 A postal indicia may be used if it meets the following criteria: a) it is printed in the OCR ink color prescribed for the form; and b) no part of the indicia is within 1 print position of the scannable area.

.15 The Catalog Number (Cat. No.) shown on the 1997 forms is used for IRS distribution purposes and need not be printed on any substitute forms.

PART C. SPECIFICATIONS FOR SUBSTITUTE FORMS W-2G TO BE FILED WITH IRS

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements for **Form W–2G**—COPY A ONLY.

.02 A filer may file a substitute **Form W–2G** with the IRS (hereinafter referred to as "substitute Copy A"). The substitute form (filed with the IRS) must be an exact replica of the official form with respect to layout and contents.

that it has not been reported."
Copy C—"Copy C is provided to you for information only. Only the policyholder is required to report this information on a tax return."

(f) **Form 1099–MSA**—"This information is being furnished to the Internal Revenue Service."

(g) **Form 1099–S**—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines that it has not been reported."

(h) **Form 5498**—"This information in boxes 1 through 7 is being furnished to the Internal Revenue Service." **Note:** If you do not furnish another statement to the participant because no contributions were made for the year, the statement of the fair market value of the account must contain a legend designating which information is being furnished to the Internal Revenue Service."

(i) **Form 5498–MSA**—"The information in boxes 1 through 5 is being furnished to the Internal Revenue Service."

.04 COMPOSITE SUBSTITUTE STATEMENT – FORMS SPECIFIED IN 7.03 ONLY.—A composite form recipient statement for forms specified in 7.03 is permitted when one filer is reporting more than one of the related payments during a calendar year to the same form recipient. A composite statement is not allowable for a combination of forms listed in 7.01 and forms listed in 7.03 except that a filer may report **Form 1099–B** information on a composite form with the forms listed in 7.01 as described in 7.02. Although the composite form recipient statement may be on one sheet, the format of the composite form recipient statement must satisfy the requirements listed in 7.02 above in addition to the requirements specified in 7.03. A composite statement of **Forms 1098 and 1099–INT** (for interest reportable under section 6049) IS NOT ALLOWABLE.

PART B—SPECIFICATIONS FOR SUBSTITUTE FORMS TO BE FILED WITH IRS (EXCEPT Form W–2G)

SEC. 1. GENERAL

.01 The following specifications prescribe the format requirements for **Forms 1096** and Copy A of **Forms 1098, 1099, and 5498. (See Part C for Form W–2G specifications.)**

.02 The form identifying number (*e.g.*, 9191 for **Form 1099–DIV**) must be printed in nonreflective black carbon-based ink in print positions 15 through 19 using an OCR A font. The checkboxes located to the right of the form identifying number must be 10-point boxes, the void check box is in print position 25 and the corrected check box in position 33. These measurements are from the left edge of the paper, not including the perforated strip.

SEC. 2. SPECIFICATIONS FOR FORM 1096 AND COPY A OF FORMS 1098, 1099 AND 5498

.01 The substitute form must be an exact replica of the official IRS form with respect to layout and content. **NOTE:** To determine the correct form measurements, see Exhibits A through R at the end of this publication. Hot wax and cold carbon spots are not permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply. Use of chemical transfer paper for Copy A is acceptable. The Government Printing Office (GPO) symbol must be deleted.

.02 Color and quality of paper for Copy A (cut sheets and continuous pinfeed forms) as specified by JCP Code 0-25, dated November 29, 1978, must be white 100% bleached chemical wood, optical character recognition (OCR) bond produced in accordance with the following specifications:

NOTE: Reclaimed fiber in any percentage is permitted provided the requirements of this standard are met.

(1) Acidity: Ph value, average, not less than 4.5

(2) Basis Weight 17 × 22 500 cut sheets 18–20
Metric equivalent—g/m^2 75
A Tolerance of ±5 pct. shall be allowed.

(3) Stiffness: Average, each direction, not less than—milligrams 50

(4) Tearing strength: Average, each direction, not less than—grams 40

(5) Opacity: Average, not less than—percent 82

(6) Thickness: Average—inch—0.0038
Metric equivalent—mm—0.097
A tolerance of +0.0005 inch (0.0127 mm) shall be allowed. Paper shall not vary more than 0.0004 inch (0.0102 mm) from one edge to the other.

(7) Porosity: Average, not less than—seconds 10

(8) Finish (smoothness): Average, each side—seconds 20–55
For information only, the Sheffield equivalent—units 170–100

(9) Dirt: Average, each side, not to exceed—parts per million 8

.03 All printing on Copy A of Forms 1098, 1099, 5498 must be in red OCR dropout ink, Flint J–6983 (formerly Sinclair-Valentine) or an exact match, except for the 4-digit form identifying numbers, which must be printed in non-reflective carbon-based black ink. The shaded areas of any substitute form should generally correspond to that present on the official form. Printing on **Form 1096** above the statement: **"Please return this entire page to the Internal Revenue Service. Photocopies are NOT acceptable."** must be in red OCR dropout ink (except for the 4-digit form identifying number 6969). All printing including and below the Form 1096 statement may be in any shade or tone of black ink. Black ink should only appear on the lower portion of the reverse side of **Form 1096** where it would not bleed through and interfere with scanning. **NOTE:** The instructions on the back of Form 1096, which include filing addresses, must be printed. The instructions to filers printed on the back of the copy designated for the Payer, Recipient for Form 1098, Lender for Form 1099–A, Creditor for Form 1099–C, Filer for Form 1099–S, or Trustee or Issuer for Forms 5498 and Form 5498–MSA, in any ink

caption **"Federal income tax withheld"** must be in bold face type on the form recipient statement. **Exception:** If you are reporting a payment as "Other income" in box 3 of **Form 1099–MISC,** you may substitute appropriate explanatory language for the box title. For example, for payments of accrued wages and leave to a beneficiary of a deceased employee, you might change the title of box 3 to "Beneficiary payments" or something similar. **(You cannot make this change on Copy A.)**

(5) Appropriate instructions to the form recipient, similar to those on the official IRS form, must be provided to aid in the proper reporting of the items on the form recipient's income tax return. For payments reported on **Form 1099–B,** the requirement to include instructions that are substantially similar to those on the official IRS form may be satisfied by providing form recipients with a single set of instructions with respect to all forms 1099–B statements required to be furnished in a calendar year. **NOTE:** If Federal income tax is withheld is shown on **Form 1099–R or W–2G,** Copy B (to be attached to the tax return) and Copy C (for recipient's/winner's records) ***must*** be furnished to the recipient. If Federal income tax withheld is not shown on **Form 1099–R or W–2G,** only Copy C is required to be furnished. However, instructions similar to those contained on the back of the official Copy B and Copy C of **Form 1099–R** must be furnished to the recipient. For convenience, you may choose to provide both Copies B and C of Form 1099–R to the recipient.

(6) The quality of carbon used to produce statements to recipients must meet the following standards:

(a) all copies must be *CLEARLY LEGIBLE;*

(b) all copies must have the capability to be photocopied;

(c) fading must not be of such a degree as to preclude legibility and the ability to photocopy. In general, black chemical transfer inks are preferred; other colors are permitted only if the above standards are met. Hot wax and cold carbon spots are *NOT* permitted on any of the internal form plies. These spots are permitted on the back of a mailer top envelope ply.

(7) A mutual fund family may separately state on one document (*e.g.,* one piece of paper) the Form **1099–B** information for a recipient from each fund as required by **Form 1099–B.** However, the gross proceeds, *etc.,* from each transaction within a fund must be separately stated. The form must contain an instruction to the recipient that each fund's amount and name, not the name of the mutual fund family, must be reported on the recipient's tax return. The form cannot contain an aggregate total of all funds.

(8) For **Form 1099–S,** you may use a Uniform Settlement Statement under the Real Estate Settlement Procedures Act of 1974 (RESPA) as the written statement to the transferor if it is conformed by including on the statement the legend described in (8)(g) below and by designating which information on the Uniform Settlement Statement is being reported to IRS on **Form 1099–S.**

(9) Form recipient statements must contain the following legends:

(a) **Form 1098**—(i) "The information in boxes 1, 2 and 3 is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if the IRS determines that an underpayment of tax results because you overstated a deduction for this mortgage interest or for these points or because you did not report this refund of interest on your return." (ii) "The amount shown may not be fully deductible by you on your Federal income tax return. Limitations based on the cost and value of the secured property may apply. In addition, you may only deduct an amount of mortgage interest to the extent it was incurred by you, actually paid by you, and not reimbursed by another person."

(b) **Forms 1099–A and 1099–C**—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if taxable income results from this transaction and the IRS determines that it has not been reported."

(c) **Forms 1099–B, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–OID, 1099–PATR, and W–2G Copy B**—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported." Copy B of **Form W–2G** must state "This information is being furnished to the Internal Revenue Service. Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 2, attach this copy to your return."

(d) **Form 1099—R, Copy B**—"Report this income on your Federal tax return. If this form shows Federal income tax withheld in box 4, attach this copy to your return. This information is being furnished to the Internal Revenue Service." **Form 1099–R, Copy C**—"This information is being furnished to the Internal Revenue Service."

(e) **Form 1099–LTC, Copy B**—"This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this item is required to be reported and the IRS determines

Code 2, and enter the employee's contributions in Amount Code 5. If the taxable amount cannot be determined, enter a "1" (one) in position 48 of the "B" Record. If reporting an IRA, SEP, or SIMPLE distribution, generally include the amount of the distribution in the Taxable Amount (Payment Amount Field 2, positions 61–70) and enter a "1" (one) in the IRA/SEP/SIMPLE Indicator Field (position 44). A "1" (one) may be entered in the Taxable Amount Not Determined Indicator Field (position 48) of the Payee "B" Record, but the amount of the distribution must still be reported in Payment Amount Fields 1 and 2. See the explanation for Box 2a of Form 1099–R in the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G" for more information on reporting the taxable amount.

☞ **Note 3: See the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" for information concerning Federal income tax withheld for Form 1099–R.**

☞ **Note : For payers who wish to report state or local income tax, see Part B, Section 8 (7) Payee "B" Record — Record Layout Positions 322–420 Form 1099–R.**

Amount Codes **Form 1099–S** — Proceeds From Real Estate Transactions

For Reporting Payments on Form 1099–S:

Amount Code	*Amount Type*
2	Gross proceeds (See **Note**)
5	Buyer's part of real estate tax

☞ **Note: Include payments of timber royalties made under a "pay-as-cut" contract, reportable under section 6050N. If timber royalties are being reported, enter "TIMBER" in the description field of the "B" Record. For more information, see Announcement 90–129, 1990–48 I.R.B. 10.**

Amount Codes **Form 5498** — IRA, SEP, or *SIMPLE Retirement Plan Information* (See **Note**)

For Reporting Payments on Form 5498:

Amount Code	*Amount Type*
1	Regular IRA contributions made in *1997* and *1998 for 1997.*
2	IRA, *SEP, or SIMPLE rollover* contributions
3	Life insurance cost included in Amount Code 1
4	Fair market value of account
6	*SEP contributions*
7	*SIMPLE contributions*

☞ **Note: For information regarding Inherited IRAs, refer to the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" and Rev. Proc. 89–52, 1989–2 C.B. 632. Beneficiary information must be given in the Payee Name Line Field of the "B" Record.**

If reporting IRA contributions for a Desert Storm/Shield participant for other than 1997 or an Operations Joint Guard (OJG) (Bosnia Region) participant, enter "DS" for Desert Storm or "JG" for Joint Guard, the year for which the contribution was made, and the amount of the contribution in the Special Data Entries Field of the "B" Record. Do not enter the contributions in Amount Code 1.

For information concerning Desert Storm/Shield participant reporting, refer to the 1994 "Instructions for Forms 1099, 1098, 5498, and W–2G," or Notice 91–17, 1991–1 C.B. 319. The instructions for filing Form 5498 for Desert Storm/Shield participants will also apply to participants of Operations Joint Guard (OJG) of the Bosnia Region.

Amount Codes ***Form 5498–MSA*** *Medical Savings Account Information*

For Reporting Contributions to Medical Savings Accounts

Amount Code	*Amount Type*
1	*Employee MSA contributions made in 1997 and 1998 for 1997*
2	*Total MSA contributions made in 1997*
3	*Total MSA contributions made in 1998 for 1997*
4	*MSA rollover contributions (not included in Amount Code 1, 2, or 3) (See* **Note 1***)*
5	*Fair market value of account (See* **Note 2**)

Amount Code	*Amount Type*
1	*Gross distribution*
2	*Earnings on excess contributions*

Amount Codes **Form 1099–OID** — Original Issue Discount

For Reporting Payments on Form1099–OID:

Amount Code	*Amount Type*
1	Original issue discount for 1997
2	Other periodic interest
3	Early withdrawal penalty
4	Federal income tax withheld (backup withholding)

Amount Codes **Form 1099–PATR** — Taxable Distributions Received From Cooperatives

For Reporting Payments on Form 1099–PATR:

Amount Code	*Amount Type*
1	Patronage dividends
2	Nonpatronage distributions
3	Per-unit retain allocations
4	Federal income tax withheld (backup withholding)
5	Redemption of nonqualified notices and retain allocations
Pass-Through Credits (See **Note**)	
6	For filers' use
7	*Investment credit**
8	*Work opportunity credit***
9	Patron's Alternative Minimum Tax (AMT) adjustment

**The title of Amount Code 7 has been changed from Energy investment credit to Investment credit.*

***The title of Amount Code 8 has been changed from Jobs credit to Work opportunity credit.*

☞ **Note: Amount Codes 6, 7, 8, and 9 are reserved for the patron's share of unused credits that the cooperative is passing through to the patron. Other credits, such as the Indian employment credit may be reported in Amount Code 6. The title of the credit reported in Amount Code 6 should be reported in the Special Data Entries Field in the Payee "B" Record. The amounts shown for Amount Codes 6, 7, 8, and 9 must be reported to the payee. These Amount Codes and the Special Data Entries Field are for the convenience of the filer. This information is not needed by IRS/MCC.**

Amount Codes **Form 1099–R** — Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.

For Reporting Payments on Form 1099-R:

Amount Code	**Amount Type**
1	Gross distribution (See **Note 1**)
2	Taxable amount (See **Note 2**)
3	Capital gain (included in Amount Code 2)
4	Federal income tax withheld (See **Note 3**)
5	Employee contributions or insurance premiums
6	Net unrealized appreciation in employer's securities
8	Other
9	Total employee contributions

☞ **Note 1: If the payment shown for Amount Code 1 is a total distribution, enter a "1" (one) in position 47 of the "B" Record. An amount must be shown in Amount Field 1 unless reporting an amount ONLY for Amount Code 8.**

☞ **Note 2: If a distribution is a loss, do not enter a negative amount. For example, if stock is distributed but the value is less than the employee's after-tax contributions, enter the value of the stock in Amount Code 1, enter "0" (zero) in Amount**

Amount Code	*Amount Type*
4	Federal income tax withheld (backup withholding) *or voluntary withholding on unemployment compensation or Commodity Credit Corporation Loans, or certain crop disaster payments*
6	Taxable grants
7	Agriculture payments

Amount Codes **Form 1099–INT** — Interest Income

For Reporting Payments on Form 1099–INT:

Amount Code	*Amount Type*
1	Interest income not included in Amount Code 3
2	Early withdrawal penalty
3	Interest on U.S. Savings Bonds and Treasury obligations
4	Federal income tax withheld (backup withholding)
5	Foreign tax paid

Amount Codes ***Form 1099–LTC*** *— Long-Term Care and Accelerated Death Benefits*

For Reporting Payments on Form 1099–LTC:

Amount Code	*Amount Type*
1	*Gross long-term care benefits paid*
2	*Accelerated death benefits paid*

Amount Codes **Form 1099–MISC** — Miscellaneous Income

For Reporting Payments on Form 1099–MISC:

Amount Code	*Amount Type*
1	Rents (See **Note 1**)
2	Royalties (See **Note 2**)
3	Other income
4	Federal income tax withheld (backup withholding or withholding on payments of Indian gaming profits)
5	Fishing boat proceeds
6	Medical and health care payments
7	Nonemployee compensation or crop insurance proceeds (See **Note 3**)
8	Substitute payments in lieu of dividends or interest
9	Excess golden parachute payments

☞ **Note 1: If reporting the Direct Sales Indicator only, use Type of Return Code A for 1099–MISC in position 22, and Amount Code 1 in position 23 of the Payer "A" record. All payment amount fields in the Payee "B" record will contain zeros.**

☞ **Note 2: Do not report timber royalties under a "pay-as-cut" contract; these must be reported on Form 1099–S.**

☞ **Note 3: Amount Code 7 is normally used to report nonemployee compensation. However, Amount Code 7 may also be used to report crop insurance proceeds. See positions 4–5 of the "B" Record for instructions. If nonemployee compensation and crop insurance proceeds are being paid to the same payee, a separate "B" Record for each transaction is required.**

Amount Codes ***Form 1099–MSA*** *Distributions From Medical Savings Accounts*

For Reporting Distributions from Medical Savings Accounts on Form 1099–MSA

Amount Code	*Amount Type*
7	Unrealized profit (or loss) on open contracts-12/31/96 (See **Note 2**).
8	Unrealized profit (or loss) on open contracts- 12/31/97 (See **Note 2**).
9	Aggregate profit (or loss) (See **Note 2**).

☞ **Note 1: The payment amount field associated with Amount Code 2 may be used to represent a loss from a closing transaction on a forward contract. Refer to the "B" Record — General Field Descriptions, Payment Amount Fields, for instructions on reporting negative amounts.**

☞ **Note 2: Payment Amount Fields 6, 7, 8, and 9 are to be used for the reporting of regulated futures or foreign currency contracts.**

Amount Codes **Form 1099–C** — Cancellation of Debt (See **Note 1**)

For Reporting Cancellation of Debt on Form 1099–C:

Amount Code	*Amount Type*
2	Amount of debt canceled
3	Interest if included in Amount Code 2
7	Fair market value of property (See **Note 2**)

☞ **Note 1: If, in the same calendar year, a debt is canceled in connection with the acquisition or abandonment of secured property for one debtor and the filer would be required to file both Forms 1099–C and 1099–A (Acquisition or Abandonment of Secured Property), the filer is required to file Form 1099–C only. See the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" for further information on coordination with Form 1099–A.**

☞ **Note 2: Amount Code 7 will be used only if a combined Form 1099–A and 1099–C is being filed.**

Amount Codes **Form 1099–DIV** — Dividends and Distributions

For Reporting Payments on Form 1099–DIV:

Amount Code	*Amount Type*
1	Gross dividends and other distributions on stock (See **Note**)
2	Ordinary dividends (See **Note**)
3	Capital gain distributions (See **Note**)
4	Nontaxable distributions (if determinable) (See **Note**)
5	Investment expenses (See **Note**)
6	Federal income tax withheld (backup withholding)
7	Foreign tax paid
8	Cash liquidation distributions
9	Noncash liquidation distributions (show fair market value)

☞ **Note: Amount Code 1 must be present (unless the payer is using Amount Codes 8 or 9 only) and must equal the sum of amounts reported for Amount Codes 2, 3, 4, and 5. If an amount is present for Amount Code 1, there must be an amount present for Amount Codes 2–5, as applicable.**

Amount Codes **Form 1099–G** — Certain Government Payments

For Reporting Payments on Form 1099–G:

Amount Code	*Amount Type*
1	Unemployment compensation
2	State or local income tax refunds, credits, or offsets

Example of Amount Codes:

If position 22 of the Payer/Transmitter "A" Record is "A" (for 1099–MISC) and positions 23–31 are "1247bbbbb", this indicates the payer is reporting any or all four payment amounts (1247) in all of the following "B" Records. **(In this example, "b" denotes blanks in the designated positions. Do not enter the letter "b".)**

The first payment amount field will represent rents;
the second will represent royalties;
the third will be all "0" (zeros);
the fourth will represent Federal income tax withheld;
the fifth and sixth will be all "0" (zeros);
the seventh will represent nonemployee compensation;
and
the eighth and ninth will be all "0" (zeros).

Enter the amount codes in **ascending sequence** (*i.e.*, 1247bbbbb, left justify information, and fill unused positions with blanks. For further clarification of the amount codes, contact IRS/MCC. **(In this example, "b" denotes blanks in the designated positions. Do not enter the letter "b.")**

☞ **Note: A type of return and an amount code must be present in every Payer "A" Record even if no money amounts are being reported. For a detailed explanation of the information to be reported in each amount code, refer to the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G."**

Amount Codes **Form 1098** — Mortgage Interest Statement

For Reporting Mortgage Interest Received From Payers/Borrowers (Payer of Record) on Form 1098:

Amount Code	*Amount Type*
1	Mortgage interest received from payer(s)/borrower(s)
2	Points paid on purchase of principal residence
3	Refund (or credit) of overpaid interest

Amount Codes **Form 1099–A** — of Secured Property (See **Note**)

For Reporting the Acquisition or Acquisition or Abandonment Abandonment of Secured Property on Form 1099–A:

Amount Code	*Amount Type*
2	Balance of principal outstanding
4	Fair market value of property

☞ **Note: If, in the same calendar year, a debt is canceled in connection with the acquisition or abandonment of secured property for one debtor and the filer would be required to file both Forms 1099–A and 1099–C, the filer is required to file Form 1099–C only. See the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" for further information on coordination with Form 1099–C.**

Amount Codes **Form 1099–B** Proceeds From Broker and Barter Exchange Transactions

For Reporting Payments on Form 1099–B:

Amount Code	*Amount Type*
2	Stocks, bonds, etc. (For forward contracts, See **Note 1**)
3	Bartering (Do not report negative amounts.)
4	Federal income tax withheld (backup withholding) (Do not report negative amounts.)
6	Profit (or loss) realized on closed regulated futures or foreign currency contracts in 1997 (See **Note 2**).

Record Name: Payer/Transmitter "A" Record—Continued

Field Position	Field Title	Length	Description and Remarks
			electronically. The mail label **does not** contain a name control. Names of less than four (4) characters should be left- justified, filling the unused positions with blanks. If a Package 1099 has not been received or the Payer Name Control is unknown, this field must be blank filled.
20	Last Filing Indicator	1	Enter a "1" (one) if this is the last year the payer will file; otherwise, **enter blank**. Use this indicator if the payer will not be filing information returns under this payer name and TIN in the future either magnetically, electronically, or on paper.
21	Combined Federal/State Filer	1	**Required** for the Combined Federal/State Filing Program. Enter "1" (one) if participating in the Combined Federal/State Filing Program; otherwise, **enter blank**. Refer to Part A, Sec. 16, for further information. Forms 1098, 1099–A, 1099–B, 1099–C, 1099–LTC, 1099–MSA, 1099–S, 5498–MSA and W–2G **cannot** be filed under this program.
22	Type of Return	1	**Required**. Enter the appropriate code from the table below: **Type of Return** — **Code** 1098 — 3 1099–A — 4 1099–B — B 1099–C — 5 1099–DIV — 1 1099–G — F 1099–INT — 6 1099–LTC — T 1099–MISC — A 1099–MSA — M 1099–OID — D 1099–PATR — 7 1099–R — 9 1099–S — S 5498 — L 5498–MSA — K W–2G — W
23–31	Amount Codes (See **Note**)	9	**Required**. Enter the appropriate amount codes for the type of return being reported. Generally, for each amount code entered in this field, a corresponding payment amount **must** appear in the Payee "B" Record. **In most cases, the box numbers on paper information returns correspond with the amount codes used to file magnetically/electronically. However, if discrepancies occur, this revenue procedure governs.**

.02 The number of "A" Records depends on the number of payers and the different types of returns being reported. The payment amounts for one payer and for one type of return should be consolidated under one "A" Record if submitted on the same file.

.03 Do not submit separate "A" Records for each payment amount being reported. For example, if a payer is filing Form 1099–DIV to report Amount Codes 1, 2, and 3, all three amount codes should be reported under one "A" Record, not three separate "A" Records. For "B" Records that do not contain payment amounts for all three amount codes, enter zeros for those which have no payment to be reported.

.04 The first record on the file must be an "A" Record. A transmitter may include "B" Records for more than one payer on a tape or diskette. However, each **group** of "B" Records must be preceded by an "A" Record and followed by an End of Payer "C" Record. A single tape or diskette may contain different types of returns but the types of returns **must not** be intermingled. A separate "A" Record is required for each payer and each type of return being reported.

.05 All records must be a fixed length of 420 positions.

.06 An "A" Record may be blocked with "B" Records, however, the initial record on a file must be an "A" Record. IRS/MCC will accept an "A" Record after a "C" Record.

.07 Do not begin any record at the end of a block or diskette and continue the same record into the next block or diskette.

.08 All alpha characters entered in the "A" Record must be upper-case.

.09 When filing Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name of the recipient of the interest referred to as the payer in these instructions. The "B" Record will reflect the individual paying the interest (borrower/payer of record) and the amount paid.

☞ **Note: For all fields marked Required, the transmitter must provide the information described under Description and Remarks. For those fields not marked Required, a transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated media position(s) and for the indicated length. All records are now a fixed length of 420 positions.**

Record Name: Payer/Transmitter "A" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "A."
2–3	Payment Year	2	**Required**. Enter *"97"* (unless reporting prior year data).
4–6	Reel Sequence Number	3	The reel sequence number is incremented by 1 for each tape or diskette on the file starting with 001. The transmitter may enter blanks or zeros in this field. IRS/MCC bypasses this information. Indicate the proper sequence on the external media label.
7–15	Payer's TIN	9	**Required**. Must be the valid nine-digit Taxpayer Identification Number assigned to the payer. **Do not enter blanks, hyphens, or alpha characters.** All zeros, ones, twos, etc., will have the effect of an incorrect TIN.

☞ **Note:** For foreign entities that are not required to have a TIN, this field **must be blank.** However, the Foreign Entity Indicator, position 49 of the "A" Record, must be set to "1" (one).

16–19	Payer Name Control	4	The Payer Name Control can be obtained only from the mail label on the Package 1099 that is mailed to most payers each December. To distinguish between Package 1099 and the Magnetic Media Reporting (MMR) Package, the Package 1099 contains instructions for paper filing only, and the mail label on the package contains a four (4) character name control. The MMR Package contains instructions for filing magnetically or

Size	*Tracks*	*Density*	*Capacity*
QIC-11	*4/5*	*4 (8000 BPI)*	*22Mb or 30Mb*
QIC-24	*8/9*	*5 (8000 BPI)*	*45Mb or 60Mb*
QIC-120	*15*	*15 (10000 BPI)*	*120Mb or 200Mb*
QIC-150	*18*	*16 (10000 BPI)*	*150Mb or 250Mb*
QIC-320	*26*	*17 (16000 BPI)*	*320Mb*
QIC-525	*26*	*17 (16000 BPI)*	*525Mb*
QIC-1000	*30*	*21 (36000 BPI)*	*1Gb*
QIC-1350	*30*	*18 (51667 BPI)*	*1.3Gb*
QIC-2Gb	*42*	*34 (40640 BPI)*	*2Gb*

(c) *The general specifications that apply to 8mm cartridges will also apply to QIC cartridges.*

Sec. 5. 5 1/4-inch And 3 1/2-inch Diskette Specifications

.01 To be compatible, a diskette file must meet the following specifications:

(a) *5 1/4- or 3 1/2-inches in diameter.*

(b) *IRS recommends data be recorded in standard ASCII code. However, if data is recorded using EBCDIC, a 5 1/4-inch diskettes must be used and a 1024 byte sector would be valid for System 36 or AS400.*
The following command to format the diskette into a 1024 byte sector is: ***INIT IRSTAX,,FORMAT2***
The save commands are as follows:
(1) *The save command for System 36 is SAVE.*
(2) *The save command for AS400 is SAF36F.*

(c) Records must be a fixed length of 420 bytes per record.

(d) Delimiter character commas (,) must not be used.

(e) Positions 419 and 420 of each record have been reserved for use as carriage return/line feed (cr/lf) characters, if applicable.

(f) Filename of IRSTAX must be used. Do not enter any other data in this field. If a file will consist of more than one diskette, the filename IRSTAX will contain a three-digit extension. This extension will indicate the sequence of the diskettes within the file. For example, the first diskette will be named IRSTAX.001, the second diskette will be IRSTAX.002, etc.

(g) A diskette file may consist of multiple diskettes as long as the file naming conventions are followed.

(h) Diskettes must meet one of the following specifications:

Capacity	*Tracks*	*Sides/Density*	*Sector Size*
1.44 mb	*96tpi*	*hd*	*512*
1.44 mb	*135tpi*	*hd*	*512*
1.2 mb	*96tpi*	*hd*	*512*
720 kb	*48tpi*	*ds/dd*	*512*
360 kb	*48tpi*	*ds/dd*	*512*
320 kb	*48tpi*	*ds/dd*	*512*
180 kb	*48tpi*	*ss/dd*	*512*
160 kb	*48tpi*	*ss/dd*	*512*

.02 IRS/MCC encourages transmitters to use blank or currently formatted diskettes when preparing files (See **Note**). If extraneous data follows the End of Transmission "F" Record, the file must be returned for replacement.

.03 IRS/MCC prefers that 5 1/4- and 3 1/2-inch diskettes be created using MS-DOS; however, diskettes created using other operating systems may be acceptable. IRS/MCC has equipment that can convert diskettes created under most operating systems to the appropriate MS-DOS format. IRS/MCC strongly recommends that transmitters submit a test file for 5 1/4- and 3 1/2-inch diskettes, especially if their data was not created using MS-DOS.

☞ **Note: 3 1/2-inch diskettes created on a System 36 or AS400 are not acceptable.**

.04 Transmitters are encouraged to use high density diskettes. Low density diskettes are acceptable but must be formatted in low density.

.05 Transmitters should check media for viruses before submitting media to IRS/MCC.

Sec. 6. Payer/Transmitter "A" Record — General Field Descriptions

.01 The Payer/Transmitter "A" Record identifies the payer and transmitter of the magnetic media file and provides parameters for the succeeding Payee "B" Records. IRS computer programs rely on the absolute relationship between the parameters and data fields in the "A" Record and the data fields in the "B" Records to which they apply.

☞ **Note: Filers should indicate on the external media label and transmittal Form 4804 whether the cartridge is 36-track or 18-track.**

Sec. 4. 8mm, 4mm, and Quarter Inch Cartridge Specifications

.01 In most instances, IRS/MCC can process 8mm tape cartridges that meet the following specifications:

(a) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:

(1) Created from an AS400 operating systems only.

(2) 8mm (.315-inch) tape cartridges will be 2 1/2-inch by 3 3/4-inch.

(3) The 8mm tape cartridges must meet the following specifications:

Tracks	*Density*	*Capacity*
1	*20 (43245 BPI)*	*2.3 Gb*
1	*21 (45434 BPI)*	*5 Gb*

(4) Mode will be full function.

(5) Compressed data is not acceptable.

(6) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used. However, IRS/MCC encourages the use of EBCDIC. This information must appear on the external media label affixed to the cartridge.

(7) A file may consist of more than one cartridge, however, no more than 250,000 documents may be transmitted per file or per cartridge. The filename, for example; IRSTAX, will contain a three digit extension. The extension will indicate the sequence of the cartridge within the file (*e.g.,* 1 of 3, 2 of 3, and 3 of 3 and would appear in the header label IRSTAX.001, IRSTAX.002, and IRSTAX.003 on each cartridge of the file). ***The end of transmission "F" Record should be placed on the last cartridge only for files containing multiple cartridges.***

.02 The 8mm (.315-inch) tape cartridge records defined in this revenue procedure may be blocked subject to the following:

(a) A block **must not** exceed 32,760 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. **Do not pad a block with blanks.**

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item (b) above). The block length must be evenly divisible by 420.

(d) *Various COPY commands have been successful, however, the SAVE OBJECT COMMAND is not acceptable.*

(e) Extraneous data following the "F" record will result in media being returned for replacement.

(f) Records may not span blocks.

(g) No more than 250,000 documents per cartridge and per file.

.03 For faster processing, IRS/MCC encourages transmitters to use header labeled cartridges. IRSTAX may be used as a suggested filename.

.04 For the purposes of this revenue procedure, the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

.05 If extraneous data follows the End of Transmission "F" Record, the file must be returned for replacement. Therefore, IRS/MCC encourages transmitters to use blank tape cartridges, rather than cartridges previously used, in the preparation of data when submitting information returns.

.06 IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tapemark, but must end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

.07 *4mm (.157-inch) cassettes are now acceptable with the following specifications:*

(a) *4mm cassettes will be 2 1/4-inch by 3-inch.*

(b) *The tracks are 1 (one).*

(c) *The density is 19 (61000 BPI).*

(d) *The typical capacity is DDS (DAT Data Storage) at 1.3 Gb or 2 Gb, or DDS-2 at 4 Gb.*

(e) *The general specifications for 8mm cartridges will also apply to the 4mm cartridges.*

.08 *Various Quarter Inch Cartridges (QIC) (1/4-inch) are also acceptable.*

(a) *QIC cartridges will be 4" by 6".*

(b) *QIC cartridges must meet the following specifications:*

(2) A density of 1600 or 6250 CPI.
(3) If transmitters use UNISYS Series 1100, they must submit an interchange tape.

(b) 9 track ASCII (American Standard Coded Information Interchange) with:
(1) Odd parity.
(2) A density of 1600 or 6250 CPI.

Transmitters should be consistent in the use of recording codes and density on files.

.02 All compatible tape files must have the following characteristics: Type of tape - 1/2-inch (12.7 mm) wide, computer-grade magnetic tape on reels of up to 2,400 feet (731.52 m) within the following specifications:

(a) Tape thickness: 1.0 or 1.5 mils and

(b) Reel diameter: 10 1/2-inch (26.67 cm), 8 1/2-inch (21.59 cm), 7-inch (17.78 cm), or 6-inch.

.03 The tape records defined in this revenue procedure may be blocked subject to the following:

(a) A block must not exceed 32,760 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. **Do not pad a block with blanks.**

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item b above). The block length must be evenly divisible by 420.

(d) Records may not span blocks.

.04 Labeled or unlabeled tapes may be submitted.

.05 For the purposes of this revenue procedure the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

.06 IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tapemark, but **must** end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

Sec. 3. Tape Cartridge Specifications

.01 In most instances, IRS/MCC can process tape cartridges that meet the following specifications:

(a) Must be IBM 3480, 3490, 3490E, or AS400 compatible.

(b) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:
(1) Tape cartridges will be 1/2-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.
(2) Magnetic tape will be chromium dioxide particle based 1/2-inch tape.
(3) Cartridges must be 18-track or 36-track parallel (See **Note**).
(4) Cartridges will contain 37,871 CPI or 75,742 CPI (characters per inch).
(5) Mode will be full function.
(6) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.
(7) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used.

.02 The tape cartridge records defined in this revenue procedure may be blocked subject to the following:

(a) A block **must not** exceed 32,760 tape positions.

(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. **Do not pad a block with blanks.**

(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within the block. The number of logical records within a block (the blocking factor) must be constant in every block with the exception of the last block which may be shorter (see item b above). The block length must be evenly divisible by 420.

(d) Records may not span blocks.

.03 Tape cartridges may be labeled or unlabeled.

.04 For the purposes of this revenue procedure, the following must be used:

Tape Mark:

(a) Used to signify the physical end of the recording on tape.

(b) For even parity, use BCD configuration 001111 (8421).

(c) May follow the header label and precede and/or follow the trailer label.

6. Incorrect tax year in the Payer "A" Record and the Payee "B" Record
The tax year in both the payer and payee records should reflect the year of the information that is being reported. Filers need to check their files to ensure that this information is correct.

7. Incorrect reporting of Form W-2 information to IRS
Form W–2 information is submitted to SSA, and **not** to IRS/MCC. SSA has its own magnetic media reporting program and specifications for wage information, and the media containing Forms W-2 is submitted to SSA. Any media received at IRS/MCC that contains Form W–2 information will be returned to the filer. The local SSA office should be contacted for information concerning filing Forms W–2 on magnetic media.

8. Excessive withholding credits
Generally, for most information returns, other than Forms 1099–G, 1099–MISC, 1099–R, and W–2G, Federal withholding amounts should **not** exceed 31 percent of the income reported. Validate the total reported in the withholding field against the total income reported.

9. Incorrect format for TINs in the Payee "B" Record
A check of "B" Records should be made to ensure the Taxpayer Identification Numbers (TINs) are formatted correctly. There should be nine numerics, no alphas, hyphens, commas, or blanks. Incorrect formatting of TINs may result in a penalty.

IRS/MCC contacts filers who have submitted payee data with missing TINs in an attempt to prevent erroneous notices. Payers/transmitters who submit data with missing TINs, and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This will prevent unnecessary contact from IRS/MCC. This letter, however, will not prevent backup withholding notices (CP2100 and CP2100A Notices) or penalties for missing or incorrect TINs. For penalty information, refer to the Penalty section of the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G."

10. Distribution Codes for Form 1099-R reported incorrectly
Distribution codes for Form 1099-R are being reported incorrectly or not being reported. See valid distribution codes for Form 1099–R in the Payee "B" Record layout.

11. Incorrect Record Totals Listed on Form 4804
The Combined Total Payee Records listed on the Form 4804 (Box 9) are used in the verification process of information returns. The figure in this box should be the total number of Payee "B" Records contained on the media submitted with the Form 4804. The figures on the Form 4804 are compared against the total number of Payee "B" Records processed on the media. Imbalances may necessitate the return of the files for replacement.

12. Invalid Use of IRA/SEP/*SIMPLE* Indicator
The IRA, SEP, or *SIMPLE* Indicator for Form 1099-R should be used only for the reporting of a distribution from an IRA, SEP or *SIMPLE*. The total amount distributed from an IRA, SEP or *SIMPLE* should be reported in Payment Amount Field 2 (IRA/SEP/*SIMPLE* Distribution).

Part B. Magnetic Media Specifications

Sec. 1. General

.01 The specifications contained in this part of the revenue procedure define the required format and contents of the records to be included in the magnetic media file.

.02 A provision is made in the "B" Records for Special Data Entries. These entries are optional. If the field is not utilized, enter blanks to maintain a fixed record length of 420 positions. The field is intended to serve one or both of these purposes:

(a) Contain information required by state or local governments. Filers who wish to use this option for satisfying state or local reporting requirements should contact the state or local department of revenue for filing instructions. (Also refer to Part A, Sec. 16.)

(b) Contain information for the filer's own personal use and used at the discretion of the filer to include information related to each individual return. IRS/MCC will not use the information supplied in this field. The length of this field will vary depending on the type of return.

.03 Transmitters should be consistent in the use of recording codes and density on files. If the media does not meet these specifications, it could be returned to the transmitter for replacement. Filers are encouraged to submit a test prior to submitting the actual file. Contact IRS/MCC for further information at 304-263-8700.

Sec. 2. Tape Specifications

.01 IRS/MCC can process most magnetic tape files if the following specifications are followed:

(a) 9 track EBCDIC (Extended Binary Coded Decimal Interchange Code) with:

(1) Odd parity.

.02 Filers must adhere to the city, state, and ZIP code format for U.S. addresses in the "B" Record. This also includes American Samoa, Federated States of Micronesia, Guam, Marshall Islands, Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

.03 For foreign country addresses, filers may use a 40 position free format which should include city, province or state, postal code, and name of country in this order. This is allowable only if a "1" (one) appears in the Foreign Country Indicator, Field Position 161 of the "B" Record.

.04 When reporting APO/FPO addresses use the following format:

EXAMPLE:

Payee Name	PVT Willard J. Doe
Mailing Address	Company F, PSC Box 100
	167 Infantry REGT
Payee City	APO (or FPO)
Payee State	AE, AA, or AP*
Payee ZIP Code	098010100

*AE is the designation for ZIPs beginning with 090-098, AA for ZIP 340, and AP for ZIPs 962-966.

Sec. 19. Major Problems Encountered

IRS/MCC encourages filers to verify the format and content of each type of record to ensure the accuracy of the data. This may eliminate the need for IRS/MCC to return files for replacement. This may be important for those payers who have either had their files prepared by a service bureau or who have purchased preprogrammed software packages (see **Note**). If a filer purchased a software package for a previous tax year, it may no longer be valid for reporting current tax year information returns.

☞ **Note: If filers meet the filing requirements and engage a service bureau to prepare media on their behalf, the filers should be careful not to report duplicate data which may generate penalty notices.**

The Major Problems Encountered lists some of the most frequently encountered problems with magnetic/electronic files submitted to IRS/MCC. These problems may result in media being returned for replacement.

1. Discrepancy between IRS/MCC totals and totals in Payer "C" Records
The "C" Record is a summary record for a type of return for a given payer as reported in the "B" Records. IRS balances the total number of payees and payment amounts and compares them with totals in the "C" Records. Filers should verify the accuracy of the records because imbalances may necessitate return of files for replacement.

2. The Payment Amount Fields in the "B" Record do not correspond to the Amount Codes in the "A" Record
If codes 2, 4, and 7 appear in the Amount Codes Field of the "A" Record, then the "B" Record must show payment amounts in only Fields 2, 4, and 7, right-justified and unused positions **must be** zero (0) filled.

EXAMPLE:	"A" RECORD	247bbbbbb (Pos. 23–31)	—	('b' denotes a blank)
	"B" RECORD	0000867599 (Pos. 61–70)	—	(Payment Amount 2)
		0000709097 (Pos. 81–90)	—	(Payment Amount 4)
		0000044985 (Pos. 111–120)	—	(Payment Amount 7)

3. Blanks or invalid characters appear in Payment Amount Fields in the "B" Record
Money amounts must be right-justified and zero (0) filled. **Do not use blanks.**

4. Incorrect TIN in Payer "A" Record
The Payer's TIN reported in positions 7-15 of the "A" Record must be nine numeric characters (no alphas or special characters) in order for IRS/MCC to process the media. The TIN provided in the "A" Record **must** correspond with the name provided in the first payer name line.

5. Bad Format
IRS/MCC receives data in prior year format. Be sure to use **the current revenue procedure (Publication 1220)** for formatting data.

Taxpayer Identification Number (TIN)	Refers to either an Employer Identification Number (EIN), Social Security Number (SSN) or *Individual Taxpayer Identification Number (ITIN).*
Tax year	Generally, the year in which payments were made by a payer to a payee.
Transfer Agent	The transfer agent, or paying agent, is the entity who has been contracted or authorized by the payer to perform the services of paying and reporting backup withholding (Form 945).
Transmitter	Refers to the person or organization submitting file(s) magnetically/ electronically. The transmitter may be the payer or agent of the payer.
Transmitter Control Code (TCC)	A five character alpha/numeric number assigned by IRS/MCC to the transmitter prior to actual filing magnetically or electronically. This number is inserted in the "A" Record of the files and **must** be present before the file can be processed. An application Form 4419 must be filed with IRS/MCC to receive this number.
Vendor	Vendors include service bureaus that produce information return files on the prescribed types of magnetic media or via electronic filing for payers. Vendors also include companies who provide software for payers who wish to produce their own media or electronic files.

Sec. 18. State Abbreviations

.01 The following state and U.S. territory abbreviations are to be used when developing the state code portion of address fields. This table provides state and territory abbreviations only, and does not represent those states participating in the Combined Federal/State Filing Program.

State	Code	State	Code	State	Code
Alabama	AL	Kentucky	KY	Ohio	OH
Alaska	AK	Louisiana	LA	Oklahoma	OK
American Samoa	AS	Maine	ME	Oregon	OR
Arizona	AZ	Marshall Islands	MH	Pennsylvania	PA
Arkansas	AR	Maryland	MD	Puerto Rico	PR
California	CA	Massachusetts	MA	Rhode Island	RI
Colorado	CO	Michigan	MI	South Carolina	SC
Connecticut	CT	Minnesota	MN	South Dakota	SD
Delaware	DE	Mississippi	MS	Tennessee	TN
District of Columbia	DC	Missouri	MO	Texas	TX
Federated States		Montana	MT	Utah	UT
of Micronesia	FM	Nebraska	NE	Vermont	VT
Florida	FL	Nevada	NV	Virginia	VA
Georgia	GA	New Hampshire	NH	Virgin Islands*	VI
Guam	GU	New Jersey	NJ	Washington	WA
Hawaii	HI	New Mexico	NM	West Virginia	WV
Idaho	ID	New York	NY	Wisconsin	WI
Illinois	IL	North Carolina	NC	Wyoming	WY
Indiana	IN	North Dakota	ND		
Iowa	IA	Northern Mariana Islands	MP		
Kansas	KS				

*This abbreviation applies to the United States Virgin Islands

	1099–A, 1099–B, 1099–C, 1099–DIV, 1099–G, 1099–INT, *1099–LTC*, 1099–MISC, *1099–MSA*, 1099–OID, 1099–PATR, 1099–R, 1099–S, 5498, *5498–MSA* or W–2G.
Magnetic Media	For this revenue procedure, the term "magnetic media" refers to 1/2-inch magnetic tape; IBM 3480/3490/3490E or AS400 compatible tape cartridge; 8mm, 4mm, and QIC (Quarter Inch Cartridges) cartridges or 5 1/4- and 3 1/2-inch diskette.
Media Tracking Slip	Form 9267 accompanies media that IRS/MCC has returned to the filer for replacement due to incorrect format or errors encountered when trying to process the media. **This must be returned with the replacement file.**
Missing Taxpayer Identification Number (Missing TIN)	The payee TIN on an information return is "missing" if: (a) there is no entry in the TIN field, (b) includes one or more alpha characters (a character or symbol other than an Arabic number) as one of the nine digits, OR (c) payee TIN has less than nine digits
PS 58 Costs	The current cost of life insurance under a qualified plan taxable under section 72(m) and section 1.72–16(b) of the Income Tax Regulations. (See Part B, Sec. 7, Payee "B" Record, Document Specific/Distribution Code, Category of Distribution, Code 9.)
Payee	Person or organization receiving payments from the payer, or for whom an information return must be filed. The payee includes a borrower (Form 1099–A), a debtor (1099–C), *a policyholder or insured (Form 1099–LTC)*, an IRA, SEP, or SIMPLE plan participant (Form 5498), and a gambling winner (Form W–2G). For Form 1098, the payee is the individual paying the interest. For Form 1099–S, the payee is the seller or other transferor.
Payer	Includes the person making payments, a recipient of mortgage interest payments, a broker, a person reporting a real estate transaction, a barter exchange, a creditor, a trustee, or issuer of an IRA, SEP, or SIMPLE, or a lender who acquires an interest in secured property or who has reason to know that the property has been abandoned. The payer will be held responsible for the completeness, accuracy, and timely submission of magnetic media files.
Replacement	A replacement is an information return file that IRS/MCC has returned to the transmitter due to errors encountered during processing.

☞ **Note: Filers should never submit media to IRS/MCC marked "Replacement" unless IRS/MCC returned media to the filers. When sending "Replacement" media, be sure to include the Media Tracking Slip (Form 9267) which will accompany media returned by IRS/MCC. Media that has been incorrectly marked as Replacement may result in duplicate filing.**

Service Bureau	Person or organization with whom the payer has a contract to prepare and/or submit information return files to IRS/MCC. A parent company submitting data for a subsidiary is not considered a service bureau.
Social Security Number (SSN)	A nine-digit number assigned by SSA to an individual for wage and tax reporting purposes.
Special Character	Any character that is not a numeral, an alpha, or a blank.
SSA	Social Security Administration.

208B (4800bps), AT&T 2296A (9600bps) or Hayes OPTIMA 288 V.FC Smartmodem (14400bps) modems. Standard IBM 3780 space compression is acceptable.

Correction — A correction is an information return submitted by the transmitter to correct an information return that was previously submitted to and processed by IRS/MCC, but contained erroneous information.

☞ **Note: A correction should not be confused with a replacement. Only media returned to the filer by IRS/MCC due to processing problems should be marked replacement.**

CUSIP Number — A number developed by the Committee on Uniform Security Identification Procedures to serve as a common denominator in communications among users for security transactions and security information.

Employer Identification Number (EIN) — A nine-digit number assigned by IRS for federal tax reporting purposes.

Electronic Filing — Submission of information returns using switched telecommunications network circuits. These transmissions use modems, dial-up phone lines, and asynchronous or bisynchronous protocols. See Parts A, C, and D of this publication for specific information on electronic filing.

File — For purposes of this revenue procedure, a file consists of all records submitted by a payer or transmitter, either magnetically or electronically.

Filer — Person (may be payer and/or transmitter) submitting information returns to IRS.

Filing Year — The actual year in which the information returns are being submitted to IRS.

Golden Parachute Payment — A payment made by a corporation to a certain officer, shareholder, or highly compensated individual when a change in the ownership or control of the corporation occurs or when a change in the ownership of a substantial part of the corporate assets occurs.

Incorrect Taxpayer Identification Number (Incorrect TIN) — A TIN may be incorrect for several reasons:

(a) The payee provided a wrong number or name (*e.g.*, the payee is listed as the only owner of an account but provided someone else's TIN).

(b) A processing error (*e.g.*, the number or name was typed incorrectly).

(c) The payee's status changed (*e.g.*, a payee name change was not conveyed to the IRS or SSA so that they could enter the change in their records).

Individual Taxpayer Identification Number (ITIN) — *A nine digit number issued by IRS to individuals who are required to have a U.S. taxpayer identification number but are not eligible to obtain a Social Security Number (SSN).*

Information Return — The vehicle for submitting required information about another person to IRS. Information returns are filed by financial institutions and by others who make certain types of payments as part of their trade or business. The information required to be reported on an information return includes interest, dividends, pensions, nonemployee compensation for personal services, stock transactions, sales of real estate, mortgage interest, and other types of information. For this revenue procedure, an information return is a Form 1098,

Table 1. Participating States And Their Codes—Continued

State	Code	State	Code	State	Code
California	06	Massachusetts	25	South Carolina	45
Delaware	10	Minnesota	27	Tennessee	47
District of Columbia	11	Mississippi	28	Wisconsin	55
Georgia	13	Missouri	29		
Hawaii	15	Montana	30		
Idaho	16	New Jersey	34		
Indiana	18	New Mexico	35		

Table 2. Dollar Criteria For State Reporting

STATE	1099–DIV	1099–G	1099–INT	1099–MISC	1099–OID	1099–PATR	1099–R	5498
Alabama	$1500	$ NR	$1500	$1500	$1500	$1500	$1500	NR
Arkansas	100	2500	100	2500	2500	2500	2500	[a]
District of Columbia[b]	600	600	600	600	600	600	600	NR
Hawaii	10	a	10	600	10	10	600	a
Idaho	*NR*	*NR*	*NR*	600	*NR*	*NR*	a	a
Iowa	100	1000	1000	1000	1000	1000	1000	NR
Minnesota	10	10	10	600	10	10	600	a
Mississippi	600	600	600	600	600	600	600	NR
Missouri	NR	NR	NR	1200[c]	NR	NR	NR	NR
Montana	10	10	10	600	10	10	600	a
New Jersey	1000	1000	1000	1000	1000	1000	1000	NR
North Carolina	100	100	100	600	100	100	100	a
Tennessee	25	NR	25	NR	NR	NR	NR	NR
Wisconsin	NR	NR	NR	600	NR	NR	600	NR

The preceding list is for information purposes only. The state filing requirements are subject to change by the states. For complete information on state filing requirements, contact the appropriate state tax agencies.

Filing requirements for states in TABLE 1 not shown in TABLE 2 are the same as the federal requirement.

NR = No filing requirement

Footnotes:

a. All amounts are to be reported.

b. Amounts are for aggregates of several types of income from the same payer.

c. Missouri would prefer those returns filed with respect to non-Missouri residents to be sent directly to their state agency.

Sec. 17. Definition of Terms

Element	*Description*
Asynchronous Protocols	This type of data transmission is most often used by microcomputers, PCs and some minicomputers. Asynchronous transmissions transfer data at arbitrary time intervals using the start-stop method. Each character transmitted has its own start bit and stop bit.
b	Denotes a blank position. Enter blank(s) when this symbol is used (do not enter the letter "b"). This appears in numerous areas throughout the record descriptions.
Bisynchronous Protocols	For purposes of this publication, these are electronic transmissions made using IBM 3780 protocols. These transmissions must be in EBCDIC character code and use the Bell

Sec. 16. Combined Federal/State Filing Program

.01 The Combined Federal/State Filing Program was established to simplify information returns filing for the taxpayer. IRS/MCC will forward this information to participating states free of charge for approved filers. Separate reporting to those states is not necessary. The following information returns **may not** be filed under this program:

Form 1098 — Mortgage Interest Statement
Form 1099–A — Acquisition or Abandonment of Secured Property
Form 1099–B — Proceeds From Broker and Barter Exchange Transactions
Form 1099–C — Cancellation of Debt
Form 1099–LTC — Long-Term Care and Accelerated Death Benefits
Form 1099–MSA — Distributions From Medical Savings Accounts
Form 1099–S — Proceeds From Real Estate Transactions
Form 5498–MSA — Medical Savings Account Information
Form W–2G — Certain Gambling Winnings

.02 To request approval to participate, a magnetic media or electronic test file coded for this program **must** be submitted to IRS/MCC between November 1 and December 31. **Hard copy print tests are not acceptable** for Combined Federal/State Filing approval.

.03 Attach a letter to the Form 4804 submitted with the test file to indicate a desire to participate in this program.

.04 A test file is only required for the first year. Each record, both in the test and the actual data file, must conform to this revenue procedure.

.05 If the test file is acceptable, IRS/MCC will send the filer an approval letter, and a Form 6847, Consent for Internal Revenue Service to Release Tax Information, which the payer **must** complete, sign, and return to IRS/MCC before any tax information can be released to the state. Filers must write their TCC on Form 6847.

.06 If the test file is not acceptable, IRS/MCC will return the media with a letter indicating the problems. The replacement test file must be returned to IRS/MCC on or before December 31.

.07 A separate Form 6847 is **required** for each payer. A transmitter may not combine payers on one Form 6847 even if acting as Attorney-in-Fact for several payers. Form 6847 may be computer-generated as long as it includes all information that is on the original form or it may be photocopied. If the Form 6847 is signed by an Attorney-in-Fact, the written consent from the payer must clearly indicate that the Attorney-in-Fact is empowered to authorize release of the information.

.08 Only code the records for participating states and for those payers who have submitted Form 6847.

.09 Some participating states require separate notification that the payer is filing in this manner. Since IRS/MCC acts as a forwarding agent only, **it is the payer's responsibility to contact the appropriate states for further information.**

.10 All corrections properly coded for the Combined Federal/ State Filing Program will be forwarded to the participating states.

.11 Participating states and corresponding valid state codes are listed in **Table 1** of this section. The appropriate state code **must** be entered for those documents that meet the state filing requirements; **do not use state abbreviations.**

.12 To simplify filing, some of the participating states have provided their information return reporting requirements (see **Table 2**). **State filing regulations are subject to change by the state. It is the payer's responsibility to contact the participating states to verify the criteria provided in this table.**

.13 Upon submission of the actual files, the transmitter must be sure of the following:

(a) All records should be coded exactly as required by this revenue procedure.

(b) The "C" Record **must be** followed by a State Totals "K" Record for each state being reported.

(c) Payment amount totals and the valid participating state code must be included in the State Totals "K" Record.

(d) The last "K" Record **must be** followed by an "A" Record or an End of Transmission "F" Record (if this is the last record of the entire file).

Table 1. Participating States And Their Codes

State	Code	State	Code	State	Code
Alabama	01	Iowa	19	North Carolina	37
Arizona	04	Kansas	20	North Dakota	38
Arkansas	05	Maine	23	Oregon	41

Chart 1. Guidelines for Social Security Numbers—Continued

For this type of account-	In the Taxpayer Identification Number Field of the Payee "B" Record, enter the SSN of-	In the First Payee Name Line of the Payee "B" Record, enter the name of-
5. A so-called trust account that is not a legal or valid trust under state law	The actual owner	The actual owner
6. Sole proprietorship	The owner (An SSN or EIN)	The owner, not the business name (the filer may enter the business name on the second name line).

Chart 2. Guidelines for Employer Identification Numbers

For this type of account-	In the Taxpayer Identification Number Field of the Payee "B" Record, enter the EIN of-	In the First Payee Name Line of the Payee "B" Record, enter the name of-
1. A valid trust, estate, or pension trust	The legal entity [1]	The legal trust, estate, or pension trust[1]
2. Corporate	The corporation	The corporation
3. Association, club, religious, charitable, educational, or other tax-exempt organization	The organization	The organization
4. Partnership account held in the name of the business	The partnership	The partnership
5. A broker or registered nominee/ middleman	The broker or nominee/middleman	The broker or nominee/middleman
6. Account with Department of Agriculture in the name of a public entity (such as a state or local government, school district, or prison), that receives agriculture program payments	The public entity	The public entity
7. Sole proprietorship	The business (An EIN or SSN)	The owner, not the business name (the filer may enter the business name on the second name line).

[1] Do not furnish the identification number of the personal representative or trustee unless the name of the representative or trustee is used in the account title.

Sec. 15. Effect on Paper Returns and Statements to Recipients

.01 Magnetic/electronic reporting of information returns eliminates the need to submit paper documents to the IRS. **CAUTION! Do not send Copy A of the paper forms to IRS/MCC in addition to magnetic media and electronic filing.** This will result in duplicate filing; therefore, erroneous notices could be generated.

.02 Payers are responsible for providing statements to the recipients as outlined in the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G." Refer to these instructions for filing information returns on paper with the IRS and furnishing statements to recipients.

.03 Statements to recipients should be clear and legible. If the official IRS form is not used, the filer must adhere to the specifications and guidelines in Publication 1179, "Rules and Specifications for Private Printing of Substitute Forms 1096, 1098, 1099 series, 5498, and W–2G."

2. Original return was filed with one or more of the following errors:
   (a) Incorrect payment amount codes in the "A" Record
   (b) Incorrect payment amounts in the "B" Record
   (c) Incorrect code in the document specific/distribution code field in the "B" Record
   (d) Incorrect payee address
   (e) Direct sales indicator

   A. Prepare a new Form 4804/4802 that includes information relating to this new file.
   B. Mark "Correction" in Block 1 of Form 4804.
   C. Prepare a new file. Make separate "A" Records for each type of return being reported. Information in the "A" Record may be the same as it was in the original submission.
   D. The "B" Record must show the correct information as well as a "G" in Field Position 7.
   E. Corrected returns submitted to IRS/MCC using a "G" coded "B" Record may be on the same tape or diskette as those returns submitted without the "G" code; **however, separate "A" Records are required.**
   F. Prepare a "C" Record.
   G. Mark "Correction" on the external media label.

☞ **Note 2: If a filer is correcting the name and/or TIN in addition to any errors listed in item 2 of the chart, then two transactions will be required. If a filer is reporting "G" coded, "C" coded, and/or "Non-coded" (original) returns on the same media, they must be reported under separate "A" Records.**

Sec. 14. Taxpayer Identification Number (TIN)

.01 Section 6109 of the Internal Revenue Code requires a person to furnish his/her TIN to the person obligated to file the information return.

.02 The payee's TIN and name combination is used to associate information returns reported to IRS/MCC with corresponding information on tax returns. It is imperative that **correct** Social Security Number (SSN), Individual Tax Identification Number (ITIN), and Employer Identification Number (EIN), for payees be provided to IRS/MCC. **Do not enter hyphens or alpha characters.** Entering all zeros, ones, twos, etc., will have the effect of an incorrect TIN.

.03 The payer and payee names with associated TINs should be consistent with the names and TINs used on other tax returns. Also, the name and TIN provided must belong to the owner of the account. If the account is recorded in more than one name, furnish the name and TIN of one of the owners of the account. The TIN provided **must** be associated with the name of the payee provided in the first name line of the "B" Record. For individuals, the payee TIN is generally the payee's Social Security Number. For other entities, the payee TIN is the payee's Employer Identification Number. For sole proprietors, the payee TIN may be either an SSN or EIN but **the sole proprietor's name** (not the business name) **must be used on the first name line**.

.04 Failure to provide the correct name and corresponding TIN could result in a penalty and/or backup withholding notice (sometimes referred to as a "B" Notice). (For penalty information, refer to the Penalty section of the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G." For "B" Notice information, refer to the Backup Withholding section of the same publication.)

.05 The following charts will help payers determine the TIN to be furnished to IRS/MCC for those persons for whom they are reporting information (payees).

Chart 1. Guidelines for Social Security Numbers

For this type of account-	In the Taxpayer Identification Number Field of the Payee "B" Record, enter the SSN of-	In the First Payee Name Line of the Payee "B" Record, enter the name of-
1. Individual	The individual	The individual
2. Joint account (Two or more individuals, including husband and wife)	The actual owner of the account or, if combined funds, the first individual on the account	The individual whose SSN is entered
3. Custodian account of a minor (Uniform Gift, or Transfers, to Minors Act)	The minor	The minor
4. The usual revocable savings trust account (grantor is also trustee)	The grantor-trustee	The grantor-trustee

.10 The "B" Record provides a 20-position field for the Payer's Account Number for the Payee. This number will help identify the appropriate incorrect return if more than one return is filed for a particular payee. **Do not enter a TIN in this field.** A payer's account number for the payee may be a checking account number, savings account number, serial number, or any other number assigned to the payee by the payer that will distinguish the specific account. This number should appear on the initial return and on the corrected return in order to identify and process the correction properly.

.11 The record sequence for filing corrections is the same as for original returns.

.12 Review the chart that follows. Errors normally fall under one of the two categories listed. Next to each type of error made is a list of instructions on how to file the corrected return.

Guidelines for Filing Corrected Returns Magnetically/Electronically

Error Made on the Original Return	How To File the Corrected Return

Two (2) separate transactions are required to make the following corrections properly. Follow the directions for both Transactions 1 and 2. (See Note 1)

1. Original return was filed with one or more of the following errors:
   - **(a)** No payee TIN (SSN or EIN)
   - **(b)** Incorrect payee TIN
   - **(c)** Incorrect payee name
   - **(d)** Wrong type of return indicator

Transaction 1: Identify incorrect returns

- **A.** Prepare a new Form 4804/4802 that includes information related to this file.
- **B.** Mark "Correction" in Block 1 of Form 4804.
- **C.** Prepare a new file. Make a separate "A" Record for each **type** of return being reported. The information in the "A" Record will be **exactly** the same as it was in the original submission.
- **D.** The Payee "B" Record must contain **exactly the same** information as submitted previously, except, insert a "G" in Field Position 7 of the "B" Record, and for all payment amounts, enter "0" (zero).
- **E.** Corrected returns submitted to IRS/MCC using a "G" coded "B" Record may be on the same tape or diskette as those returns submitted without the "G" code; however, separate "A" Records are required.

Transaction 2: Report the correct information

- **A.** Prepare a new file with the correct information in all records.
- **B.** Make a separate "A" Record for each type of return and each payer being reported.
- **C.** The "B" Record must show the correct information as well as a "C" in Field Position 7.
- **D.** Corrected returns submitted to IRS/MCC using a "C" coded "B" Record may be on the same tape or diskette as those returns submitted without the "C" code; **however, separate "A" Records are required.**
- **E.** Prepare a "C" Record.
- **F.** Indicate "Correction" on the external media label.

☞ **Note 1: Payers who can show that they have reasonable cause (defined in the regulations under sections 6721–6724 of the Internal Revenue Code) are not required to make corrections for returns filed with a missing or incorrect name and/or TIN. These payers should change their records in order to submit correct information in the future. Payers who cannot show reasonable cause are encouraged to make corrections for the current processing year by August 1 to reduce applicable penalties. Corrections filed by August 1 will reduce the $50 per return penalty for filing returns with missing or incorrect information to $30 or $15 if filed within 30 days. (For penalty information, refer to the Penalty section of the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G.") Corrections filed after August 1 will not reduce the penalty but will allow IRS to update the payee's records. The regulations for IRC sections 6721–6724 are available in Publication 1586, Reasonable Cause Regulations and Requirements as They Apply to Missing and Incorrect TINs. The publication may be obtained by calling 1-800-TAX-FORM (1-800-829-3676).**

One transaction is required to make the following corrections properly (See Note 2).

☞ **Note: If the filer is contacted by IRS/MCC, a prompt response is important. IRS/MCC may have information that the filer needs to correct his or her file.**

.08 IRS/MCC contacts payers who have submitted payee data with missing TINs in an attempt to prevent errors that could result in penalties. Payers who submit data with missing TINs and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This will prevent unnecessary contact from IRS/MCC. This letter, however, will not prevent backup withholding notices (CP2100 or CP2100A Notices) or penalties for missing or incorrect TINs.

.09 Do not use special shipping containers for transmitting data to IRS/MCC. Shipping containers will not be returned.

Sec. 13. Corrected Returns

.01 The magnetic media filing requirements of 250 information returns applies separately to both original and corrected returns.

EXAMPLE If a payer has 100 Forms 1099-A to be corrected, they can be filed on paper since they fall under the 250 threshold. However, if the payer has 300 Forms 1099-B to be corrected, they must be filed magnetically or electronically since they meet the 250 threshold. If for some reason a payer cannot file the 300 corrections on magnetic media, to avoid penalties, a request for a waiver must be submitted before filing on paper. If a waiver is approved for original documents, any corrections for the same type of return will be covered under this waiver.

.02 Corrections should be filed **as soon as possible**. Corrections filed after August 1 may be subject to the maximum penalty of $50 per return. Corrections filed prior to August 1 may be subject to a lesser penalty. (For information on penalties, refer to the Penalty Section of the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G.") However, if payers discover errors after August 1, they may still be required to file corrections so that they will not be subject to a penalty for intentional disregard of the filing requirements. Failure to correct information returns may result in penalties for failure to provide correct information. **All fields must be completed with the correct information, not just the data fields needing correction.** Submit corrections only for the returns filed in error, not the entire file. Furnish corrected statements to recipients as soon as possible.

.03 There are numerous types of errors, and in some cases, more than one transaction may be required to correct the initial error. **If the original return was filed as an aggregate, the filers must consider this in filing corrected returns.**

.04 Corrected returns may be included on the same medium as original returns; however, separate "A" Records are required. Corrected returns must be identified on the Form 4804 and the external media label by indicating "Correction."

☞ **Note: If filers discover that certain information returns were omitted on their original file, they must not code these documents as corrections. The file must be coded and submitted as originals.**

.05 If a payer discovers errors for prior years that affect a large number of payees, in addition to sending IRS the corrected returns and notifying the payees, a letter containing the following information should be sent to IRS/MCC:

(a) Name and address of payer
(b) Type of error (please explain clearly)
(c) Tax year
(d) Payer TIN
(e) TCC
(f) Type of Return
(g) Number of Payees

This information will be forwarded to the appropriate office in an attempt to prevent erroneous notices from being sent to the payees. The correction must be submitted on an actual information return document or filed magnetically/electronically. Provide the correct tax year in Box 2 of the Form 4804 and on the external media label.

.06 Prior year data, original and corrected, **must** be filed according to the requirements of this revenue procedure. If submitting prior year corrections, use the record format for the current year and submit on separate media. However, use the actual year designation of the correction in Field Positions 2–3. If filing electronically, a separate transmission must be made for each tax year.

.07 In general, filers should submit corrections for returns to be filed within the last three calendar years (four years if the payment is a reportable payment subject to backup withholding under section 3406 of the Code).

.08 All paper returns, whether original or corrected, must be filed with the appropriate service center.

.09 Form 4804 and Form 4802 (if applicable), must be submitted with corrected files submitted magnetically or electronically.

.07 As soon as it is apparent that a 30-day extension of time to file is needed, Form 8809 may be submitted. It will take a minimum of 30 days for IRS/MCC to respond to an extension request. Under certain circumstances, a request for an extension of time could be denied. When a denial letter is received, any additional or necessary information may be resubmitted within 20 days.

.08 If an additional extension of time is needed, a second Form 8809 must be submitted before the end of the initial extension. Line 7 on the form should be checked to indicate that an additional extension is being requested. A second 30-day extension will be approved **only** in cases of extreme hardship or catastrophic event. When requesting a second 30-day extension of time, **do not** hold your files waiting for a response.

.09 Form 8809 must be postmarked **no later than the due date of the return** for which an extension is requested. If requesting an extension of time to file several types of forms, use one Form 8809, but the Form 8809 must be postmarked no later than the earliest due date. For example, if requesting an extension of time to file both Forms 1099–INT and 5498, submit Form 8809 postmarked on or before February 28. Complete more than one Form 8809 to avoid this problem.

.10 If an extension request is approved, the approval letter should be kept on file. The approval letter or copy of the approval letter for extension of time should not be sent to IRS/MCC with the magnetic media file or to the service center where the paper returns are filed.

.11 Request an extension for only one tax year.

.12 The extension request must be signed by the payer or a person who is duly authorized to sign a return, statement or other document for the payer.

.13 Failure to properly complete and sign the Form 8809 may cause delays in processing the request or result in a denial. Carefully read and follow the instructions on the back of the Form 8809.

.14 Form 8809 may be obtained by calling **1-800-TAX-FORM (1-800-829-3676).**

.15 Request an extension of time to furnish the statements to recipients of Forms 1098, 1099, 5498, W–2G, W–2, and 1042–S by submitting a letter to IRS/MCC containing the following information:

(a) Payer name
(b) TIN
(c) Address
(d) Type of return
(e) Specify that the extension request is to provide statements to recipients.
(f) Reason for delay
(g) Signature of payer or person duly authorized

Requests for an extension of time to furnish the statements for Forms 1098, 1099, 5498, W–2G, W–2, and 1042–S to recipients are not automatically approved; however, if approved, generally an extension will allow a maximum of 30 additional days from the due date to furnish the statements to the recipients. The request must be postmarked by the date on which the statements are due to the recipients.

Sec. 12. Processing of Information Returns Magnetically/Electronically

.01 All data received at IRS/MCC for processing will be given the same protection as individual income tax returns (Form 1040). IRS/MCC will process the data and determine if the records are formatted and coded according to this revenue procedure.

.02 If the data is formatted incorrectly, the file will be returned for replacement accompanied with a Media Tracking Slip (Form 9267). When media is returned, it is because IRS/MCC encountered errors (not limited to format) and was unable to process the media, therefore, requiring a replacement. Open all packages immediately.

.03 Files must be corrected and returned with the Media Tracking Slip (Form 9267) to IRS/MCC within 45 days from the date of the letter IRS/MCC included with the returned files. A penalty for failure to file correct information returns by the due date will be assessed if the files are not corrected and returned within the 45 days **or if the incorrect files are returned by IRS/MCC for replacement more than two times.** A penalty for intentional disregard of filing requirements will be assessed if a replacement file is not received. (For penalty information, refer to the Penalty section of the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G.")

.04 Sample records identifying errors encountered will be provided with the returned media. It is the responsibility of the transmitter to check the entire file for similar errors.

.05 The following definitions have been provided to help distinguish between a correction and a replacement:

- A **correction** is an information return submitted by the transmitter to correct an information return that was previously submitted to and processed by IRS/MCC, but contained erroneous information.
- A **replacement** is an information return file that IRS/MCC has returned to the transmitter due to errors encountered during processing. After necessary changes have been made, the file must be returned for processing along with the Media Tracking Slip (Form 9267) which was included in the shipment from IRS/MCC.
- **Filers should never send anything to IRS/MCC marked "Replacement" unless IRS/ MCC returned media to them.**

.06 IRS/MCC will not return media after successful processing. Therefore, if the transmitter wants proof that IRS/MCC received a shipment, the transmitter should select a service with tracking capabilities or one that will provide proof of delivery.

.07 IRS/MCC will work with filers as much as possible to assist with processing problems.

.02 If any due date falls on a Saturday, Sunday or legal holiday, the return or statement is considered timely if filed or furnished on the next business day (*i.e.*, the next day that is not a Saturday, Sunday, or legal holiday).

.03 Information returns filed magnetically/electronically for Forms 1098, 1099, and W–2G must be submitted to IRS/MCC postmarked on or before *March 2, 1998.*

.04 *Returns postmarked by the United States Postal Service (USPS) on or before March 2, 1998, and delivered by United States mail to the IRS/MCC after the due date, are treated as timely under the "timely mailing as timely filing" rule. A similar rule applies to items delivered by private delivery services (PDSs) designated by the IRS. A PDS must be designated by the IRS before it will qualify for the timely mailing rule. Designation is determined with respect to each type of delivery service offered by a PDS (e.g., next day delivery, two day delivery, etc.). Notice 97–26, 1997–17 I.R.B. 6, provides the first list of designated PDSs and the types of delivery services designated. Designation is effective until the IRS issues a revised list of designated PDSs. Notice 97–26 also provides rules for determining the date that is treated as the postmark date. For items delivered by a non-designated PDS, the actual date of receipt by IRS/MCC will be used as the filing date. For items delivered by a designated PDS, but through a type of service not designated in Notice 97–26, the actual date of receipt by IRS/MCC will be used as the filing date. The timely mailing rule also applies to furnishing statements to recipients and participants and filing Forms 5498 and 5498–MSA.*

.05 Statements to recipients must be furnished on or before *February 2, 1998 for TY97.* Form 5498 statements to the participants must be furnished on or before *February 2, 1998 for TY97* for the fair market value of the account and by *June 1, 1998 for TY97* for contributions made to IRAs for the prior calendar year.

.06 *Forms 5498 and 5498–MSA filed magnetically or electronically must be filed with IRS/MCC on or before June 1, 1998 for TY97. Form 5498 and 5498–MSA are filed for contributions to be applied to 1997 that are made January 1, 1997, through April 15, 1998, and/or to report the fair market value of the IRA, SEP, or SIMPLE or the medical savings account.*

.07 Use this revenue procedure to prepare information returns filed magnetically or electronically beginning January 1, *1998*, and received by IRS/MCC no later than December 31, *1998*.

Sec. 11. Extensions of Time

.01 An extension of time to file may be requested for Forms 1099, 1098, 5498, *5498–MSA*, W–2G, W–2, and 1042–S.

.02 Form 8809, Request for Extension of Time To File Information Returns, should be submitted to IRS/MCC. This form may be used to request an extension of time to file information returns submitted on paper, magnetically or electronically.

.03 Requesting an extension of time for multiple payers (50 or less) may be done by submitting Form 8809 and attaching a list of the payer names and their TINs (EIN or SSN). **The listing must be attached to ensure that the extension is recorded for all payers.** Form 8809 may be computer-generated or photocopied. Be sure that all the pertinent information is included.

.04 Requests for an extension of time to file for more than 50 payers are required to be submitted magnetically or electronically (See **Note**). Requests for an extension of time for 10 to 50 payers are encouraged to be filed magnetically or electronically. (See Part E, Sec. 3, for the record format.) The request may be filed on tape, tape cartridge, 5 1/4- or 3 1/2-inch diskette, or electronically through the IRP-BBS or mainframe.

☞ **Note: If a filer does not have an IRS/MCC assigned Transmitter Control Code (TCC), a Form 4419, Application for Filing Information Returns Magnetically/Electronically, must be submitted to obtain a TCC. This number must be used to submit an extension request magnetically/electronically.**

.05 A magnetically filed request for an extension of time should be sent using the following addresses:

If by Postal Service:
IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

If by private delivery service:
IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.06 Requests for extensions of time for multiple payers will be responded to with one approval letter, accompanied by a list of payers covered under that approval.

separated by an "A" Record. Only one "F" record may be used at the end of a transmission. Multiple tapes or diskettes can be sent in one package. Filers **must** include Form 4804, 4802, or computer-generated substitute with their shipment.

.04 Multiple types of media may be submitted in a shipment. However, submit a separate Form 4804 for each type of media.

.05 Current and prior year data may be submitted in the same shipment; however, each tax year must be on separate media, and a separate Form 4804 must be prepared to clearly indicate each tax year.

.06 Filers who have prepared their information returns in advance of the due date are encouraged to submit this information to IRS/MCC no earlier than January 1 of the year the return is due.

.07 Do not report duplicate information. If a filer submits returns magnetically/electronically, identical paper documents must not be filed. This may result in erroneous penalty notices.

.08 Form 4804 may be signed by the payer or the transmitter, service bureau, paying agent, or disbursing agent (all hereafter referred to as agent), on behalf of the payer. An agent may sign the Form 4804 if the agent has the authority to sign the affidavit under an agency agreement (either oral, written, or implied) that is valid under state law and adds the caption "FOR: (name of payer)."

☞ **Note: Failure to sign the affidavit on Form 4804 may delay processing or could result in the files being returned unprocessed.**

.09 Although an authorized agent may sign the affidavit, the payer is responsible for the accuracy of the Form 4804 and the returns filed. The payer will be liable for penalties for failure to comply with filing requirements.

.10 *A self-adhesive external media label, created by the filer, must be affixed to each tape and diskette. (IRS no longer provides self-adhesive labels for this purpose.)* For instructions on how to prepare an external media label, refer to Notice 210 in the forms section. If diskettes are used, and the operating system is not MS-DOS compatible, the operating system and hardware information **must** be provided. Failure to provide this information may result in the diskettes being returned to the filer.

.11 On the outside of the shipping container, affix or attach a label which reads **IRB Box ___of___** reflecting the number of containers in the shipment. *(Filers can create a label with this information or cut out one of the labels on the special label page provided in this publication. IRS no longer provides self-adhesive labels for this purpose.)* If there is only one container, mark the outside as Box *1* of *1*. For multiple containers, include the sequence (for example, Box 1 of 3, 2 of 3, 3 of 3).

.12 When submitting files include the following:

(a) A **signed** Form 4804;

(b) Form 4802, if applicable;

(c) External media label *(created by filer)* affixed to magnetic media;

(d) IRB _____ of _____ outside label.

☞ **Note: See Parts C and D for Electronic Submission Requirements.**

.13 If returns from different locations (using the same name and TIN) are submitted on the same file, IRS encourages the filer to consolidate each type of information return under one "A" Record. For example, all "B" Records for the same type of return should be together under one "A" Record and followed by the End of Payer "C" Record.

.14 IRS/MCC will not pay for or accept "Cash-on-Delivery" or "Charge to IRS" shipments of tax information that an individual or organization is legally required to submit.

.15 Payers should retain a copy of the information returns filed with IRS or have the ability to reconstruct the data for at least 3 years from the reporting due date, with the exception of Form 1099–C. A financial entity must retain a copy of Form 1099–C, Cancellation of Debt, or have the ability to reconstruct the data required to be included on the return, for at least 4 years from the date such return is required to be filed. Whenever backup withholding is imposed, a 4 year retention is required.

Sec. 10. Due Dates

As a result of due dates for Tax Year 1997 falling on weekends in 1998, the information returns, the recipient copies, and the participant copies will be treated as timely if filed or furnished on or before the following dates:

Forms 1098, 1099 and W-2G
Recipient Copy – **February 2, 1998**
IRS Copy – **March 2, 1998**

Forms 5498 and 5498-MSA
Participant Copy – **June 1, 1998**
IRS Copy – **June 1, 1998**
(***5498 Only for fair market value*** – **February 2, 1998**)

.01 The due dates for filing paper returns with IRS also apply to magnetic media or electronic filing. Filing of information returns is on a calendar year basis, except for Forms 5498 and *5498-MSA*, which are used to report amounts contributed during or after the calendar year (but not later than April 15).

.10 One Form 4419 may be submitted regardless of how many types of media or methods are used to file the returns. ***Multiple TCCs will only be issued to payers with multiple TIN. Only one TCC will be issued per TIN.***

.11 In accordance with Regulations section 1.6041-7(b), payments by separate departments of a health care carrier to providers of medical and health care services may be reported on separate returns on magnetic media. In this case, the headquarters will be considered the transmitter, and the individual departments of the company filing reports will be considered payers. A single Form 4419 covering all departments filing on magnetic media should be submitted. One TCC may be used for all departments.

.12 Approval to file does not imply endorsement by IRS/MCC of any computer software or of the quality of tax preparation services provided by a service bureau or software vendor.

Sec. 8. Test Files

.01 IRS/MCC does not require test files, **except** for filers wishing to participate in the Combined Federal/State Filing Program (see Part A, Sec. 16, for further information concerning the Combined Federal/State Filing Program).

.02 IRS/MCC encourages first-time magnetic media or electronic filers to submit a test. The test file **must** consist of a sample of each type of record:

(a) Payer "A" Record (must not be fictitious data)
(b) Multiple Payee "B" Records **(at least 11 "B" Records per each "A" Record)**
(c) End of Payer "C" Record
(d) State Totals "K" Record, if participating in the Combined Federal/State Filing Program
(e) End of Transmission "F" Record

(See **Part B** for record formats.)

.03 Use the Test Indicator "T" in Field Position 32 of the "A" Record to show that this is a test file.

.04 IRS/MCC will check the file to ensure it meets the specifications of this revenue procedure. For current filers, sending a test file will provide the opportunity to ensure that their software reflects any programming changes.

If unable to submit a magnetic or electronic test file, a hardcopy printout that shows a sample of each record type (A, B, C, and F) may be submitted. **The hard copy print test is not acceptable for Combined Federal/State Filing approval.**

.05 Tests should be sent to IRS/MCC between November 1 and December 31. The test file **must** be received at MCC by December 31 in order to be processed. Filers may begin submitting test tapes and diskettes after October 1; however, the data will not be processed until on or after November 1.

.06 For tests filed electronically, the transmitter must send the signed Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically, the same day the transmission is made. For tests filed on magnetic tape, tape cartridge, *8mm, 4mm, and quarter inch cartridge*, 5 1/4- and 3 1/2-inch diskette, the transmitter must include the signed Form 4804 in the same package with the corresponding magnetic media. Mark the "TEST" box in block 1 on the form. Also, mark "TEST" on the external media label.

If submitting a hard copy printout, mark the printout as "TEST" and include name, telephone number, and address of a person who can be contacted to discuss its acceptability.

.07 IRS/MCC will send a letter of acknowledgment to indicate the test results. Unacceptable magnetic media files, along with documentation identifying the errors, will be returned. Resubmission of test files must be received by IRS/MCC no later than December 31.

.08 Successfully processed media will not be returned to filers.

Sec. 9. Filing of Information Returns Magnetically/Electronically and Retention Requirements

.01 Form 4804, Transmittal of Information Returns Reported Magnetically/Electronically, Form 4802, Transmittal of Information Returns Reported Magnetically/Electronically (Continuation), or a computer-generated substitute, must accompany **all** magnetic media shipments. For electronic transmissions, the Form 4804 and Form 4802, if applicable, must be sent the same day as the electronic transmission. Form 4802, Transmittal of Information Returns Reported Magnetically/Electronically (Continuation), is a continuation of Form 4804 and should only be used if the filer is reporting more than five types of returns and/or more than five payers. Form 4802 is not a stand-alone form; it can only accompany Form 4804.

.02 IRS/MCC allows for the use of computer-generated substitutes for Form 4804/4802 (See **Note**). The substitutes must contain all information requested on the original forms including the affidavit and signature line. Photocopies are acceptable but an original signature is required.

☞ **Note: When using computer-generated forms, be sure to mark very clearly which tax year is being reported. This will eliminate a phone communication from IRS/MCC to question the tax year.**

.03 A transmitter may report for any combination of payers and/or documents in a submission. For example, if reporting Forms 1099-INT for Bank A, Forms 1099-DIV for Bank B, and Forms 1098 for Bank C, three separate tapes or diskettes need not be created. All three banks and all types of documents can be coded on one tape or diskette as long as each filing entity or type of return is

Sec. 7. Form 4419, Application for Filing Information Returns Magnetically/Electronically

.01 Transmitters are required to submit Form 4419, Application for Filing Information Returns Magnetically/Electronically, to request authorization to file information returns with IRS/MCC. A single Form 4419 should be filed no matter how many types of returns the transmitter will be submitting magnetically/ electronically. For example, if a transmitter plans to file Forms 1099–INT, one Form 4419 should be submitted. If, at a later date, another type of form (Form 1098, 1099 series, 5498, and W–2G) is to be filed, the transmitter does not need to submit a new Form 4419.

EXCEPTIONS

An additional Form 4419 is required for filing each of the following types of returns: Forms 1042–S, 8027, and W–4.

FORM	TITLE	EXPLANATION
1042–S	Foreign Person's U.S. Source Income Subject to Withholding	Payments subject to withholding under Chapter 3 of the Code, including interest, dividends, royalties, pensions, and annuities, gambling winnings and compensation for personal services.
8027	Employer's Annual Information Return of Tip Income and Allocated Tips	Receipts from food or beverage operations, tips reported by employees, and allocated tips.
W–4 (See **Note**)	Employee's Withholding Allowance Certificate	Forms received during the quarter from employees still employed at the end of the quarter who claim the following: (a) More than 10 withholding allowances or (b) Exempt status and wages normally would be more than $200 a week.

☞ **Note: Employers are not required to send other Forms W–4 unless notified to do so by the IRS.**

.02 Magnetic tape, tape cartridge, diskette, and electronically filed returns may not be submitted to IRS/MCC until the application has been approved. Please read the instructions on the back of Form 4419 carefully. A Form 4419 is included in the Publication 1220 for the filer's use. This form may be photocopied. Additional forms may be obtained by calling **1-800-TAX-FORM (1-800-829-3676).**

.03 Upon approval, a five-character alpha/numeric Transmitter Control Code (TCC) will be assigned and included in an approval letter. The TCC **must** be coded in the Payer "A" Record. If a transmitter uses more than one TCC to file, each TCC must be reported on separate media or in separate transmissions if filing electronically.

.04 Annually, a magnetic media reporting package containing the current revenue procedure, forms, and instructions will be sent to the attention of the contact person indicated on Form 4419.

.05 If **any** of the information (name, TIN or address) on the Form 4419 changes, please notify IRS/MCC in writing so that the IRS/MCC database can be updated. However, a change in the method by which information returns are being submitted is not information which needs to by updated (*i.e.*, tape to disk, disk to BBS). The transmitter should include the TCC in all correspondence.

.06 Form 4419 can be submitted any time during the year; however, it **must** be submitted to IRS/MCC at least 30 days before the due date of the return(s) for current year processing. **For documents to be filed electronically using IBM 3780 bisynchronous protocols, Form 4419 must be submitted at least 45 days prior to the due date of the returns (See Part C, Sec. 2).** This will allow IRS/MCC the minimum amount of time necessary to process and respond to applications. In the event that computer equipment or software is not compatible with IRS/MCC, a waiver may be requested to file returns on paper documents.

.07 IRS/MCC encourages transmitters who file for multiple payers to submit one application and to use the assigned TCC for all payers. Include a list of all payers and TINs with the Form 4419.

.08 If a payer's files are prepared by a service bureau, the payer may not need to submit an application to obtain a TCC. Some service bureaus will produce files, code their own TCC on the media, and send it to IRS/MCC for the payer. Other service bureaus will prepare magnetic media and return the media to the payer for submission to IRS/MCC. These service bureaus may require the payer to obtain a TCC to be coded in the "A" Record. Payers should contact their service bureaus for further information.

.09 Once a transmitter is approved to file magnetically or electronically, it is not necessary to reapply each year **unless:**

(a) The payer has discontinued filing magnetically or electronically for three years; the payer's TCC may have been reassigned by IRS/MCC. Payers who are aware that the TCC assigned will no longer be used, are requested to notify IRS/MCC so these numbers may be reassigned.

(b) The payer's magnetic media files were transmitted in the past by a service bureau using the service bureau's TCC, but now the payer has computer equipment compatible with that of IRS/MCC and wishes to prepare his or her own files. The payer must request a TCC by submitting Form 4419.

1099–C	with IRS. These are stand
1099–DIV	alone documents and are not
1099–G	to be aggregated for purposes
1099–INT	of determining the 250
1099–LTC	threshold. For example, if
1099–MISC	you must file 100 Forms
1099–MSA	1099–B and 300 Forms
1099–OID	1099–INT, Forms 1099–B
1099–PATR	need not be filed magneti-
1099–R	cally or electronically since
1099–S	they do not meet the thres-
5498	hold of 250. However,
5498–MSA	Forms 1099–INT must be
W–2G	filed magnetically or electronically since they meet the threshold of 250.

.06 The above requirements do not apply if the payer establishes hardship (see Part A, Sec. 5).

Sec. 5. Form 8508, Request for Waiver from Filing Information Returns on Magnetic Media

.01 If a payer is required to file on magnetic media but fails to do so (or fails to file electronically, in lieu of magnetic media filing) and does not have an approved waiver on record, the payer will be subject to a penalty of $50 per return in excess of 250. (For penalty information, refer to the Penalty section of the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G.")

.02 If payers are required to file original or corrected returns on magnetic media, but such filing would create a hardship, they may request a waiver from these filing requirements by submitting Form 8508, Request for Waiver From Filing Information Returns on Magnetic Media, to IRS/MCC.

.03 Even though a payer may submit as many as 249 corrections on paper, IRS encourages magnetically or electronically submitted corrections. Once the 250 threshold has been met, filers are required to submit any returns of 250 or more magnetically or electronically. However, if a waiver for original documents is approved, any corrections for the same type of returns will be covered under this waiver.

.04 Generally, only the payer may sign the Form 8508. A transmitter may sign if given power of attorney; however, a letter signed by the payer stating this fact must be attached to the Form 8508.

.05 A transmitter must submit a separate Form 8508 for each payer. Do not submit a list of payers.

.06 All information requested on the Form 8508 must be provided to IRS for the request to be processed.

.07 The waiver, if approved, will provide exemption from magnetic media filing for the current tax year only. Payers may not apply for a waiver for more than one tax year at a time; application must be made each year a waiver is necessary.

.08 Form 8508 may be photocopied or computer-generated as long as it contains all the information requested on the original form.

.09 Filers are encouraged to submit Form 8508 to IRS/MCC at least 45 days before the due date of the returns.

.10 File Form 8508 for Forms W–2 with IRS/MCC, not SSA.

.11 Waivers are evaluated on a case-by-case basis and are approved or denied based on criteria set forth under section 6011(e) of the Internal Revenue Code. The transmitter must allow a minimum of 30 days for IRS/MCC to respond to a waiver request.

.12 If a waiver request is approved, the transmitter should keep the approval letter on file. **The transmitter should not send a copy of the approved waiver to the service center where the paper returns are filed.**

.13 An approved waiver from filing information returns on magnetic media does not provide exemption from all filing. The payer must timely file information returns on acceptable paper forms with the appropriate service center.

.14 Desert Storm/*Operation Joint Guard (OJG)* [*See* Note] (Bosnia Region) Contributions — If a payer is required to file a Form 5498 magnetically/electronically, the payer may request an **automatic** waiver to file Forms 5498 on paper for participants of Desert Storm or Operation Joint *Guard*. The payer should clearly mark Desert Storm or Operation Joint *Guard* on the waiver request form.

☞ **Note: Military personnel under Operation Joint Guard (OJG) will be treated the same as military personnel under Operation Joint Endeavor (OJE) for purposes of Publication L. 104–117 and Rev. Proc. 96–34.**

Sec. 6. Vendor List

.01 IRS/MCC prepares a list of vendors who support magnetic media or electronic filing. The Vendor List (Pub. 1582) contains the names of service bureaus that will produce files on the prescribed types of magnetic media or via electronic filing. It also contains the names of vendors who provide software packages for payers who wish to produce magnetic media or electronic files on their own computer systems. This list is compiled as a courtesy and in no way implies IRS/MCC approval or endorsement.

☞ **Note: If filers meet the filing requirements and engage a service bureau to prepare media on their behalf, the filers should be careful not to report duplicate data, which may cause penalty notices to be generated.**

.02 *The Vendor List may be updated in print every other year. The most recently printed copy will be available by contacting IRS/MCC at (304) 263-8700 or by way of a letter (see Part A, Sec. 3.) The most current Vendor List is available for downloading from the Information Reporting Program-Bulletin Board System (refer to Part D).*

.03 A vendor, who offers a software package, has the ability to produce magnetic media for customers, or has the capability to electronically file information returns, and would like to be included on the list, must submit a written request to IRS/MCC. The request should be submitted by August 15 and must include:

- **(a)** Company name
- **(b)** Address (include city, state, and ZIP code)
- **(c)** Telephone number (include area code)
- **(d)** Contact person
- **(e)** Type(s) of service provided (*e.g.*, service bureau and/or software)
- **(f)** Type(s) of media offered (*e.g.*, magnetic tape or tape cartridge, 5 1/4- or 3 1/2-inch diskettes, or electronic filing)
- **(g)** Type of return

.04 The vendor list is updated annually. Therefore, any changes to information already on the vendor list must also be received by IRS/MCC no later than August 15 to be included on the most current vendor list.

letin Board System) - Part D
304-264-7080 – 4.8 Modems – Part C
304-264-7040 – 9.6 Modems – Part C
304-264-7045 – 14.4 Modems – Part C
304-267-3367 – TDD (Telecommunication Device for the Deaf)
304-264-5602 – Fax Machine
(These are not toll-free telephone numbers.)
TO OBTAIN FORMS, CALL:
1-800-TAX-FORM (1-800-829-3676)

.04 The *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G" have been included in the Publication 1220 for transmitter convenience. The Form 1096 is used only to transmit Copy A of **paper** Forms 1099, 1098, 5498, and W–2G. If filing paper returns, follow the mailing instructions on the Form 1096 and submit the paper returns to the appropriate IRS Service Center.

.05 Requests for paper Forms 1096, 1098, 1099, and W–2G, and publications related to magnetic media/electronic filing should be requested by calling the IRS toll-free number **1-800-TAX-FORM (1-800-829-3676)**.

.06 Questions pertaining to magnetic media filing of Forms W–2 **must** be directed to the Social Security Administration (SSA). Filers can call 1-800-SSA-1213 to obtain the phone number of the SSA Magnetic Media Coordinator for their area.

.07 Payers **should not** contact IRS/ MCC if they have received a penalty notice and need additional information, or are requesting an abatement of the penalty. A penalty notice contains an IRS representative's name and/or phone number for contact purposes; or, the payer may be instructed to respond in writing to the address provided. IRS/MCC does **not** issue penalty notices and does **not** have the authority to abate penalties. For penalty information, refer to the Penalty Section of the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G."

.08 A taxpayer or authorized representative may request a copy of a tax return, including Form W–2 filed with a return, by submitting Form 4506, Request for Copy or Transcript of Tax Form, to IRS. This form may be obtained by calling **1-800-TAX-FORM (1-800-829-3676).**

.09 The IRS Centralized Call Site answers both magnetic media and tax law questions relating to the filing of information returns (Forms 1096, 1098, 1099, 5498, 8027, W–2G, W–3, 1042S, and W-4's). The IRS/MCC Call Site answers tax law and paper filing related questions about W–2s as well as handling inquiries dealing with backup withholding due to missing and incorrect taxpayer identification numbers. The Call Site is located at IRS/MCC and operates in conjunction with the Information Reporting Program. The Call Site provides service to the payer community (financial institutions, employers, and other transmitters of information returns). Recipients of information returns (payees) should continue to contact **1-800-829-1040** or other numbers specified in the tax return instructions with any questions on how to report information on their tax returns.

The Call Site accepts calls from all areas of the country. The number to call is **304-263-8700** or Telecommunications Device for the Deaf (TDD) **304-267-3367.** These are toll calls. Hours of operation for the Call Site are Monday through Friday, 8:30 a.m. to 4:30 p.m. Eastern Time. The Call Site is in operation throughout the year to handle the questions of payers, transmitters, and employers. Due to the high demand for assistance at the end of January and February, it is advisable to call as soon as possible to avoid these peak filing seasons.

Sec. 4. Filing Requirements

.01 Under section 6011(e)(2)(A) of the Internal Revenue Code, any person, including a corporation, partnership, individual, estate, and trust, who is required to file 250 or more information returns must file such returns magnetically/electronically. **The 250* or more requirement applies separately for each type of return and also to each type of corrected return.**

Even though as many as 249 information returns may be submitted on paper to the Internal Revenue Service, IRS encourages filers to transmit information returns magnetically or electronically.

.02 All filing requirements that follow apply individually to each reporting entity as defined by its separate Taxpayer Identification Number (TIN) [Social Security Number (SSN), or Employer Identification Number (EIN)]. For example, if a corporation with several branches or locations uses the same EIN, the corporation must aggregate the total volume of returns to be filed for that EIN and apply the filing requirements to each type of return accordingly.

.03 Payers who are required to submit their information returns on magnetic media may choose to submit their documents by electronic filing. Payers who submit their information returns electronically are considered to have satisfied the magnetic media filing requirements.

.04 IRS/MCC has two methods by which payers may submit their files electronically. Bisynchronous (mainframe) electronic filing, which can be found in Part C of this publication, or Asynchronous (Information Reporting Program-Bulletin Board System), which is in Part D. An overview of some features provided on the IRP-BBS are as follows:

- Electronic filing of information returns to the IRS using dial-up modems
- Return notification of the acceptability of the data transmitted within 24 to 48 hours
- Electronic communication with IRS and SSA bulletin board systems
- Access to information reporting publications
- Access to shareware
- Access to forms relating to the Information Reporting Program
- News about the latest changes and updates that affect the Information Reporting Program at IRS
- Answers to messages and questions left on the bulletin board
- Available for public use and can be reached by dialing 304-264-7070
- IRP-BBS is accessible 24 hours a day, 7 days a week. Routine maintenance is performed daily, at approximately 7:00 a.m. Eastern Time.
- Questions, comments, or suggestions can be directed to the Systems Operator (SYSOP) through IRP-BBS.

.05 The following requirements apply separately to both originals and corrections filed magnetically/electronically:

1098 1099–A 1099–B	**250 or more of any** of these forms require magnetic media or electronic filing

are advised throughout the publication that the new forms cannot be filed under the Combined Federal/State Filing Program.

(d) A ZIP code change has occurred for the Martinsburg Computing Center. For all Martinsburg Computing Center addresses containing a post office box, the ZIP code has been changed from 25401 to 25402. The changes will appear in Part A, Sec. 3.01, Part C, Sec. 2.02(c) and (e), Part D, Sec. 5.04, and Part F, Sec. 1. The ZIP code for the street address (Route 9 and Needy Road) of the Martinsburg Computing Center remains 25401.

(e) In Part A, Sec. 4.01, under Filing Requirements, filers are encouraged to file magnetically/electronically even though the number of returns being filed is less than the filing requirement of 250 or more.

(f) In Part A, Sec. 6.02, filers are advised that the most current version of the Vendor List (Pub. 1582) will not be printed. It will be available for reading or downloading from the Information Reporting Program-Bulletin Board System (IRP-BBS).

(g) In Part A, Sec. 7.10, information has been added to advise filers that multiple Transmitter Control Codes (TCCs) will only be issued to a payer with multiple TINs, one TCC per TIN.

(h) In Part A, Sec. 9.10, filers are advised to create a self-adhesive label with the required information to attach to each tape, cartridge, or diskette.

(i) In Part A, Sec. 9.11, filers are advised to attach a label that states "IRB, Box __of__" to the outside of the shipping container.

(j) In Part A, Sec. 10, filers are advised that, since the due dates for Tax Year 1997 fall on weekends, information returns, recipient copies, and participant copies will be treated as timely if filed or furnished on the next business day after the particular due date.

(k) In Part A, Sec. 10.04, filers are advised that the timely mailing rule now applies to designated private delivery services.

(l) In Part A, Sec. 16, in Table 2. Dollar Criteria for State Reporting, the dollar criteria for the state of Idaho has been corrected.

(m) In part A, Sec. 17, Definition of Terms, ITIN (Individual Taxpayer Identification Number) has been added. ITIN has also been added to Part B, Sec. 6, Type of TIN, Field Position 14 of the Payee "B" Record.

(n) In Part B, Sec. 6, for the Form 1099-PATR, the titles of Amount Codes 7 and 8 in Field Positions 23–31 of the Payer "A" Record have been changed. The title of Amount Code 7 has been changed from Energy investment credit to Investment credit. The title of Amount Code 8 has been changed from Jobs credit to Work opportunity credit.

(o) In Part B, Sec. 6, for Form 5498, Amount Code 2 has been changed from Rollover IRA contributions to IRA, SEP, or SIMPLE rollover contributions in Field Positions 23-31 of the Payer "A" Record.

(p) In Part B, Sec. 8, for Document Specific/Distribution Codes, Field Positions 4–5 of the Payee "B" Record, information has been added to clarify that this field is only required for 1099–MISC if Crop Insurance Proceeds are being reported.

.05 Editorial Changes—Magnetic Media Specifications

(a) In Part B, Sec. 4.01(a)(7), filers are advised to place the end of transmission "F" Record at the end of the last cartridge only, for files with multiple cartridges.

(b) In Part B, Sec. 4.02(d), filers are advised that for 8mm tape cartridge, the SAVE OBJECT COMMAND is not acceptable.

(c) In Part B, Sec. 4.07, filers are now advised that 4mm cassettes are an acceptable form of media. Specifications are provided.

(d) In Part B, Sec. 4.08, filers are now advised that Quarter Inch Cartridges (QIC) are an acceptable form of media. Specifications are provided.

(e) In Part B, Sec. 05.01(b), for 5 1/4-inch diskettes created on a System 36 or AS400, specific save commands are provided as well as EBCDIC specifications.

(f) In Part B, Sec. 6, for Form 1099–G, Field Positions 23–31 of the Payer "A" Record, Amount Code 4, for Federal income tax withheld, has been expanded to include requested withholding on unemployment compensation, Commodity Credit Corporation loans, or certain crop disaster payments.

Sec. 3. Where to File and How to Contact the IRS, Martinsburg Computing Center

.01 All information returns filed magnetically or electronically are processed at IRS/MCC. Files containing information returns, requests for IRS magnetic media and electronic filing information, undue hardship waivers, and requests for extension of time to file returns or to furnish the statements to recipients are to be sent to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Information Reporting Program
P. O. Box 1359, MS-360
Martinsburg, WV 25402-1359

or if by private delivery service:

IRS-Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

☞ **Note: The ZIP code has changed from 25401-1359 to 25402-1359 for the IRS P.O. Box addresses for Martinsburg, WV.**

.02 Send a magnetically filed extension of time request to one of the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

If by private delivery service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.03 Telephone inquiries for the Information Reporting Call Site may be made between 8:30 a.m. and 4:30 p.m. Eastern time. The telephone numbers for magnetic media inquiries or electronic submissions are:

304-263-8700 – Call Site – Part A, Sec. 3.9
304-264-7070 – IRP–BBS (Information Reporting Program Bul-

☞ **Note 1: This is the amount of any rollover made to this MSA in 1997 after a distribution from another MSA. For detailed information on reporting, see 1997 "Instructions for Filing Forms 1099, 1098, 5498 and W–2G."**

☞ **Note 2: This is the fair market value (FMV) of the account at the end of 1997.**

Amount Codes **Form W–2G** — Certain Gambling Winnings

For Reporting Payments on Form W–2G:

Amount Code	*Amount Type*
1	Gross winnings
2	Federal income tax withheld
3	State income tax withheld (See **Note**)
7	Winnings from identical wagers

☞ **Note: State income tax withheld is added for the convenience of the payer but need not be reported to IRS/MCC.**

32	Test Indicator	1	**Required.** Enter "T" if this is a test file, otherwise, enter a blank.
33	Service Bureau Indicator	1	Enter "1" (one) if a service bureau was used to develop and/or transmit files, otherwise, **enter blank**. See Part A, Sec. 17 for the definition of service bureau.
34–41	Blank	8	**Enter blanks**.
42–43	Magnetic Tape Filer Indicator	2	**Required** for magnetic tape/tape cartridge filers **only**. Enter the letters "LS" (in **uppercase only**). Use of this field by filers using other types of media will be acceptable but is not required.
44–48	Transmitter Control Code (TCC)	5	**Required**. Enter the five character alpha/numeric Transmitter Control Code assigned by IRS/MCC. A TCC must be obtained to file data on this program. **Do not enter more than one TCC per file.**
49	Foreign Entity Indicator	1	Enter a "1" (one) if the payer is a foreign entity and income is paid by the corporation to a U.S. resident. If the payer is not a foreign entity, enter a blank (See **Note**).

☞ **Note: If payers erroneously report entities as foreign, they may be subject to a penalty for providing incorrect information to IRS. Therefore, payers must be sure to code only those records as foreign entities that should be coded.**

50–89	First Payer Name Line	40	**Required**. Enter the name of the payer whose TIN appears in positions 7–15 of the "A" Record. Any extraneous information must be deleted. Left justify information, and fill unused positions with blanks. (Filers should not enter a transfer agent's name in this field. Any transfer agent's name should appear in the Second Payer Name Line Field.)

☞ **Note: When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name and TIN of the recipient of the interest/the filer of Form 1098 (the payer). The "B" Record will reflect the individual paying the interest (the payer of record) and the amount paid. For Form 1099–S, the "A" Record will reflect the person responsible for reporting the transaction (the filer of Form 1099–S) and the "B" Record will reflect the seller/transferor.**

ternative last-in, first-out (LIFO) inventory computation method (the "Alternative LIFO Method") for a taxpayer engaged in the trade or business of retail sales of new automobiles or new light-duty trucks ("automobile dealer"). A taxpayer may change to or adopt the Alternative LIFO Method. The procedures for a taxpayer to change to the Alternative LIFO Method are provided in Rev. Proc. 97–37, page 18, which provides simplified and uniform procedures to obtain automatic consent to make this and other changes in methods of accounting. This revenue procedure modifies and supersedes Rev. Proc. 92–79, 1992–2 C.B. 457.

.02 The Alternative LIFO Method described in this revenue procedure is the same method of accounting that was described in Rev. Proc. 92–79. Accordingly, a taxpayer that properly changed to or adopted this method pursuant to Rev. Proc. 92-79 is not required to change its method of accounting to comply with this revenue procedure.

SECTION 2. BACKGROUND

.01 *In general.* Section 472(a) of the Internal Revenue Code provides that a taxpayer may use the LIFO inventory method of inventorying goods if, among other requirements, the change to, and use of, the method is in accordance with such regulations as the Secretary may prescribe as necessary in order that the use of the method may clearly reflect income.

.02 *Dollar-value LIFO method.* Section 1.472–8(a) of the Income Tax Regulations provides that any taxpayer may elect to determine the cost of its LIFO inventories under the dollar-value LIFO method of accounting, provided such method is used consistently and clearly reflects income in accordance with the rules of that section.

.03 *Link-chain method.* Section 1.472–8(e)(1) permits the use of a "link-chain" method of computing the LIFO value of a dollar-value pool if the "double-extension" method and an "index" method would be impractical or unsuitable in view of the nature of the inventory in the dollar-value pool. Further, in applying a link-chain method, an index may be computed by "double extending" a representative portion of the inventory in a dollar-value, link-chain pool at both the current-year cost and the prior-year cost. Additionally, an index may be computed under a link-chain method using other sound and consistent statistical methods.

.04 *Acceptable methods.* Under existing LIFO inventory provisions, there are three general dollar-value LIFO methods:

(1) *Simplified dollar-value LIFO method.*

(a) Section 474 provides an elective simplified dollar-value LIFO method for eligible small businesses. In general, a taxpayer is an eligible small business for any taxable year if its average annual gross receipts for the three preceding years do not exceed $5,000,000.

(b) The simplified dollar-value LIFO method under § 474 is based on a so-called link-chain method of computing the LIFO value of an inventory pool. Under § 474, inventory pools are established by the major categories in the applicable Government price index, and an annual index for each pool is obtained from that Government price index. Therefore, under § 474, an eligible automobile dealer uses a single inventory pool for new automobiles and new trucks under the major category, transportation equipment, in the Producer Price Index ("PPI") published by the Bureau of Labor Statistics ("BLS").

(c) Under this link-chain method, two price indexes are computed for each pool, an annual index and a cumulative index. The annual index represents the change in price level of goods in the ending inventory of the pool for the current year from the price level of comparable goods for the prior year. Under § 474, the annual index for computing the LIFO value of an automobile dealer's single inventory pool is obtained using the price change from the preceding taxable year for the major index category, transportation equipment, from the PPI.

(d) The cumulative index represents the price level change from the beginning of the base year to the end of the current year and is the product of each of the annual indexes. The cumulative index is used to convert the total current-year cost in an inventory pool at the close of the taxable year to base-year dollars by dividing the total current-year cost by the cumulative index, and also to determine the value of any incremental increase in the pool to be added to the ending inventory of the preceding year by multiplying that increment by the cumulative index.

(2) *Inventory price index computation method.*

(a) Section 1.472-8(e)(3) provides another simplified dollar-value LIFO method, the inventory price index computation (IPIC) method, which is available to all taxpayers. An automobile dealer using the IPIC method must use that method in determining the value of all goods for which the automobile dealer has elected to use the LIFO method. Under the IPIC method, special inventory pooling rules permit an automobile dealer to establish a single inventory pool for new automobiles and new trucks under the major category of the applicable Government price index published by the BLS. *See* § 1.472–8(e)(3)(iv) and Rev. Proc. 84–57, 1984–2 C.B. 496.

(b) The IPIC method under § 1.472–8(e)(3) is also based on a link-chain method of computing the LIFO value of an inventory pool. The annual index for the pool is generally computed using a stated percentage of the percent change in the applicable detailed index(es) for the major category of the applicable Government price index. The stated percentage is 80 percent unless a taxpayer qualifies as an eligible small business under § 474, in which case the stated percent is 100 percent.

(3) *General dollar-value LIFO method.*

(a) If an automobile dealer does not want to use either the simplified dollar-value LIFO method for certain small businesses provided in § 474 of the Code (if the taxpayer is eligible) or the IPIC method provided in § 1.472–8(e)(3), the automobile dealer may use the general dollar-value LIFO inventory rules contained in § 1.472–8. Under these general rules, an automobile dealer establishes inventory pools for each separate trade or business under § 1.472–8(c) by major lines, types, or classes of goods (for example, one separate pool for all new automobiles and another separate pool for all new trucks). *See Fox Chevrolet, Inc. Maryland v. Commissioner,* 76 T.C. 708 (1981), *acq.*, 1984–2 C.B. 1, and *Richardson Investments, Inc., and Subsidiaries v. Commissioner,* 76 T.C. 736 (1981).

(b) An automobile dealer may use the double-extension method, an index

talization and 48-month amortization method constitutes a permissible method of accounting. Under the pool-of-cost capitalization and 48-month amortization method, the taxpayer must capitalize all its package design costs and amortize the costs over a period of 48 months. Thus, in computing taxable income, package design costs incurred during the tax year are allowed as a deduction ratably over a 48-month period, beginning with the month the costs are treated as incurred. See section 5.03(3) of this revenue procedure. The taxpayer may not deduct the unamortized portion of the cost of a package design (or modification to the design) if the design (or modification to the design) is never placed in service or is disposed of or abandoned within the 48-month period.

(2) *Costs subject to capitalization.* All package design costs are subject to capitalization without regard to whether the costs create a package design (or modification to the design) having an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. Thus, all package design costs incurred prior to January 1, 1987, or in taxable years beginning after December 31, 1993, that are capitalized under § 263 and the regulations thereunder or that would be capitalized under § 263 and the regulations thereunder but for the fact that the costs create a package design (or modification to the design) having an ascertainable useful life that does not extend substantially beyond the end of the tax year in which the costs are incurred must be capitalized. All package design costs incurred after December 31, 1986, in taxable years beginning before January 1, 1994, that are capitalized under § 263A and the regulations thereunder or that would be capitalized under § 263A and the regulations thereunder but for the fact that the costs create a package design (or modification to the design) having an ascertainable useful life that does not extend substantially beyond the end of the tax year in which the costs are incurred must be capitalized. The costs required to be capitalized are described in section 2 of this revenue procedure.

(3) *Half-year convention.* Under the pool-of-cost capitalization and 48-month amortization method, the amortization allowance for package design costs must be determined by treating all package design costs incurred during the tax year as incurred on the mid-point of the tax year. If the tax year in which the package design costs are incurred is 12 full months, the costs are treated as incurred on the first day of the seventh month of the tax year. For guidance in computing the amortization allowance under the pool-of-cost capitalization and 48-month amortization method when package design costs are incurred in a taxable year of less than 12 months (a short taxable year), see Rev. Proc. 89–15.

SECTION 6. CHANGING PACKAGE DESIGN COSTS METHOD

.01 *Automatic change.* A taxpayer wanting to change its method of accounting for package design costs must follow the provisions in Rev. Proc. 97-37.

.02 *Section 481(a) adjustment.*

(1) *Change to the capitalization method.* If the taxpayer is changing its method of accounting for package design costs to the capitalization method, the § 481(a) adjustment (which will be positive) will restore to income the total amounts deducted or amortized in tax years prior to the year of change with respect to all package designs (or modifications to designs) subject to capitalization and not abandoned as of the first day of the tax year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to designs (or modifications to designs) which had an ascertainable useful life on the date the designs (or modifications to the designs) were placed in service. The § 481(a) adjustment is the difference at the beginning of the tax year of change between the basis of all such package designs (or modifications to designs) determined under the taxpayer's present method of accounting and the basis redetermined under the capitalization method.

(2) *Change to the design-by-design capitalization and 60-month amortization method.* If the taxpayer is changing its method of accounting for package design costs to the design-by-design capitalization and 60-month amortization method, the § 481(a) adjustment is equal to the total amounts deducted or amortized in tax years prior to the year of change with respect to all package designs (or modifications to designs) subject to capitalization and not abandoned as of the first day of the tax year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to such designs (or modifications to designs) had the design-by-design capitalization and 60-month amortization method been used.

(3) *Change to the pool-of-cost capitalization and 48-month amortization method.* If the taxpayer is changing its method of accounting for package design costs to the pool-of-cost capitalization and 48-month amortization method, the § 481(a) adjustment is equal to the total amounts deducted or amortized in tax years prior to the year of change with respect to all package design costs treated as incurred during the tax years prior to the year of change, less the amounts that would have been amortized during the tax years prior to the year of change with respect to such costs had the pool-of-cost capitalization and 48-month amortization method been used.

SECTION 7. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: Office of Assistant Chief Counsel (Income Tax and Accounting) CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 89–23, 1989–1 C.B. 85, is modified. Rev. Proc. 90–63, 1990–2 C.B. 664, is modified, and as modified, is superseded. However, see the transition rules in section 13.02 of Rev. Proc. 97-37.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective on August 18, 1997.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 472; 1.446–1, 1.472–1.)

Rev. Proc. 97–36

SECTION 1. PURPOSE

This revenue procedure provides an al-

.07 As stated in Rev. Rul. 89–23, package designs generally do not have an ascertainable useful life, and thus no depreciation or amortization is allowed under § 167 and the regulations thereunder. *See* § 1.167(a)–3. Only when such a package design is abandoned may the capitalized costs be deducted. *See* § 165 and § 1.165–2(a).

.08 Thus except for the costs of a package design that is an amortizable § 197 intangible, taxpayers are generally required under the Code and regulations to use the capitalization method of accounting for package design costs described in section 5.01 of this revenue procedure. However, to minimize disputes regarding the accounting for package design costs, the Internal Revenue Service, as a matter of administrative convenience, will allow a taxpayer that complies with the requirements of this revenue procedure to choose one of two alternative methods of accounting for package design costs:

(1) the capitalization and 60-month amortization method described in section 5.02 of this revenue procedure, determined on a design-by-design basis for all package designs or;

(2) the capitalization and 48-month amortization method described in section 5.03 of this revenue procedure, determined on a pool-of-cost basis for all package design costs.

SECTION 4. SCOPE

.01 *Applicability.* Except as provided in section 4.02 of this revenue procedure, this revenue procedure applies to the costs of a package design as defined in section 2 of this revenue procedure.

.02 *Inapplicability.* This revenue procedure does not apply to the costs of a package design that is an amortizable § 197 intangible as defined in § 197(c).

SECTION 5. ALTERNATIVE METHODS OF ACCOUNTING

.01 *The capitalization method.*

(1) *Description of method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the capitalization method constitutes a permissible method of accounting. Under the capitalization method, the taxpayer must capitalize the costs of developing (or modifying) any package design if the asset created by those costs has no ascertainable useful life or an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. If the asset created by the costs has an ascertainable useful life, the taxpayer may amortize the costs ratably over the useful life, beginning with the month the package design (or modification to the design) is placed in service. If the asset created by the costs has no ascertainable useful life, the taxpayer may deduct the costs only upon the disposition or abandonment of the package design (or modification to the design). *See* Rev. Rul. 89–23.

(2) *Computation of basis.* The basis of each package design (or modification to the design) subject to capitalization is determined by applying the provisions of § 263 and the regulations thereunder to costs incurred prior to January 1, 1987, or in taxable years beginning after December 31, 1993, and by applying the provisions of § 263A and the regulations thereunder to costs incurred after December 31, 1986, in taxable years beginning before January 1, 1994 (regardless of the tax year the design (or modification to the design) is placed in service). The costs required to be capitalized are described in section 2 of this revenue procedure.

.02 *The design-by-design capitalization and 60-month amortization method.*

(1) *Description of method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the design-by-design capitalization and 60-month amortization method constitutes a permissible method of accounting. Under the design-by-design capitalization and 60-month amortization method, the taxpayer must capitalize the costs of developing (or modifying) any package design if the asset created by those costs has no ascertainable useful life or an ascertainable useful life that extends substantially beyond the end of the tax year in which the costs are incurred. The taxpayer must amortize the basis of any package design (or modification to the design) subject to capitalization over a period of 60 months. Thus, in computing taxable income, the basis of each package design (or modification to the design) subject to capitalization is allowed as a deduction ratably over a 60-month period, beginning with the month the design (or modification to the design) is treated as placed in service. *See* section 5.02(3) of this revenue procedure. If the package design (or modification to the design) is disposed of or abandoned within the 60-month period, the taxpayer is permitted to deduct the unamortized portion of the basis of the design (or modification to the design) in the tax year of disposition or abandonment.

(2) *Computation of basis.* Under the design-by-design capitalization and 60-month amortization method, the basis of each package design (or modification of the design) subject to capitalization must be determined by applying the provisions of § 263 and the regulations thereunder to costs incurred prior to January 1, 1987, or in taxable years beginning after December 31, 1993, and by applying the provisions of § 263A and the regulations thereunder to costs incurred after December 31, 1986, in taxable years beginning before January 1, 1994 (regardless of the tax year the design (or modification to the design) is placed in service). The costs required to be capitalized are described in section 2 of this revenue procedure.

(3) *Half-year convention.* Under the design-by-design capitalization and 60-month amortization method, the amortization allowance for each package design (or modification to the design) subject to capitalization must be determined by treating a design (or modification to the design) placed in service during the tax year as placed in service on the mid-point of the tax year. If the tax year in which the package design (or modification to the design) is placed in service is 12 full months, the design (or modification to the design) is treated as placed in service on the first day of the seventh month of the tax year. For guidance in computing the amortization allowance under the design-by-design capitalization and 60-month amortization method when a package design (or modification to the design) is placed in service in a taxable year of less than 12 months (a short taxable year), see Rev. Proc. 89–15, 1989-1 C.B. 816.

.03 *The pool-of-cost capitalization and 48-month amortization method.*

(1) *Description of method.* The treatment of the costs of developing new package designs or modifying existing designs in accordance with the pool-of-cost capi-

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 165, 167, 263, 263A, 446, 481; 1.165-2, 1.167(a)-3, 1.263(a)-2, 1.263A-2, 1.446-1, 1.481-4.)

Rev. Proc. 97-35[1]

SECTION 1. PURPOSE

This revenue procedure describes three alternative methods of accounting for package design costs: (1) the capitalization method (*see* section 5.01 of this revenue procedure), (2) the design-by-design capitalization and 60-month amortization method (*see* section 5.02 of this revenue procedure), and (3) the pool-of-cost capitalization and 48-month amortization method (*see* section 5.03 of this revenue procedure). A taxpayer may change to or adopt any one of these three methods. The procedures for a taxpayer to change to one of these three methods are provided in Rev. Proc. 97–37, page 18, which provides simplified and uniform procedures to obtain automatic consent to make this and other changes in methods of accounting. This revenue procedure modifies and supersedes Rev. Proc. 90–63, 1990–2 C.B. 664.

SECTION 2. DEFINITIONS

For purposes of this revenue procedure, the terms "package design" and "package design cost" have the meanings provided in Rev. Rul. 89–23, 1989–1 C.B. 85. If the taxpayer develops the package design, the term includes the cost of materials, labor, and overhead associated with the design, including all design exploration and study (for example, the development of any related design which, although abandoned, advances the development of the design selected), refinement of the basic design selected, testing, and preparation of the final master comprehensive design. If an independent contractor performs the work, the term includes all billings related to the development of the particular package, including all design exploration and study (for example, the development of any related design which, although abandoned, advances the development of the design selected), refinement of the basic design selected, testing, and preparation of the final master comprehensive design. If the taxpayer purchases the package design, the term includes the purchase price. The costs associated with coupon inserts, refund offers, and other short-lived promotion-related changes are specifically excepted from the definition of "package design cost."

SECTION 3. BACKGROUND

.01 Section 263(a) of the Internal Revenue Code provides that no deduction is allowed for any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. Section 1.263(a)–2 of the Income Tax Regulations includes in its examples of capital expenditures the costs of acquiring property having a useful life substantially beyond the tax year.

.02 An expenditure generally must be capitalized under § 263 if the expenditure creates, enhances, or is part of the cost of acquiring a tangible or intangible asset having a useful life that extends substantially beyond the end of the tax year in which the expenditure is incurred. *See INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992); *Commissioner v. Lincoln Savings and Loan Association*, 403 U.S. 345 (1971), 1971-2 C.B. 116; *Central Texas Savings and Loan Association v. United States*, 731 F.2d 1181 (5th Cir. 1984); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376 (11th Cir. 1982), *cert. denied*, 463 U.S. 1207 (1983); and *Cleveland Electric Illuminating Company v. United States*, 7 Cl. Ct. 220 (1985). Generally, taxpayers must capitalize package design costs incurred prior to January 1, 1987 under § 263 because those costs create intangible assets having useful lives that extend substantially beyond the end of the tax year in which the costs are incurred. *See* Rev. Rul. 89-23.

.03 Section 263A, enacted by the Tax Reform Act of 1986, provides, in part, for the capitalization of certain direct and indirect costs with respect to real or tangible personal property produced by the taxpayer. All costs that are incurred with respect to real or tangible personal property that the taxpayer produces are to be capitalized with respect to the property. The term "produce" includes construct, build, install, manufacture, develop, improve, create, raise, or grow. For purposes of §263A, "tangible personal property" includes a film, sound recording, video tape, book, or other similar property embodying words, ideas, concepts, images, or sounds (*see* 2 H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II–308 (1986), 1986–3 (Vol. 4) C.B. 308) without regard to whether the property is treated as tangible or intangible under other provisions of the Code. *See* § 1.263A–1T(a)(5)(iii) of the temporary regulations. Section 263A and the temporary regulations thereunder required that costs incurred after December 31, 1986, in taxable years beginning before January 1, 1994, must be capitalized to the extent that they were attributable to the development and design of product packages. *See* Rev. Rul. 89–23.

.04 Section 1.263A–2(a)(2)(ii) of the final regulations, which, in the case of property that is not inventory, applies to costs incurred in taxable years beginning after December 31, 1993, modified the definition of tangible personal property to exclude from "other similar property" any intellectual or creative property that is embodied in a tangible medium that is mass distributed merely incident to the distribution of a principal product or good of the creator. Thus, package design costs incurred in taxable years beginning after December 31, 1993, are not treated as costs of tangible personal property under § 263A.

.05 Accordingly, taxpayers are required to: (1) capitalize under § 263 package design costs incurred prior to January 1, 1987, or in taxable years beginning after December 31, 1993; and (2) capitalize under § 263A package design costs incurred after December 31, 1986, in taxable years beginning before January 1, 1994.

.06 Section 197(a), which is generally applicable to property acquired after August 10, 1993, provides that a taxpayer is entitled to an amortization deduction with respect to any "amortizable § 197 intangible" (as defined in § 197(c)), which may include the costs of certain package designs. Section 197(b) provides that, other than the amoritization provided in § 197(a), no other depreciation or amortization is allowable for an amortizable § 197 intangible.

[1] This revenue procedure includes the modifications made by Rev. Proc. 98–39, 1998–26 I.R.B. 36. These modifications, effective on August 18, 1997, make clear that capitalization under § 263 (and not § 263A) applies to certain package design costs, and that this revenue procedure does not apply to the costs of a package design that is an amortizable § 197 intangible.

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Internal Revenue Service
Martinsburg Computing Center
Information Reporting Program
P O Box 1359
Martinsburg WV 25402

(use this label for U S Postal deliveries)

Internal Revenue Service
Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road
Martinsburg WV 25401

(use this label for truck or air freight deliveries)

(Reproduce as needed)

To expedite handling, please affix this label, or a substitute label, to your OUTSIDE shipping container.

Shipping by private delivery service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

Section 2. Telephone Numbers for Contacting IRS/MCC

Information Reporting Program Call Site:

304-263-8700

Between 8:30 a.m. and 4:30 p.m. Eastern Time
Monday through Friday

Telecommunication Device for the Deaf (TDD):
304-267-3367

Information Returns FAX Machine:

304-264-5602

Electronic Filing:

(IRP–BBS)
(Asynchronous)
304-264-7070

Mainframe Filing
(Bisynchronous Filing)
4.8 Modems 304-264-7080
9.6 Modems 304-264-7040
14.4 Modems 304-264-7045

HOURS OF OPERATION —
24 HOURS A DAY
7 DAYS A WEEK

This is the end of Publication 1220 for Tax Year 1997.

☞ **Note: Do not enter any other values in this field. Submit a separate record for each document. For example, if you are requesting an extension for 1099–INT and 5498 for the same payer, submit one record with "2" coded in this field and another record with "3" coded in this field. If you are requesting an extension for 1099–DIV and 1099–MISC for the same payer, submit one record with "2" coded in this field.**

176	Foreign Entity Indicator	1	Enter character "X" if the payer is a foreign entity.
177–198	Blank	22	**Enter blanks.**
199–200	Blank	2	**Enter blanks.** Diskette filers may code the ASCII carriage return/line feed (cr/lf) characters.

Extension of Time Record Layout

Transmitter Control Code	Payer TIN	Payer Name	Second Payer Name	Payer Address	Payer City
1–5	6–14	15–54	55–94	95–134	135–163

Payer State	Payer Zip Code	Document Indicator	Foreign Entity Indicator	Blank
164–165	166–174	175	176	177–198

Blank or CR/LF
199–200

Part F. Miscellaneous Information

Section 1. Addresses for Martinsburg Computing Center

To submit an application to file, waiver request (forms), correspondence, and magnetic media files, use the following:

Mailing by U. S. Postal Service:
IRS—Martinsburg Computing Center
Information Reporting Program
P. O. Box 1359, MS-360
Martinsburg, WV *25402-1359*

Shipping private delivery service:

IRS—Martinsburg Computing Center
Information Reporting Program
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

To submit a magnetically filed extension of time request, use the following:

Mailing by U.S. Postal Service:
IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

☞ **Note: See Part D, IRP–BBS Electronic Filing Specifications, for detailed information on filing with IRS/MCC via IRP–BBS.**

Sec. 3. Record Layout

.01 Positions 6 through 174 of the following record should contain information about the **payer** for whom the extension of time to file is being requested. Do not enter transmitter information in these fields. **Only one TCC may be present in a file.**

Record Layout for Extension of Time

Field Position	Field Title	Length	Description and Remarks
1–5	Transmitter Control Code (TCC)	5	**Required**. Enter the five digit Transmitter Control Code issued by IRS. **Only one TCC per file is acceptable.**
6–14	Payer TIN	9	**Required**. Must be the valid nine-digit EIN/SSN assigned to the payer. **Do not enter blanks, hyphens or alpha characters.** All zeros, ones, twos, etc. will have the effect of an incorrect TIN. For foreign entities that are not required to have a TIN, this field may be blank; however, the Foreign Entity Indicator, position 17***6***, **must** be set to "X."
15–54	Payer Name	40	**Required**. Enter the name of the payer whose TIN appears in positions 6–14. Left justify information.
55–94	Second Payer Name	40	If additional space is needed, this field may be used to continue name line information (*e.g.*, c/o First National Bank); otherwise, **enter blanks.**
95–134	Payer Address	40	**Required**. Enter the payer's address. Street address should include number, street, apartment or suite number (or P.O. Box if mail is not delivered to a street address).
135–163	Payer City	29	**Required**. Enter payer city, town, or post office.
164–165	Payer State	2	**Required**. Enter payer valid U.S. Postal Service state abbreviation (refer to Part A, Sec. 18).
166–174	Payer ZIP Code	9	**Required**. Enter payer ZIP code. If using a five-digit ZIP code, left justify information and fill unused positions with blanks.
175	Document Indicator (See **Note**)	1	**Required**. Enter the document you are requesting an extension of time for using the following code:

Code	Document
1	W–2
2	1098, 1099–A, 1099–B, 1099–C, 1099–DIV, 1099–G, 1099–INT, *1099–LTC*, 1099–MISC, *1099–MSA*, 1099–OID, 1099–PATR, 1099–R, 1099–S, or W–2G
3	5498, *5498–MSA*
4	1042–S
5	REMIC Documents (1099–INT or 1099–OID)

(5) If extraneous data follows the End of Transmission "F" Record, the file must be returned for replacement. Therefore, IRS/MCC encourages transmitters to use blank tape cartridges, rather than cartridges previously used, in the preparation of data when submitting information returns.

(6) IRS/MCC can only read one data file on a tape. A data file is a group of records which may or may not begin with a tape-mark, but must end with a trailer label. Any data beyond the trailer label cannot be read by IRS programs.

(7) 4mm (.157-inch) cassettes are now acceptable with the following specifications:

(a) 4mm cassettes will be 2 1/4-inch by 3-inch.

(b) The tracks are 1 (one).

(c) The density is 19 (61000 BPI).

(d) The typical capacity is DDS (DAT data storage) at 1.3 Gb or 2 Gb, or DDS-2 at 4 Gb.

(e) The general specifications for 8mm cartridges will also apply to the 4mm cassettes.

(8) Various Quarter Inch Cartridges (QIC) (1/4-inch) are also acceptable.

(a) QIC cartridges will be 4" by 6".

(b) QIC cartridges must meet the following specification:

Size	*Tracks*	*Density*	*Capacity*
QIC-11	*4/5*	*4 (8000 BPI)*	*22Mb or 30Mb*
QIC-24	*8/9*	*5 (8000 BPI)*	*45Mb or 60Mb*
QIC-120	*15*	*15 (10000 BPI)*	*120Mb or 200Mb*
QIC-150	*18*	*16 (10000 BPI)*	*150Mb or 250Mb*
QIC-320	*26*	*17 (16000 BPI)*	*320Mb*
QIC-525	*26*	*17 (16000 BPI)*	*525Mb*
QIC-1000	*30*	*21 (36000 BPI)*	*1Gb*
QIC-1350	*30*	*18 (51667 BPI)*	*1.3Gb*
QIC-2Gb	*42*	*34 (40640 BPI)*	*2Gb*

(c) The general specifications that apply to 8mm cartridges will also apply to QIC cartridges.

.04 Diskette specifications are as follows:

(a) 5 1/4- or 3 1/2-inches in diameter.

(b) ASCII recording mode **only**. Additional specifications may be found in Part B, Sec. 3, of this revenue procedure.

(c) Record length of 200 bytes.

(d) Diskettes must be created using the MS-DOS operating system.

(e) Filename of IRSEOT must be used. No other filenames are acceptable. If a file will consist of more than one diskette, the filename IRSEOT will contain a three-digit extension. This extension will indicate the sequence of the diskettes within the file. For example, the first diskette will be named IRSEOT.001, the second diskette will be named IRSEOT.002, etc.

(f) Delimiter character commas (,) must not be used.

(g) Positions 199 and 200 of each record have been reserved for use as carriage return/line feed (cr/lf) characters, if applicable.

.05 Bisynchronous electronic specifications include:

(a) Transmitter must have Transmitter Control Code (TCC) *and a valid IRS/MCC-assigned password prior to submitting data files.*

(b) Access phone numbers:

4800 bps	**304-264-7080**
9600 bps	**304-264-7040**
14400 bps	**304-265-7045**

☞ **Note: See Part C, Bisynchronous (Mainframe) Electronic Filing Specifications, for detailed information on filing with IRS/MCC via bisynchronous protocols.**

.06 IRP-BBS specifications include:

(a) Transmitter must have Transmitter Control Code (TCC).

(b) IRP-BBS access phone number is **304-264-7070.**

(c) Communications software settings are:

— No parity
— Eight data bits
— One stop bit
— Full duplex

(d) Access speeds from 1200 to 28,800 bps.

(e) Record length of 200 bytes.
(f) Labeled or unlabeled tapes may be submitted.

.02 Tape cartridge specifications are as follows:
(a) Must be IBM 3480, 3490, or AS400 compatible.
(b) Must meet American National Standard Institute (ANSI) standards and have the following characteristics:
(1) Tape cartridges will be 1/2-inch tape contained in plastic cartridges which are approximately 4-inches by 5-inches by 1-inch in dimension.
(2) Magnetic tape will be chromium dioxide particle based 1/2-inch tape.
(3) Cartridges will be 18-track or 36-track parallel. Indicate on the external media label if the tape cartridge is 18- or 36-track.
(4) Mode will be full function.
(5) The data may be compressed using EDRC (Memorex) or IDRC (IBM) compression.
(6) Either EBCDIC or ASCII.
(c) A block must not exceed 32,600 tape positions and must be a multiple of 200.
(d) Record length of 200 bytes.
(e) Labeled or unlabeled tape cartridges may be submitted.

.03 *8mm, 4mm, and Quarter Inch Cartridge Specifications*
(a) In most instances, IRS/MCC can process 8mm tape cartridges that meet the following specifications:
(1) Must meet American National Standard Institute (ANSI) standards, and have the following characteristics:
(a) Created from an AS400 operating system **only.**
(b) 8mm (.315-inch) tape cartridges will be 2 1/2 -inch by 3 3/4-inch.
(c) The 8mm tape cartridges must meet the following specifications:

Tracks	*Density*	*Capacity*
1	*20 (43245 BPI)*	*2.3 Gb (10Gb)*
1	*21 (45434 BPI)*	*5 Gb (20 Gb)*

(d) Mode will be full function.
(e) **Compressed data is not acceptable.**
(f) Either EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) may be used. However, IRS/MCC encourages the use of EBCDIC. This information must appear on the external media label affixed to the cartridge.
(g) A file may consist of more than one cartridge, however, no more than 250,000 documents may be transmitted per file or per cartridge. The filename, for example; IRSTAX, will contain a three digit extension. The extension will indicate the sequence of the cartridge within the file 1 of 3, 2 of 3, or 3 of 3 and would appear in the header label IRSTAX.001, IRSTAX.002, and IRSTAX.003. on each cartridge of the file. The end of transmission "F" Record should be placed on the last cartridge only for files containing multiple cartridges.
(2) The 8mm (.315-inch) tape cartridge records defined in this revenue procedure may be blocked subject to the following:
(a) A block must not exceed 32,600 tape positions.
(b) If the use of blocked records would result in a short block, all remaining positions of the block must be filled with 9s; however, the last block of the file may be filled with 9s or truncated. Do not pad a block with blanks.
(c) All records, except the header and trailer labels, may be blocked or unblocked. A record may not contain any control fields or block descriptor fields which describe the length of the block or the logical records within a block (the blocking factor) must be constant in every block with the exception the last block which may be shorter (see item (b) above). The block length must be evenly divisible by 200.
(d) Various SAVE commands have been successful, however, the **SAVE OBJECT COMMAND is not acceptable.**
(e) Extraneous data following the "F" Record will result in media being returned for replacement.
(f) Records may not span blocks.
(g) No more than 250,000 documents per cartridge and per file.
(3) For faster processing, IRS/MCC encourages transmitters to use header labeled cartridges. IRSTAX may be used as a suggested filename.
(4) For the purposes of this revenue procedure, the following must be used:
Tape Mark:
(a) Used to signify the physical end of the recording on tape.
(b) For even parity, use BCD configuration 001111 (8421).
(c) May follow the header label and precede and/or follow the trailer label.

.07 The extension record format is also on the IRP-BBS and can be downloaded. **See Part D for more information on how to contact the IRP–BBS.**

.08 A magnetically-filed request for an extension of time should be sent using the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
P. O. Box 879, MS-360
Kearneysville, WV 25430

If by private delivery service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Extension of Time Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

☞ **Note: Due to the large volume of mail received by IRS/MCC and the time factor involved in processing the Form 8809, it is imperative that the attention line be present on all envelopes or packages containing Extension of Time (EOT) requests.**

.09 Requests for extension of time to file postmarked by the United States Postal Service on or before the due date of the returns, and delivered by United States mail to the IRS/MCC after the due date, are treated as timely under the "timely mailing as timely filing" rule. A similar rule applies to designated private delivery services (PDSs). See section 10 of Part A for more information on PDSs. For requests delivered by a designated PDS, but through a non-designated service, the actual date of receipt by IRS/MCC will be used as the filing date.

.10 Transmitters who submit their extensions of time requests magnetically or electronically will receive a letter from IRS/MCC with an attached list of the payers specifying approval and/or denial.

.11 Do not submit tax year *1997* extensions of time to file requests on magnetic media or electronically before January 1, *1998.*

.12 Filers may request an extension of time **as soon as they are aware** that an extension is necessary but not later than the due date of the return. It will take a minimum of 30 days for IRS/MCC to respond to an extension request. Under certain circumstances a request for an extension of time could be denied. In such cases, the transmitter receives a denial letter. When this denial letter is received, the transmitter has 20 days to provide the additional or necessary information and resubmit the extension request to IRS/MCC.

.13 Each piece of magnetic media **must** have an external media label containing the following information:

(a) Transmitter name
(b) Transmitter Control Code (TCC)
(c) Tax year
(d) The words "Extension of Time"
(e) Record count

.14 A request for an extension of time to file is not automatically granted. Approval or denial is dependent on information provided on the Form 8809.

.15 If the first request for an extension of time to file was submitted magnetically or electronically, additional extension requests should be submitted in the same manner.

.16 If an additional extension of time is needed, a second Form 8809 and file may be submitted before the end of the initial extension period. Line 7 on the form should be checked to indicate that the original extension has been received and the additional extension is being requested.

.17 See part A, Sec. 11, for complete information on requesting an extension of time to file information returns. If there are additional questions or concerns, contact IRS/MCC.

Sec. 2. Magnetic Tape, Tape Cartridge, 8mm, 4mm and QIC (quarter inch cartridge), 5 1/4- and 3 1/2-inch Diskette and Electronic Specifications

.01 Tape specifications are as follows:

(a) 9 track.
(b) EBCDIC (Extended Binary Coded Decimal Interchange Code) or ASCII (American Standard Coded Information Interchange) recording mode.
(c) 1600 or 6250 BPI.
(d) A block must not exceed 32,600 tape positions and must be a multiple of 200.

Cannot determine file status	Not dialing back thru IRP-BBS to check the status of the file	Within 24 to 48 hours after sending a file, check under (F)ile Status for notification of acceptability
Transfer aborts before it starts	Transfer protocol mismatch	Ensure protocols match on both the sending and receiving ends

IRS Encountered Problems

Problem	Probable Cause	Solution
Loss of carrier during session	Incorrect modem settings on user's end	Reference your modem manual about increasing the value of the S10 register
Unreadable screens after selecting "IBM w/ANSI"	ANSI.SYS driver not loaded in the user's PC	Select non ANSI under (Y) our settings
IRS cannot complete final processing of data	User did not mail the Form 4804	Mail completed Form 4804 the same day as the electronic transmission
IRS cannot determine which file is being replaced	User did not indicate which file is being replaced	Must enter the file name that is being replaced under the replacement option
IRS cannot determine the type of file being sent	User incorrectly indicated T, P, C, or R for the type of file	When prompted, enter the correct type of file for data being sent
Replacement file not returned within 45 days	User did not dial back thru IRP–BBS to check the status of file	Within two workdays check under (F)ile Status for notification of acceptability
Duplicate data	Transmitter sends corrections for entire file	Only submit corrections for incorrect records

Part E. Magnetic/Electronic Specifications For Extensions of Time

Sec. 1. General

.01 The specifications in Part E include the required 200-byte record format for extensions of time to file requests submitted magnetically or electronically. Also included are the instructions for the information that is to be entered in the record. **Filers are advised to read this section in its entirety to ensure proper filing.**

.02 Only filers who have been assigned a Transmitter Control Code may request an extension of time magnetically or electronically. If you meet the threshold of more than 50 payers when requesting an extension but are below the 250 documents threshold, you must still submit a Form 4419, Application for Filing Information Returns Magnetically/Electronically.
Requests for extensions of time may be made for Forms 1098, 1099, 5498, W-2G, W-2, and 1042-S.

.03 For Tax Year *1997* (returns due to be filed in *1998*), transmitters requesting an extension of time to file for **more than 50 payers (not payees) are required to file the extension request magnetically or electronically**. Transmitters requesting an extension of time for 10 to 50 payers (not payees) are encouraged to file the request magnetically or electronically. The request may be filed on tape, tape cartridge, 5 1/4- and 3 1/2-inch diskette, or electronically.

.04 For extension requests filed on magnetic media, the transmitter must mail the completed, signed Form 8809, Request for Extension of Time To File Information Returns, in the same package as the corresponding media. For extension requests filed electronically, the transmitter must FAX the Form 8809 the same day the transmission is made.

.05 Transmitters submitting an extension of time magnetically or electronically should not submit a list of payer names and TINS with the Form 8809. However, Box 6 of the Form 8809 must be completed with the total number of records included on the magnetic media or electronic file.

.06 To be considered, an extension request must be submitted or transmitted on or before the due date of the returns; otherwise, the request will be denied.

.05 A signed Form 4804 submitted for electronically filed information returns may be sent to IRS/MCC at the following number: **304-264-5602**. Faxed transmittals will allow IRS/MCC to begin processing the file immediately; however, a filer must still send the actual signed Form 4804 the same day as the electronic submission.

Sec. 6. Information Reporting Program Bulletin Board System (IRP-BBS) Specifications

.01 The IRP-BBS is an electronic bulletin board system available to filers of information returns. In addition to filing information returns electronically, the IRP-BBS provides other capabilities. Some of the advantages of IRP-BBS are as follows:

(1) Notification within two workdays as to the acceptability of the data transmitted.

(2) Immediate access to the latest changes and updates that affect the Information Reporting Program at IRS/MCC (program, legislative, etc.).

(3) Access to publications such as the Publication 1220 as soon as they are available.

(4) Capability to communicate with IRS/MCC personnel.

(5) Ability to retrieve information and files applicable to the IRP-BBS.

.02 The IRP-BBS is available for public use and accessible using various personal computer communications equipment; however, electronic submission of information returns is limited to holders of valid TCCs. A TCC is not needed to access those portions of the IRP-BBS that contain forms and publications or to leave questions or messages for IRS/MCC personnel.

.03 Filers using IRP-BBS can determine the acceptability of files submitted by checking the file status area of the bulletin board. These reports are not immediately available but will be available two workdays after the transmission is received by IRS/MCC.

.04 Contact the IRP-BBS by dialing **304-264-7070.** The communication software settings for IRP-BBS are:

— No parity
— Eight data bits
— One stop bit
— Full duplex

The communication software should be set up to use the fastest speed allowed by the filer's modem.

.05 Due to the large number of communication products available, it is impossible to provide specific information on a particular software package or hardware configuration. Filers should contact their software or hardware supplier for assistance.

.06 IRP-BBS software provides a menu-driven environment allowing access to different parts of IRP-BBS. Whenever possible, IRS/MCC personnel will provide assistance in resolving any communication problems with IRP-BBS.

.07 IRP-BBS can be accessed at speeds from 1200 to 28,800 bps. The speed is automatically negotiated for connection at the speed of the calling modem. The communication standards supported include Industry Standard 212A, V.22bis, V.32, V.32bis, V.34, and V.FC. Point-to-point error control is supported using the V.42 ITU-T standard or MNP 2-4. Data compression is supported using V.42bis ITU-T standard or MNP5.

Sec. 7. IRP-BBS First Logon Procedures

.01 The following information will be requested to set up the filer's user profile when logging onto the IRP-BBS for the first time.

(A) Enter the letter, that corresponds to the filer's terminal, from the following:

<A> IBM PC <B> IBM w/ANSI <C> Atari
<D> ADM-3 <E> H19/Z19/H89 <F> Televid 925
<G> TRS-80 <H> Vidtex <I> VT-52
<J> VT-100 <CR> if none of the above

Most PCs, clones, etc., will select the IBM PC emulation. Machines with color, CGA, EGA, or VGA should select IBM w/ANSI.

(B) Upper/lower case, line feed needed, O (zero) nulls after each <CR>, do you wish to modify this? (Most users answer no.)

Common User Problems

Problem	Probable Cause	Solution
File does not upload/download	Not starting communication when prompted by 'Awaiting Start Signal'	Start upload/download on filers end
All files not processed	Compressing several files into one filename	Compress only one file for every filename
Replacement needed	Original data does not meet processing and/or format requirements	Replacement must be submitted within 45 days of original transmission

time) into several smaller files. For example, if large files contain several types of returns or payers, transmit each type of return or payer as a separate file. As a result, if only one of the files is incorrect, a replacement would be needed for only the incorrect file.

.03 Do not transmit data using IRP-BBS January 1 through January 7. This will allow time for the IRP-BBS to be updated to reflect current year changes.

.04 Data compression is encouraged when submitting information returns by way of the IRP-BBS. MCC has the ability to decompress files created using several popular software compression programs such as ARC, LHARC, and PKZIP. Software data compression can be done alone or in conjunction with V.42bis hardware compression.

The time required to transmit information returns electronically will vary depending on the modem speed and the type of data compression used, if any. However, transmissions to IRP-BBS will be significantly faster than electronic filing to the mainframe. **The time required to transmit a file can be reduced by as much as 85 percent by using software compression and hardware compression.**

The following are actual transmission rates achieved in test uploads at MCC using compressed files (PKZIP) and the XMODEM-1K protocol. The actual transmission rates will vary depending on the protocol that is used. (ZMODEM is normally the fastest protocol and XMODEM and KERMIT are the slower protocols.)

Transmission Speed in bps	500 Records	2500 Records	10000 Records
9600	*40 sec*	*2 min 50 sec*	*12 min 21 sec*
19200	*31 sec*	*1 min 34 sec*	*7 min 1 sec*
38400	*17 sec*	*36 sec*	*4 min 7 sec*

.05 Files submitted to IRP-BBS must have a unique filename; therefore, the IRP-BBS will build the filename that must be used. The name will consist of the filer's TCC, submission type (T = Test, P = Production, C = Correction, and R = Replacement) and a sequence number. Filers may call the file anything they choose on their end. The sequence number will be incremented every time the filers send, or attempt to send, a file. Record the upload date, time, and filename. This information will be needed by MCC in order to identify the file if assistance is required and to complete Form 4804.

Sec. 5. Transmittal Requirements

.01 The results of the electronic transmission will be posted to the (F)ile Status area of the IRP-BBS; however, no further processing will occur until the signed Form 4804 is received. The transmitter must send the signed Form 4804 the same day the electronic transmission is made. No return is considered filed until a Form 4804 is received by IRS/MCC.

.02 Form 4804 can be ordered by calling the IRS toll-free forms and publication order number **1-800-TAX-FORM, (1-800-829-3676),** downloaded from the IRP-BBS, or it may be computer-generated. If a filer chooses to computer-generate Form 4804, all of the information contained on the original form, including the affidavit, must also be contained on the computer-generated form.

.03 The filer whose TCC is used in the "A" Record is responsible for submitting the transmittal Form 4804.

.04 Forms 4804 may be mailed to the following addresses:

If by Postal Service:
IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Electronic Filing Coordinator
P. O. Box 1359, MS-360
Martinsburg, WV ***25402-1359***

☞ **Note: The ZIP Code has changed from 25401–1359 to 25402–1359 for the IRS P.O. Box addresses for Martinsburg, WV**

If by private delivery service:
IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Electronic Filing Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

Type of File Indicator	Replacement File Name	Quote	Blanks
44	45–51	52	53–420

Part D. Asynchronous (IRP–BBS) Electronic Filing Specifications

Sec. 1. General

.01 Asynchronous electronic filing of Forms 1098, 1099, 5498, and W–2G, originals, corrections, and replacements of information returns is offered as an alternative to magnetic media (tape, tape cartridge, or diskette) or paper filing, but is not a requirement. Electronic filing using the Information Reporting Program Bulletin Board System (IRP–BBS) will fulfill the magnetic media requirements for those payers who are required to file magnetically. It may also be used by payers who are under the filing threshold requirement, but would prefer to file their information returns this way. If the original file was sent magnetically, but was returned for replacement, the replacement may be transmitted electronically. Also, if the original file was submitted via magnetic media, any corrections may be transmitted electronically.

.02 The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 tax returns. Filers with questions of this nature will be directed to the Taxpayer Service toll-free number (**1-800-829-1040**) for assistance.

.03 Filers participating in the electronic filing program, for information returns will submit their returns to IRS/MCC via electronically and not through magnetic media or paper filing. Files submitted in this manner must be in standard ASCII code.

.04 If a request for extension is approved, transmitters who file electronically will be granted an extension of 30 days to file. Part A, Sec. 11, explains procedures for requesting extensions of time. Filers are encouraged to file their data as soon as possible.

.05 The formats of the "A", "B", "C", "K", and "F" Records are the same for electronically filed records as they are for 5 1/4- and 3 1/2-inch diskettes, tapes, and tape cartridges and must be in standard ASCII code. For electronically filed documents, each transmission is considered a separate file; therefore, each transmission **must** have an End of Transmission (EOT) "F" Record.

Sec. 2. Electronic Filing Approval Procedure

.01 Filers must obtain, or already have, a Transmitter Control Code (TCC) assigned to them prior to submitting their files electronically. (Filers who currently have a TCC for magnetic filing do not have to request a second TCC for electronic filing.) Refer to Part A, Sec. 7, for information on how to obtain a TCC.

.02 Once a TCC is obtained, filers using IRP-BBS assign their own passwords and do not need special approval.

.03 With all passwords, it is the user's responsibility to remember the password and not allow the password to be compromised. However, if filers do forget their password, call **304-263-8700** for assistance.

☞ **Note: Passwords on the IRP–BBS are case sensitive.**

Sec. 3. Test Files

.01 Filers are not required to submit a test file; however, the submission of a test file is encouraged for first time electronic filers in order to resolve any data or communication problems prior to the filing season. If filers wish to submit an electronic test file for Tax Year *1997* (returns to be filed in *1998*), it **must** be submitted to IRS/MCC **no earlier than** November 1, *1997*, and **no later than** December 31, *1997*.

.02 If a filer encounters problems while transmitting the electronic test files, contact IRS/MCC for assistance.

.03 Filers can verify the status of their transmitted test data by dialing the IRP-BBS. This information will be available within two workdays after their transmission is received by IRS/MCC.

.04 A test file is required from filers who want approval for the Combined Federal/State Filing Program. See Part A, Sec. 16 for further details.

Sec. 4. Electronic Submissions

.01 Electronically filed information may be submitted to IRS/MCC 24 hours a day, 7 days a week. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern Time by calling **304-263-8700**.

.02 Filers may submit as many documents as they choose electronically. Filers are allowed 240 minutes a day; however, more time may be requested if needed. It may be advantageous to break down large files (**files in excess of *two* hours of transmission**

will be disconnected. If this message is not received, there was a problem with the submission, and the filer should contact IRS/MCC immediately.

.04 Upon receiving a data file and transmittal Form 4804, IRS/MCC will release the data for further processing. If the media cannot be processed, the filer will be notified by either letter or telephone that the data must be retransmitted. This file name, if necessary, will be provided by IRS/MCC and is to be placed in positions 45–51 of the $$ADD record when the file is retransmitted.

Record Name: $$ADD

Field Position	Field Title	Length	Description and Remarks
1–9	$$ADD Identifier Record	9	Enter the following characters: $$ADD ID=
10–17	Password	8	Enter the password assigned by IRS/MCC. For information concerning the password, see Part C, Sec. 2.
18	Blank	1	**Enter a blank.**
19–26	BATCHID	8	Enter the following characters: BATCHID=
27	Quote	1	Enter a single quote (‘).
28–43	Transmitter Name	16	Enter the transmitter's name. This name should remain consistent in all transmissions. If the transmitter's name exceeds 16 positions, truncate the name.
44	Type of File Indicator	1	Enter the Type of File Indicator from the list below: O = Original filing T = Test file C = Correction file R = Replacement file E = Extension file
45–51	Replacement File Name	7	**Use this field only if this is a replacement file.** Enter the replacement file name which IRS/MCC has assigned to this file. This file name will be provided to the filer in the letter notifying them that a replacement file is necessary. If contact is made by telephone, the replacement file name will be given to the filer by IRS/MCC at that time. For other than replacement files, this field will contain blanks.
52	Quote	1	Enter a single quote (‘).
53–420	Blanks	368	**Enter blanks.**

Electronic Filing Identifier $$ADD Record — Record Layout

$$ADD Identifier Record	Password	Blank	BATCHID	Quote	Transmitter Name
1–9	10–17	18	19–26	27	28–43

.04 The 9600 bps line terminates at an AT&T Dataphone II 2296A modem. The AT&T 2296A modem is a full-duplex, CCITT V.32 compatible unit which operates at 9600 bps or 4800 bps (fallback). The following options have been selected:

— Receiver Responds to Remote Loopback
— Loss-of-Carrier Disconnect
— Received-Space Disconnect
— Send-Space Disconnect
— Automatic Answer
— Answer on Ring 1
— DTR Interlock
— Retrain Enable
— Internal Timing
— CTS Controlled by RTS
— 0 - 1 ms RTS to CTS Delay
— CTS Dependent on Carrier
— RR Indicates Carrier
— 9600 Trellis Coding
— 4800 bps Fallback
— 4 dB Compromise Equalization

.05 The 14400 bps line terminates at a Hayes OPTIMA 288 V.FC Smartmodem. The Hayes OPTIMA Smartmodem is a half-duplex, ITU-T (formerly CCITT) V.32 and V.32 bis compatible unit which operates at 14400 bps, 9600 bps, or 4800 bps (fallback). The following options have been selected:

— Monitor DTR signal
— Assert DSR signal after handshake negotiation, but before connect result code
— Ring control S=1

Sec. 7. Bisynchronous Electronic Filing Record Specifications

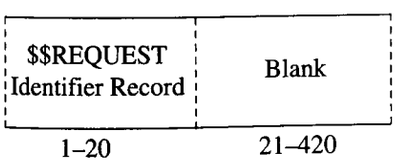
.01 For bisynchronous filing there are two additional identifier records which must be used to transmit data. These records are 420 positions in length and are the first ($$REQUEST) and second ($$ADD) records sent in an electronic transmission. The purpose of these records is to provide the password and identity of the transmitter. The $$REQUEST, $$ADD, and the data file should be transmitted as one file. In some cases, filers have attempted to send the $$REQUEST and $$ADD as separate files. Doing this will result in a failed transmission.

.02 With the exception of these additional records, the file format for electronic filing is the same as for magnetic media filing. The format of each of these records is as follows:

Record Name: $$REQUEST

Field Position	Field Title	Length	Description and Remarks
1–20	$$REQUEST Identifier Record	20	Enter the following characters: $$REQUEST ID=MSG-FILE
21–420	Blank	400	**Enter blanks.**

Electronic Filing Identifier $$REQUEST RECORD — Record Layout



.03 Upon making contact with IRS/MCC and furnishing a valid password in the $$ADD identifier record, a data transmission session will commence. The transmission will continue until an End of Transmission (EOT) "F" Record is received. At the end of each transmission, the following message should be received electronically by the filer: "DATA RECEIVED AT MCC" and the line

.03 The time required to transmit information returns electronically will vary depending on the modem speed, if IBM 3780 data compression is used, and if the records are blocked. The following transmission rates were based on actual test files received at MCC:

4,500 records	**50 minutes**	**(4800 bps, no compression, one record per block)**
54,000 records	**4 hours**	**(9600 bps, compression, two records per block)**

Sec. 5. Transmittal Requirements

.01 All data submitted electronically is verified by transmittal Form 4804. The transmitter must send the signed Form 4804 the same day the transmission is made. No return is considered filed until a Form 4804 is received by IRS/MCC.

.02 Form 4804 can be ordered by calling the IRS toll free forms and publications order number **1-800-TAX-FORM (1-800- 829-3676)** or it may be computer-generated. If a filer chooses to computer-generate Form 4804, all of the information contained on the original form, including the affidavit, must also be contained on the computer-generated form.

.03 The filer whose TCC is used in the "A" Record is responsible for submitting the transmittal Form 4804.

.04 Forms 4804 may be mailed to the following addresses:

If by Postal Service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Electronic Filing Coordinator
P. O. Box 1359, MS-360
Martinsburg, WV *25402-1359*

☞ **Note: The ZIP Code has changed from 25401-1359 to 25402-1359 for the IRS P.O. Box addresses for Martinsburg, WV.**

If by private delivery service:

IRS-Martinsburg Computing Center
Information Reporting Program
Attn: Electronic Filing Coordinator
Route 9 and Needy Road, MS-360
Martinsburg, WV 25401

.05 A signed Form 4804 submitted for electronically filed information returns may be sent to IRS/MCC at the following number: **304-264-5602.** Faxed transmittals will allow IRS/MCC to begin processing the file immediately; however, a filer must still send the actual signed Form 4804 the same day as the electronic submission.

Sec. 6. IBM 3780 Bisynchronous Communication Specifications

In compliance with Year 2000 changes, the current bisynchronous electronic filing communication package will change in the future.

.01 Transmissions using IBM 3780 bisynchronous protocols must be in EBCDIC character code. Modems must be compatible with either Bell 208B for 4800 bps transmissions, AT&T 2296A for 9600 bps transmissions, or Hayes OPTIMA 288 V.FC Smartmodem for 14400 bps transmissions. These modems are dial-up type modems using the Public Switched Telephone Network. IBM 3780 data compression is acceptable for any bisynchronous transmission. Records may be blocked up to 4096 bytes with INTER RECORD SEPARATORS.

.02 IRS/MCC will accept information returns filed electronically over switched telecommunications network circuits. For 4800 bps, the circuit will be **304-264-7080.** For 9600 bps, the circuit will be **304-264-7040. For 14400 bps, the circuit will be 304-264-7045**. These circuits are equipped for bisynchronous transmission using the IBM 3780 protocol.

.03 The 4800 bps line terminates at a Bell 208B modem. The Bell 208B modem uses phase-shift keying and eight-phase modulation to transmit binary serial data signals over the telephone line in half-duplex mode. The following options have been selected:

— Transmit Level set to -4 dBm
— Compromise Equalizer in (4-Db Slope)
— DSR off in Analog Loop Mode
— Automatic Answer
— Transmitter Internally Timed
— RS–CS Interval of 50 ms

Sec. 2. Electronic Filing Approval Procedure

.01 Filers must obtain, or already have, a Transmitter Control Code (TCC) assigned to them prior to submitting their files electronically. (Filers who currently have a TCC for magnetic filing do not have to request a second TCC for electronic filing.) Refer to Part A, Sec. 7, for information on how to obtain a TCC.

.02 Filers using bisynchronous protocols must obtain an IRS/MCC-assigned password prior to submitting test or actual data files. To obtain a password, the following steps must be taken:

(a) Bisynchronous filers who already have a TCC must submit either Form 4419 or a letter to indicate that they wish to file information returns electronically. Another TCC will not be assigned. If a letter is submitted, it must contain the following:

1) Name and address of transmitter.

2) Transmitter Control Code.

3) Name and phone number of a contact person within the filer's organization to whom a password will be assigned.

(b) Within 30 days of receiving the application or letter, IRS/MCC will send Form 6086, Time Sharing Operation (TSO) Password Assignment, to the filer which will contain the password to be used for electronic submissions.

(c) Upon receipt of Form 6086, the user (person who will actually transmit the data) will separate the acknowledgment from the password. Both the user and the user's manager **must** sign the acknowledgment and mail to:

Chief, Security and Disclosure Branch
IRS, Martinsburg Computing Center
P. O. Box 1208, MS-370
Martinsburg, WV *25402*

(d) The users or filers should retain a copy of the signed acknowledgment for their records. It is the filer's responsibility to ensure that the password is not compromised. Access to IRS/MCC computers will not be allowed without a valid password. After a password is received and the acknowledgment returned, the filer may submit a data file.

(e) For security reasons, all bisynchronous passwords will expire periodically, and a new password will automatically be assigned.If filers have any questions relating to the security procedures, and/or they need to report their password has been compromised, they must contact IRS/MCC as soon as possible at:

IRS/MCC
Information Returns Branch
P. O. Box 1359, MS-360
Martinsburg, WV *25402-1359*

or by calling: **304-263-8700.**

.03 It is the user's responsibility to remember the password and not allow the password to be compromised.

Sec. 3. Test Files

.01 Filers are not required to submit a test file; however, the submission of a test file is encouraged for first time electronic filers in order to resolve any data or communication problems prior to the filing season. If filers wish to submit an electronic test file for Tax Year *1997* (returns to be filed in *1998*), it **must** be submitted to IRS/MCC **no earlier than** November 1, *1997*, and no later than December 31, *1997*.

.02 If a filer encounters problems while transmitting electronic test files, contact IRS/MCC for assistance.

.03 A password must be obtained before submitting an electronic test file.

.04 Bisynchronous electronic test files will be processed and filers will be notified as to the acceptability of their data within 5 workdays of the date the data and transmittal Form 4804 are received by IRS/MCC.

.05 A test file is required from filers who want approval for the Combined Federal/State Filing Program. See Part A, Sec. 16, for further details.

Sec. 4. Electronic Submissions

.01 Electronically filed information may be submitted to IRS/MCC 7 days a week, 24 hours a day, except for routine maintenance/backup which is performed at 4:00 a.m. Eastern Time. Technical assistance will be available Monday through Friday between 8:30 a.m. and 4:30 p.m. Eastern Time by calling **304-263-8700.**

.02 Lengthy transmissions **(100,000 or more records)** are not encouraged since the transmission may be interrupted by line noise problems. **It is advisable to break lengthy files into multiple transmissions.**

Sec. 11. End of Transmission "F" Record — General Field Descriptions and Record Layout

.01 The end of transmission "F" record is a fixed record length of 420 positions. The "F" Record is a summary of the number of payers in the entire file.

.02 This record should be written after the last "C" Record (or last "K" Record, when applicable) of the **entire** file.

Record Name: End of Transmission "F" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "F."
2–5	Number of "A" Records	4	Enter the total number of Payer "A" Records in the entire file (right justify and zero fill) or enter all zeros.
6–30	Zero	25	Enter zeros.
31–420	Blank	390	**Enter blanks** or carriage return/line feed (cr/lf) characters in positions 419–420.

End of Transmission "F" Record — Record Layout

Record Type	Number of "A" Records	Zeros	Blank or CR/LF
1	2–5	6–30	31–420

Part C. Bisynchronous (Mainframe) Electronic Filing Specifications

Sec. 1. General

In compliance with Year 2000 changes, the current bisynchronous electronic filing communication package will change in the future.

.01 Bisynchronous electronic filing of Forms 1098, 1099, 5498, and W–2G, originals, corrections, and replacements of information returns is offered as an alternative to magnetic media (tape, tape cartridge, or diskette) or paper filing, but is not a requirement. This method uses IBM 3780 communications protocols and is used primarily by mainframe filers. Electronic filing will fulfill the magnetic media requirements for those payers who are required to file magnetically. It may also be used by payers who are under the filing threshold requirement, but would prefer to file their information returns this way.

.02 The electronic filing of information returns is not affiliated with the Form 1040 electronic filing program. These two programs are totally independent, and filers must obtain separate approval to participate in each of them. All inquiries concerning the electronic filing of information returns should be directed to IRS/MCC. IRS/MCC personnel cannot answer questions or assist taxpayers in the filing of Form 1040 tax returns. Filers with questions of this nature will be directed to the Taxpayer Service toll free number (**1-800-829-1040**) for assistance.

.03 Filers participating in the electronic filing program for information returns will submit their returns to IRS/MCC electronically, and not through magnetic media or paper filing.

.04 If a request for extension is approved, transmitters who file electronically will be granted an extension of 30 days to file. Part A, Sec. 11, explains procedures for requesting extensions of time. Filers are encouraged to file their data as soon as possible.

.05 The formats of the "A", "B", "C", "K", and "F" Records are the same for electronically filed records as they are for 5 1/4- and 3 1/2-inch diskettes, tapes, and tape cartridges. For electronically filed documents, each transmission is considered a separate file.

26–40	Control Total 2	15	into the appropriate control total fields of the appropriate "K" Record. **Control totals must be right-justified, and unused control total fields zero-filled.** All control total fields are 15 positions in length.
41–55	Control Total 3	15	
56–70	Control Total 4	15	
71–85	Control Total 5	15	
86–100	Control Total 6	15	
101–115	Control Total 7	15	
116–130	Control Total 8	15	
131–145	Control Total 9	15	
146–386	Blank	241	Reserved for IRS use. **Enter blanks.**
387–401	Control Total State Income Tax Withheld	15	**Form 1099–R only**. Aggregate totals of the state income tax withheld field in the Payee "B" Record; otherwise, **enter blanks**.
402–416	Control Total Local Income Tax Withheld	15	**Form 1099–R only**. Aggregate totals of the local income tax withheld field in the Payee "B" Record; otherwise, **enter blanks**.
417–418	Combined Federal/State Code	2	**Required.** Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16, Table 1.)
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf) characters.

State Totals "K" Record — Record Layout — Form 1099–R

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3
1	2–7	8–10	11–25	26–40	41–55

Control Total 4	Control Total 5	Control Total 6	Control Total 7	Control Total 8	Control Total 9
56–70	71–85	86–100	101–115	116–130	131–145

Blank	Control Total State Income Tax Withheld	Control Total Local Income Tax Withheld	Combined Federal/ State Code	Blank or CR/LF
146–386	387–401	402–416	417–418	419–420

86–100	Control Total 6	15	
101–115	Control Total 7	15	
116–130	Control Total 8	15	
131–145	Control Total 9	15	
146–416	Blank	271	Reserved for IRS use. **Enter blanks.**
417–418	Combined Federal/ State Code	2	**Required.** Enter the code assigned to the state which is to receive the information. (Refer to Part A, Sec. 16, Table 1.)
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf) characters.

State Totals "K" Record — Record Layout Forms 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–OID, 1099–PATR, and 5498

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3
1	2–7	8–10	11–25	26–40	41–55

Control Total 4	Control Total 5	Control Total 6	Control Total 7	Control Total 8	Control Total 9
56–70	71–85	86–100	101–115	116–130	131–145

Blank	Combined Federal/ State Code	Blank or CR/LF
146–416	417–418	419–420

(2) State Totals "K" Record — Record Layout Form 1099–R

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "K."
2–7	Number of Payees	6	**Required.** Enter the total number of "B" Records being coded for this state. Right justify information and fill unused positions with zeros.
8–10	Blank	3	**Enter blanks.**
11–25	Control Total 1	15	**Required.** Accumulate totals of any payment amount fields in the "B" Records for each state being reported

146–420	Blank	275	**Enter blanks.** Filers may enter carriage return/line feed (cr/lf) characters in positions 419–420.

End of Payer "C" Record — Record Layout

Record Type	Number of Payees	Blank	Control Total 1	Control Total 2	Control Total 3
1	2–7	8–10	11–25	26–40	41–55

Control Total 4	Control Total 5	Control Total 6	Control Total 7	Control Total 8	Control Total 9	Blank or CR/LF
56–70	71–85	86–100	101–115	116–130	131–145	146–420

Sec. 10. State Totals "K" Record — General Field Descriptions and Record Layout

.01 The State Totals "K" Record is a fixed record length of 420 positions. The control total fields are each 15 positions in length.

.02 The "K" Record is a summary for a given payer and a given state in the Combined Federal/State Filing Program, used **only** when state reporting approval has been granted.

.03 The "K" Record will contain the total number of payees and the totals of the payment amount fields filed by a given payer for a given state. The "K" Record(s) must be written after the "C" Record for the related "A" Record.

.04 In developing the "K" Record, for example, if a payer used Amount Codes 1, 3, and 6 in the "A" Record, the totals from the "B" Records coded for this state will appear in Control Totals 1, 3, and 6 of the "K" Record.

.05 There **must** be a separate "K" Record for **each state** being reported.

.06 Refer to Part A, Sec. 16 for the requirements and conditions that **must** be met to file via this program.

.07 Control total fields have been added for the accumulated totals of state and local withholding fields from the "B" Records for Form 1099–R only for each state being reported.

(1) State Totals "K" Record — Record Layout Forms 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–OID, 1099–PATR, and 5498

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "K."
2–7	Number of Payees	6	**Required.** Enter the total number of "B" Records being coded for this state. Right justify information and fill unused positions with zeros.
8–10	Blank	3	**Enter blanks.**
11–25	Control Total 1	15	**Required**. Accumulate totals of any payment amount fields in the "B" Records for each state being reported into the appropriate control total fields of the appropriate "K" Record. **Control totals must be right-justified, and unused control total fields zero-filled.** All control total fields are 15 positions in length.
26–40	Control Total 2	15	
41–55	Control Total 3	15	
56–70	Control Total 4	15	
71–85	Control Total 5	15	

Payee "B" Record — Record Layout Positions 322–420
Form W-2G

Blank	Date Won	Transaction	Race	Cashier	Window	First Id
322–352	353–358	359–373	374–378	379–383	384–388	389–403

Id	Blank or CR/LF
404–418	419–420

Sec. 9. End of Payer "C" Record — General Field Descriptions and Record Layout

.01 The End of Payer "C" Record is a fixed record length of 420 positions. The control total fields are each 15 positions in length.

.02 The "C" Record consists of the total number of payees and the totals of the payment amount fields filed by a given payer and/or a particular type of return. The "C" Record **must** be written after the last "B" Record for each type of return for a given payer. For each "A" Record and group of "B" Records on the file, there must be a corresponding "C" Record.

.03 In developing the "C" Record, for example, if a payer used Amount Codes 1, 3, and 6 in the "A" Record, the totals from the "B" Records will appear in Control Totals 1, 3, and 6 of the "C" Record. In this example, positions 26–40, 56–85, and 101–145 would be zero filled. Positions 146–420 would be blank filled.

.04 Payers/Transmitters should verify the accuracy of the totals since data with missing or incorrect "C" Records may be returned for replacement.

Record Name: End of Payer "C" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required.** Enter "C."
2–7	Number of Payees	6	**Required.** Enter the total number of "B" Records covered by the preceding "A" Record. Right justify information and fill unused positions with zeros.
8–10	Blank	3	**Enter blanks.**
11–25	Control Total 1	15	**Required.** Accumulate totals of any payment amount fields in the "B" Record into the appropriate control total fields of the "C" Record. **Control totals must be right-justified and unused control total fields zero-filled.** All control total fields are 15 positions in length.
26–40	Control Total 2	15	
41–55	Control Total 3	15	
56–70	Control Total 4	15	
71–85	Control Total 5	15	
86–100	Control Total 6	15	
101–115	Control Total 7	15	
116–130	Control Total 8	15	
131–145	Control Total 9	15	

419–420	Blank	2	Enter blanks or carriage return/line feed (cr/lf) characters.

Payee "B" Record — Record Layout Positions 322–420
Form 1099–S

Blank	Special Data Entries	Date of Closing	Address or Legal Description	Property or Services Indicator	Blank or CR/LF
322–349	350–372	373–378	379–417	418	419–420

☞ **Note: When reporting Form 1099–S, the "B" Record will reflect the seller/transferor information.**

(9) Payee "B" Record — Record Layout Positions 322–420 Form W–2G

Field Position	Field Title	Length	Description and Remarks
322–352	Blank	31	**Enter blanks**.
353–358	Date Won	6	**Required. Form W–2G** only. Enter the date of the winning event in the format MMDDYY (*e.g., 052297*). Do not enter hyphens or slashes. This is not the date the money was paid, if paid after the date of the race (or game).
359–373	Transaction	15	**Required. Form W–2G only**. For state-conducted lotteries, enter the ticket or other identifying number. For keno, bingo, and slot machines, enter the ticket or card number (and color, if applicable), machine serial number, or any other information that will help identify the winning transaction. All others, **enter blanks**.
374–378	Race	5	**Form W–2G only.** If applicable, enter the race (or game) relating to the winning ticket. Otherwise, **enter blanks**.
379–383	Cashier	5	**Form W–2G only.** If applicable, enter the initials of the cashier making the winning payment; otherwise, **enter blanks**.
384–388	Window	5	**Form W–2G only.** If applicable, enter the window number or location of the person paying the winnings; otherwise, **enter blanks.**
389–403	First ID	15	**Form W–2G only**. For other than state lotteries, enter the first identification number of the person receiving the winnings; otherwise, **enter blanks**.
404–418	Second ID	15	**Form W–2G only.** For other than state lotteries, enter the second identification number of the person receiving the winnings; otherwise, **enter blanks**.
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

			reporting local tax withheld, this field may be used as a continuation of the Special Data Entries field.
417–418	Combined Federal/State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states not participating in this program, **enter blanks**.
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

Payee "B" Record—Record Layout Positions 322–420
Form 1099–R

Blank	Special Data Entries	State Income Tax Withheld	Local Income Tax Withheld	Combined Federal/ State Code
322–349	350–396	397–406	407–416	417–418

Blank or CR/LF
419–420

(8) Payee "B" Record — Record Layout Positions 322–420 Form 1099–S

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks**.
350–372	Special Data Entries	23	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
373–378	Date of Closing	6	**Required. Form 1099–S only**. Enter the closing date in the format MMDDYY (*e.g.*, 052297). **Do not enter hyphens or slashes**.
379–417	Address or Legal Description	39	**Required. Form 1099–S only**. Enter the address of the property transferred (including city, state, and ZIP code). If the address does not sufficiently identify the property, also enter a legal description, such as section, lot, and block. For timber royalties, enter "TIMBER." If fewer than 39 positions are required, left justify information and fill unused positions with blanks.
418	Property or Services Indicator	1	**Required. Form 1099–S only.** Enter "1" (one) if the transferor received or will receive property (other than cash and consideration treated as cash in computing gross proceeds) or services as part of the consideration for the property transferred. Otherwise, enter a blank.

350–377	Special Data Entries	28	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
378–416	Description	39	**Required Form 1099–OID only**. Enter the CUSIP number, if any. If there is no CUSIP number, enter the abbreviation for the stock exchange and issuer, the coupon rate, and year of maturity (*e.g.,* NYSE XYZ 12 1/2 *98*). Show the name of the issuer if other than the payer. If fewer than 39 characters are required, left justify information and fill unused positions with blanks.
417–418	Combined Federal/ State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states **not** participating in this program, **enter blanks**.
419–420	Blank	2	**Enter blanks** or carriage return/ line feed (cr/lf) characters.

Payee "B" Record — Record Layout Positions 322–420
Form 1099–OID

Blank	Special Data Entries	Description	Combined Federal/ State Code	Blank or CR/LF
322–349	350–377	378–416	417–418	419–420

(7) Payee "B" Record — Record Layout Positions 322–420 Form 1099–R

Field Position	Field Title Length	Description and Remarks	
322–349	Blank	28	**Enter blanks**.
350–396	Special Data Entries	47	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
397–406	State Income Tax Withheld	10	**Form 1099–R only**. State income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right justified and unused positions must be zero-filled. If not reporting state tax withheld, this field may be used as a continuation of the Special Data Entries field.
407–416	Local Income Tax Withheld	10	**Form 1099–R only.** Local income tax withheld is for the convenience of the filers. This information does not need to be reported to IRS. The payment amount must be right justified and unused positions must be zero-filled. If not

(5) Payee "B" Record—Record Layout Positions 322–420 Form 1099–LTC

Field Position	Field Title	Length	Description and Remarks
322	*Type of Payment Indicator*	*1*	***Form 1099–LTC only.*** *Enter the appropriate indicator from the following table, otherwise,* ***enter blanks:*** ***Indicator*** ***Usage*** *1* *Per diem* *2* *Reimbursed amount*
323–331	*Social Security Number of the Insured*	*9*	***Required for Form 1099–LTC only.*** *Enter the Social Security Number of the individual for whom the benefits are being paid.*
332–371	*Name of the Insured*	*40*	***Required for Form 1099–LTC only.*** *Enter the name of the individual.*
372–411	*Address of the Insured*	*40*	***Form 1099–LTC.*** *Enter the address of the insured. Abbreviate or truncate the information if necessary.*
412	*Status of Illness Indicator (Optional)*	*1*	***Form 1099–LTC only.*** *Enter the appropriate code from the table below to indicate the status of the illness of the insured, otherwise,* ***enter blank:*** **Indicator** **Usage** *1* *Chronically ill* *2* *Terminally ill*
413–418	*Date Certified (Optional)*	*6*	***Form 1099–LTC only.*** *Enter the date of a doctor's certification of the status of the insured's illness. The format of the date is MMDDYY (e.g., 022097).*
419–420	*Blank*	*2*	***Enter blanks****, or carriage return/line feed (cr/lf) characters.*

Payee "B" Record—Record Layout Positions 322–420 Form 1099–LTC

Type of Payment Indicator	*SSN of Insured*	*Name of Insured*	*Address of Insured*	*Status of Illness Indicator*	*Date Certified*
322	*323–331*	*332–371*	*372–411*	*412*	*413–418*

Blank or CR/LF
419–420

(6) Payee "B" Record — Record Layout Positions 322–420 Form 1099–OID

Field Position	Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**

Blank or CR/LF
419–420

(4) Payee "B" Record — Record Layout Positions 322–420 Form 1099–C

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–370	Special Data Entries	21	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
371–376	Date Canceled	6	**Form 1099–C only**. Enter the date the debt was canceled in the format of MMDDYY (*i.e.*, 052297). **Do not enter hyphens or slashes.**
377	Bankruptcy Indicator	1	**Form 1099–C only.** Enter "1" (one) to indicate the debt was discharged in bankruptcy, if known. **Indicator** — **Usage** 1 — Debt **was** discharged in bankruptcy. Blank — Debt **was not** discharged in bankruptcy.
378–416	Debt Description	39	**Form 1099–C only.** Enter a description of the origin of the debt, such as student loan, mortgage, or credit card expenditure. If a combined Form 1099–C and 1099–A is being filed, also enter a description of the property.
417–418	Blank	2	**Enter blanks.**
419–420	Blank	2	**Enter blanks,** or carriage return/line feed (cr/lf).

Payee "B" Record — Record Layout Positions 322–420
Form 1099–C

Blank	Special Data	Date Canceled	Bankruptcy Indicator	Debt Description
322–349	350–370	371–376	377	378–416

Blank	Blank or CR/LF
417–418	419–420

(3) Payee "B" Record — Record Layout Positions 322–420 Form 1099–B

Field Position	Field Title	Length	Description and Remarks
322–349	Blank	28	**Enter blanks.**
350–359	Special Data Entries	10	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
360	Gross Proceeds Indicator	1	**Form 1099–B only**. Enter the appropriate indicator from the following table, otherwise, **enter blanks.** **Indicator** — **Usage** 1 — Gross proceeds 2 — Gross proceeds less commissions and option premiums
361–366	Date of Sale	6	**Form 1099–B only**. For broker transactions, enter the trade date of the transaction. For barter exchanges, enter the date when cash, property, a credit, or scrip is actually or constructively received. Enter the date in the format MMDDYY (*e.g.,* 052197). Enter blanks if this is an aggregate transaction. **Do not enter hyphens or slashes.**
367–379	CUSIP Number	13	**Form 1099–B only**. For broker transactions only, enter the CUSIP (Committee on Uniform Security Identification Procedures) number of the item reported for Amount Code 2 (stocks, bonds, etc.). Enter blanks if this is an aggregate transaction. Enter "0" (zeros) if the number is not available. Right justify information and fill unused positions with blanks.
380–418	Description	39	**Form 1099–B only**. If fewer than 39 characters are required, left justify information and fill unused positions with blanks. For broker transactions, enter a brief description of the disposition item (*e.g.,* 100 shares of XYZ Corp.). For regulated futures and forward contracts, enter "RFC" or other appropriate description and any amount subject to backup withholding (see **Note**). For bartering transactions, show the services or property provided.

☞ **Note: The amount withheld in these situations is to be included in Amount Code 4.**

419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

Payee "B" Record — Record Layout Positions 322–420 Form 1099–B

Blank	Special Data Entries	Gross Proceeds Indicator	Date of Sale	CUSIP Number	Description
322–349	350–359	360	361–366	367–379	380–418

Payee "B" Record — Record Layout Positions 322–420

Forms 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, *1099–MSA*, 1099–PATR, 5498, and *5498–MSA*

Blank	Special Data Entries	Combined Federal/State Code	Blank or CR/LF
322–349	350–416	417–418	419–420

(2) Payee "B" Record — Record Layout Positions 322–420 Form 1099–A

322–349	Blank	28	**Enter blanks.**
350–370	Special Data Entries	21	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for the filing requirements. If this field is not utilized, **enter blanks.**
371–376	Date of Lender's Acquisition or Knowledge of Abandonment	6	**Form 1099–A only.** Enter the acquisition date of the secured property or the date the lender first knew or had reason to know the property was abandoned, in the format MMDDYY (*i.e.*, 052297). **Do not enter hyphens or slashes.**
377	Personal Liability Indicator	1	**Form 1099-A only**. Enter the appropriate indicator from the table below: **Indicator** — **Usage** 1 — Borrower was personally liable for repayment of the debt. Blank — Borrower was not personally liable for repayment of the debt.
378–416	Description of Property	39	**Form 1099–A only**. Enter a brief description of the property. For real property, enter the address, or, if the address does not sufficiently identify the property, enter the section, lot and block. For personal property, enter the type, make and model (*e.g.*, Car-1996 Buick Regal or office equipment). Enter "CCC" for crops forfeited on Commodity Credit Corporation loans. If fewer than 39 positions are required, left justify information and fill unused positions with blanks.
417–418	Blank	2	**Enter blanks.**
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

Payee "B" Record — Record Layout Positions 322–420 Form 1099–A

Blank	Special Data Entries	Date of Lender's Acquisition or Abandonment	Personal Liability Indicator	Description of Property	Blank	Blank or CR/LF
322–349	350–370	371–376	377	378–416	417–418	419–420

Payment Amount 1	Payment Amount 2	Payment Amount 3	Payment Amount 4	Payment Amount 5
51–60	61–70	71–80	81–90	91–100

Payment Amount 6	Payment Amount 7	Payment Amount 8	Payment Amount 9	*Form 5498 IRA Indicator*
101–110	111–120	121–130	131–140	*141*

Form 5498 SEP Indicator	*Form 5498 SIMPLE Indicator*	Blank	Foreign Country Indicator	First Payee Name Line
142	*143*	144–160	161	162–201

Second Payee Name Line	Payee Mailing Address	Payee City	Payee State	Payee ZIP Code
202–241	242–281	282–310	311–312	313–321

The following sections define the field positions for the different types of returns in the Payee "B" Record (positions 322–420):

(1) Forms 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, *1099–MSA*, 1099–PATR, 5498, and *5498–MSA*
(2) Form 1099–A
(3) Form 1099–B
(4) Form 1099–C
(5) *Form 1099–LTC*
(6) Form 1099–OID
(7) Form 1099–R
(8) Form 1099–S
(9) Form W–2G

(1) Payee "B" Record — Record Layout Positions 322–420 Forms 1098, 1099–DIV, 1099–G, 1099–INT, 1099–MISC, 1099–MSA, 1099–PATR, 5498, and 5498–MSA

322–349	Blank	28	**Enter blanks.**
350–416	Special Data Entries	67	This portion of the "B" Record may be used to record information for state or local government reporting or for the filer's own purposes. Payers should contact the state or local revenue departments for filing requirements. If this field is not utilized, **enter blanks.**
417–418	Combined Federal/ State Code	2	If this payee record is to be forwarded to a state agency as part of the Combined Federal/State Filing Program, enter the valid state code from Part A, Sec. 16, Table 1. For those payers or states not participating in this program or for forms not valid for state reporting, **enter blanks.**
419–420	Blank	2	**Enter blanks**, or carriage return/line feed (cr/lf) characters.

tant that filers provide as much payee information to IRS/MCC as possible to identify the payee assigned the TIN. Left justify and fill unused positions with blanks. **Fill with blanks if no entries are present for this field.**

☞ **Note: End First Payee Name Line with a full word. DO NOT SPLIT WORDS. Begin Second Payee Name Line with the next sequential word.**

242–281	Payee Mailing Address	40	**Required**. Enter mailing address of payee. Street address should include number, street, apartment or suite number (or P.O. Box if mail is not delivered to street address). Left justify information and fill unused positions with blanks. This field **must not** contain any data other than the payee's mailing address.

For U.S. addresses, the payee city, state, and ZIP Code must be reported as a 29, 2, and 9 position field, respectively. **Filers must adhere to the correct format for the payee city, state, and ZIP code.**

For foreign addresses, filers may use the payee city, state, and ZIP code **as a continuous 40 position field.** Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Country Indicator in position 161 must contain a "1" (one).

282–310	Payee City	29	**Required.** Enter the city, town or post office. Left justify information and fill the unused positions with blanks. Enter APO or FPO if applicable. Do not enter state and ZIP code information in this field.
311–312	Payee State	2	**Required.** Enter the valid U.S. Postal Service state abbreviations for states or the appropriate postal identifier (AA, AE, or AP) described in Part A, Sec. 18.
313–321	Payee ZIP Code	9	**Required.** Enter the valid nine digit ZIP Code assigned by the U.S. Postal Service. If only the first five digits are known, left justify information and fill the unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a "1" (one) in the Foreign Country Indicator Field, located in position 161 of the "B" Record.

Standard Payee "B" Record Format For All Types of Returns up to Position 321

Record Type	Payment Year	Document Specific/ Distribution Code	2nd TIN Notice (Optional)	Corrected Return Indicator
1	2–3	4–5	6	7

Name Control	Direct Sales Indicator	Blank	Type of TIN	Taxpayer Identification Number	Payer's Account Number For Payee
8–11	12	13	14	15–23	24–43

Form 1099-R IRA/SEP/*SIMPLE* Indicator	Percentage of Total Distribution	Total Distribution Indicator	Taxable Amt Not Determined Indicator	Blank
44	45–46	47	48	49–50

141	*Form 5498 **IRA** Indicator (Individual **R**etirement **A**rrangement)*	1	**Required.** ***Form 5498 only.*** *Enter '**1**' if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 4) for an IRA and not reporting a contribution in Amount Code 1. Otherwise,* ***enter a blank.***
142	*Form 5498 **SEP** Indicator (**S**implified **E**mployee **P**ension)*	1	**Required.** ***Form 5498 only.*** *Enter '**1**' if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 4) for a SEPand not reporting a contribution in Amount Code 1. Otherwise,* ***enter a blank.***
143	*Form 5498 **SIMPLE** Indicator (**S**avings **I**ncentive **M**atch **P**lan for **E**mployees of **S**mall employers)*	1	**Required.** ***Form 5498 only.*** *Enter '**1**' if reporting a rollover (Amount Code 2) or Fair Market Value (Amount Code 4) for a SIMPLE and not reporting a contribution in Amount Code 1. Otherwise,* ***enter a blank.***
144–160	Blank	17	**Enter blanks**.
161	Foreign Country Indicator	1	If the address of the payee is in a foreign country, enter a "1" (one) in this field; otherwise, enter blanks. When filers use this indicator, they may use a free format for the payee city, state, and ZIP Code. Address information must not appear in the First or Second Payee Name Line.
162-201	First Payee Name Line	40	**Required.** Enter the name of the payee (preferably surname first) whose Taxpayer Identification Number (TIN) was provided in positions 15–23 of the "B" Record. Left justify and fill unused positions with blanks. If more space is required for the name, utilize the Second Payee Name Line Field. If there are multiple payees, only the name of the payee whose TIN has been provided should be entered in this field. The names of the other payees may be entered in the Second Payee Name Line Field. If reporting information for a sole proprietor, the individual's name must always be present on the First Payee Name Line. The use of the business name is optional in the Second Payee Name Line Field.

☞ **Note 1: When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name of the recipient of the interest (the payer). The "B" Record will reflect the individual paying the interest (the borrower/payer of record) and the amount paid. For Form 1099–S, the "B" Record will reflect the seller/transferor information.**

☞ **Note 2: For Form 5498 Inherited IRAs, enter the beneficiary's name followed by the word "beneficiary." For example, "Brian Young as beneficiary of Joan Smith" or something similar that signifies that the IRA was once owned by Joan Smith. Filers may abbreviate the word "beneficiary" as, for example, "benef." Refer to the *1997* "Instructions for Forms 1099, 1098, 5498, and W–2G." The beneficiary's TIN must be reported in positions 15–23 of the "B" Record.**

☞ **Note 3: End First Payee Name Line with a full word. DO NOT SPLIT WORDS.**

☞ **Note 4: When reporting Form 1099- LTC, Long-Term Care and Accelerated Death Benefits, the "B" record will reflect the individual receiving the payment (the policyholder) and the amount paid. The "B" record will also reflect the individual on account of whose illness the payment was made (the insured).**

202–241	Second Payee Name Line	40	If there are multiple payees, (e.g., partners, joint owners, or spouses), use this field for those names not associated with the TIN provided in position 15-23 of the "B" Record or if not enough space was provided in the First Payee Name Line, continue the name in this field (See **Note**). **Do not enter address information.** It is impor-

Payment Amounts 5 and 6 will be all "0's" (zeros); Payment amount 7 will represent nonemployee compensation, and Payment Amounts 8 and 9 will be all "0's" (zeros). Each payment field must contain 10 numeric characters (See **Note 2**). Each payment amount must contain U.S. dollars and cents. The right-most two positions represent cents in the payment amount fields. Do not enter dollar signs, commas, decimal points, or negative payments, except those items that reflect a loss on Form 1099-B. Positive and negative amounts are indicated by placing a "+" (plus) or "-" (minus sign) in the left-most position of the payment amount field. A negative over punch in the units position may be used, instead of a minus sign, to indicate a negative amount. If a plus sign, minus sign, or negative over punch is not used, the number is assumed to be positive. Negative over punch cannot be used in PC created files. Payment amounts must be right-justified and unused positions must be zero-filled. **Federal income tax withheld cannot be reported as a negative amount on** any form.

☞ **Note 1: Filers must enter numeric information in all payment fields when filing magnetically or electronically. However, when reporting information on the statement to recipient, the payer may be instructed to leave a box blank. Follow the guidelines provided in the paper instructions for the statement to recipient.**

☞ **Note 2: If a payer is reporting a money amount in excess of 9999999999* (dollars and cents), it must be reported as follows:**
(1) The first Payee "B" Record **must** contain **9999999999***.
(2) The second Payee "B" Record will contain the remaining money amount.

***DO NOT SPLIT THIS FIGURE IN HALF.**

51–60	Payment Amount 1*	10	The amount reported in this field represents payments for Amount Code 1 in the "A" Record.
61–70	Payment Amount 2*	10	The amount reported in this field represents payments for Amount Code 2 in the "A" Record.
71–80	Payment Amount 3*	10	The amount reported in this field represents payments for Amount Code 3 in the "A" Record.
81–90	Payment Amount 4*	10	The amount reported in this field represents payments for Amount Code 4 in the "A" Record.
91–100	Payment Amount 5*	10	The amount reported in this field represents payments for Amount Code 5 in the "A" Record.
101–110	Payment Amount 6*	10	The amount reported in this field represents payments for Amount Code 6 in the "A" Record.
111–120	Payment Amount 7*	10	The amount reported in this field represents payments for Amount Code 7 in the "A" Record.
121–130	Payment Amount 8*	10	The amount reported in this field represents payments for Amount Code 8 in the "A" Record.
131–140	Payment Amount 9*	10	The amount reported in this field represents payments for Amount Code 9 in the "A" Record.

***If there are discrepancies between the payment amount fields and the boxes on the paper forms, the instructions in this revenue procedure govern.**

☞ **Note: For Form 1099-R, generally, report the total amount distributed from an IRA, SEP, or *SIMPLE* in Payment Amount Field 2 (Taxable Amount), as well as Payment Amount Field 1 (Gross Distribution) of the "B" Record. Filers may indicate the taxable amount was not determined by using the Taxable Amount Not Determined Indicator (position 48) of the "B" Record. However, still report the amount distributed in Payment Amount Fields 1 and 2. Refer to the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" for exceptions.**

45–46	Percentage of Total Distribution	2	**Form 1099–R only.** Use this field when reporting a total distribution to more than one person, such as when a participant is deceased and a payer distributes to two or more beneficiaries. Therefore, if the percentage is 100, leave this field blank. If the percentage is a fraction, round off to the nearest whole number (e.g.,10.4 percent will be 10 percent; 10.5 percent will be 11 percent). Enter the percentage received by the person whose TIN is included in positions 15-23 of the "B" Record. This field must be right-justified, and unused positions must be zero-filled. If not applicable, enter blanks. Filers need not enter this information for IRA, SEP, or *SIMPLE* distributions or for direct rollovers.
47	Total Distribution Indicator (See **Note**)	1	**Form 1099–R only**. Enter a "1" (one) only if the payment shown for Amount Code 1 is a total distribution that closed out the account; otherwise, enter a blank.

☞ **Note: A total distribution is one or more distributions within one tax year in which the entire balance of the account is distributed. Any distribution that does not meet this definition is not a total distribution.**

48	Taxable Amount Not Determined Indicator	1	**Form 1099–R only.** Enter a "1" (one) only if the taxable amount of the payment entered for Payment Amount Field 1 (Gross Distribution) of the "B" Record cannot be computed; otherwise, **enter blank.** If Taxable Amount Not Determined Indicator is used, enter "0's" (zeros) in Payment Amount Field 2 of the Payee "B" Record unless the IRA/SEP/SIMPLE Indicator is present (See **Note**). Please make every effort to compute the taxable amount.

☞ **Note: If reporting an IRA, SEP, or SIMPLE distribution for Form 1099–R, the Taxable Amount Not Determined Indicator may be used; but, it is not required. If the IRA/SEP/SIMPLE Indicator is present, generally, the amount of the distribution must be reported in both Payment Amount Fields 1 and 2. Refer to the 1997 "Instructions for Forms 1099, 1098, 5498, and W–2G" for more information.**

49–50	Blank	2	**Enter blanks.**
	Payment Amount Fields (Must be numeric) (See **Note 1**)		**Required. Filers should allow for all payment amounts. For those not used, enter zeros.** For example: If position 22, Type of Return, of the "A" Record is "A" (for 1099–MISC) and positions 23–31, Amount Codes, are "1247bbbbb". This indicates the payer is reporting any or all four payment amounts (1247) in all of the following "B" Records. (In this example, "b" denotes blanks in the designated positions. Do not enter the letter 'b.') Payment Amount 1 will represent rents; Payment Amount 2 will represent royalties; Payment Amount 3 will be all "0's" (zeros); Payment Amount 4 will represent Federal income tax withheld;

13	Blank	1	**Enter blank.**
14	Type of TIN	1	This field is used to identify the Taxpayer Identification Number (TIN) in positions 15–23 as either an Employer Identification Number (EIN), or a Social Security Number (SSN) or *an Individual Taxpayer Identification Number (ITIN)*. Enter the appropriate code from the following table:

Type of TIN		Type of Account
1	EIN	A business, organization, sole proprietor, or other entity
2	SSN	An individual, including a sole proprietor or
2	*ITIN*	*An individual required to have a taxpayer identification number, but who is not eligible to obtain an SSN*
Blank	N/A	If the type of TIN is not determinable, enter a blank.

15–23	Taxpayer Identification Number	9	**Required.** Enter the nine digit Taxpayer Identification Number of the payee (SSN, *ITIN*, or EIN). If an identification number has been applied for but not received, enter blanks. Do not enter hyphens or alpha characters. All zeros, ones, twos, etc. will have the effect of an incorrect TIN. If the TIN is not available, enter blanks (See **Note**).

☞ **Note: IRS/MCC contacts payers who have submitted payee data with missing TINs in an attempt to prevent erroneous notices. Payers who submit data with missing TINs, and have taken the required steps to obtain this information are encouraged to attach a letter of explanation to the required Form 4804. This will prevent unnecessary contact from IRS/MCC. This letter, however, will not prevent backup withholding notices (CP2100 or CP2100A Notices) or penalties for filing incorrect information returns.**

24–43	Payer's Account Number For Payee	20	Enter any number assigned by the payer to the payee (e.g., checking or savings account number). Filers are encouraged to use this field. This number helps to distinguish individual payee records and should be unique for each document. Do not use the payee's TIN since this will not make each record unique. This information is particularly useful when corrections are filed. This number will be provided with the backup withholding notification and may be helpful in identifying the branch or subsidiary reporting the transaction. Do not define data in this field in packed decimal format. If fewer than twenty characters are used, filers may either left or right justify, filling the remaining positions with blanks.
44	Form 1099–R IRA/SEP/*SIMPLE* Indicator	1	**Form 1099–R only.** Enter "1" (one) if reporting a distribution from an IRA, SEP, or *SIMPLE*; otherwise, enter a blank (See **Note**).

☞ **Note: Although extraneous words, titles, and special characters are allowed (i.e., Mr., Mrs., Dr., apostrophe ['], or dash [-]), this information may be dropped during subsequent IRS/MCC processing.**

The following examples may be helpful to filers in developing the Name Control:

	Name	Name Control
Individuals:		
	Jane ***Brow***n	BROW
	John A. ***Lee***	LEE*
	James P. ***En***, Sr.	EN*
	John ***O'Neill***	ONEI
	Mary ***Van B***uren	VANB
	Juan ***De Je***sus	DEJE
	Gloria A. ***El-R***oy	EL-R
	Mr. John ***Smit***h	SMIT
	Joe ***McCa***rthy	MCCA
	Pedro ***Torr***es-Lopes	TORR
	Maria ***Lope***z Moreno**	LOPE
	Binh To ***La***	LA*
	Nhat Thi ***Pham***	PHAM
	Mark ***D'All***esandro	DALL
Corporations:		
	The ***Firs***t National Bank	FIRS
	The Hideaway	THEH
	A & B Cafe	A&BC
	11TH Street Inc.	11TH
Sole Proprietor:		
	Mark ***Heml***ock DBA The Sunshine Club	HEML
Partnership:		
	Robert ***Aspe***n and Bess Willow	ASPE
	Harold ***Fir***, Bruce Elm, and Joyce Spruce et al Ptr	FIR*
Estate:		
	Frank ***Whit***e Estate	WHIT
	Sheila ***Blue*** Estate	BLUE
Trusts and Fiduciaries:		
	Daisy Corporation Employee Benefit Trust	DAIS
	Trust FBO The ***Cherr***yblossom Society	CHER
Exempt Organization:		
	Laborer's Union, AFL-CIO	LABO
	St. Bernard's Methodist Church Bldg. Fund	STBE

*Name Controls of less than four (4) significant characters must be left-justified and blank-filled.
**For Hispanic names, when two last names are shown for an individual, derive the name control from the first last name.

12	Direct Sales Indicator	1	**1099 MISC only.** Enter a "1" (one) to indicate sales of $5,000 or more of consumer products to a person on a buy/sell, deposit/ commission, or any other commission basis for resale anywhere other than in a permanent retail establishment. Otherwise, enter a blank.

☞ **Note: If reporting direct sales only, use Type of Return "A" in Field Position 22, and Amount Code 1 in Field Position 23 of the Payer "A" Record. All payment amount fields in the Payee "B" Record will contain zeros.**

☞ **Note 1: Do not use code B or C for payments with respect to employees who died after August 20, 1996.**

	Type of Wager **(Form W–2G Only)**		For Form W–2G, enter the applicable code in position 4. Position 5 will be blank.

Category	**Code**
Horse race track (or off-rack betting of a horse track nature)	1
Dog race track (or off- track betting of a dog track nature)	2
Jai-alai	3
State-conducted lottery	4
Keno	5
Bingo	6
Slot machines	7
Any other type of gambling winnings	8

6	2nd TIN Notice	1	For Forms 1099–B, 1099–DIV, 1099–INT, 1099–MISC, 1099–OID, and 1099–PATR only. Enter "2" to indicate notification by IRS/MCC twice within three calendar years that the payee provided an incorrect name and/or TIN combination; otherwise, enter a blank.
7	Corrected Return Indicator	1	Indicate a corrected return.

Code	**Definition**
G	If this is a one- transaction correction or the first of a two-transaction correction
C	If this is the second transaction of a two transaction correction
Blank	If this is not a return being submitted to correct information already processed by IRS.

☞ **Note: C, G, and non-coded records must be reported using separate Payer "A" Records. Refer to Part A, Sec. 13, for specific instructions on how to file corrected returns.**

8–11	Name Control	4	If determinable, enter the first four (4) characters of the surname of the person whose TIN is being reported in positions 15–23 of the "B" Record; otherwise, enter blanks. This usually is the payee. If the name that corresponds to the TIN is not included in the first or second payee name line and the correct name control is not provided, a backup withholding notice may be generated for the record. Surnames of less than four (4) characters should be left-justified, filling the unused positions with blanks. Special characters and imbedded blanks should be removed. In the case of a business, other than a sole proprietorship, use the first four significant characters of the business name. Disregard the word "the" when it is the first word of the name, unless there are only two words in the name. A dash (-) and an ampersand (&) are the only acceptable special characters. Surname prefixes are considered part of the surname, e.g., for Van Elm, the name control would be VANE.

(Form 1099–R only)

(For a detailed explanation of the distribution codes, see the 1997 "Instructions for Forms 1099, 1098, 5498 and W–2G.")

For **Form 1099-R**, enter the appropriate distribution code(s). More than one code may apply for Form 1099-R. If only one code is required, it must be entered in position 4 and position 5 must be blank. Enter at least one (1) distribution code. A blank in position 4 is not acceptable. Enter the applicable code from the table that follows. *Position 4 must contain a numeric code in all cases except when using P, D, E, F, G, H, L, or S. (L and S have been added for TY97.)* Distribution Code A, B, or C, when applicable, must be entered in position 5 with the applicable numeric code in position 4. When using Code P for an IRA distribution under section 408(d)(4) of the Internal Revenue Code, the filer may also enter Code 1 if applicable. Only three numeric combinations are acceptable, codes 8 and 1, codes 8 and 2 and codes 8 and 4, on one return. These three combinations can be used only if both codes apply to the distribution being reported. If more than one numeric code is applicable to different parts of a distribution, report two separate "B" Records. Distribution Codes E, F, and H cannot be used in conjunction with other codes. Distribution Code G may be used in conjunction with Distribution Code 4 only, if applicable.

Category	**Code**
Early distribution, no known exception	**1***
Early distribution, exception applies (as defined in section 72(q), (t), or (v) of the Internal Revenue Code (other than disability or death)	**2***
Disability	**3***
Death (includes payments to an estate or other beneficiary)	**4***
Prohibited transaction	**5***
Section 1035 exchange	**6**
Normal distribution	**7***
Excess contributions plus earnings/excess deferrals (and/or earnings) taxable in 1997	**8***
PS 58 costs	**9**
Excess contributions plus earnings/excess deferrals taxable in 1996	**P***
May be eligible for 5- or 10-year tax option	**A**
May be eligible for death benefit exclusion (See **Note 1**)	**B**
May be eligible for both A and B (See **Note 1**)	**C**
Excess contributions plus earnings/excess deferrals taxable in 1995	**D***
Excess annual additions under section 415	**E**
Charitable gift annuity	**F**
Direct rollover to IRA	**G**
Direct rollover to qualified plan or tax-sheltered annuity	**H**
Loans treated as deemed distributions under section 72(p)	**L**
Early distribution from a SIMPLE (IRA in first 2 years, no known exception)	**S***

*If reporting an IRA, SEP, or *SIMPLE* distribution, code a "1" (one) in position 44 of the "B" Record.

Record Name: Payee "B" Record

Field Position	Field Title	Length	Description and Remarks
1	Record Type	1	**Required**. Enter "B."
2–3	Payment Year	2	**Required**. Enter *"97"* (unless reporting prior year data).
4–5	Document Specific/ Distribution Code	2	**Required** for Forms 1099–G, 1099–MISC *(for Crop Insurance Proceeds only), 1099–MSA,* 1099–R and W–2G. For all other forms, or if not used, **enter blanks**.
	Tax Year of Refund for **(Form 1099–G only)**		**For Form 1099–G**, use only for reporting the tax year which the refund*, credit, or offset (Amount Code 2) was issued. Enter in position 4; position 5 must be blank. If the refund, credit, or offset is not attributable to income from a trade or business, enter the **numeric** year from the table below for which the refund, credit, or offset was issued (*e.g.*, for *1996*, enter *6*). If the refund, credit or offset is exclusively attributable to income from a trade or business and is not of general application, enter the **alpha** equivalent of the year from the table below (*e.g.*, for *1996*, enter *F*).

Code For Tax Year Which Refund Was Issued

Tax Year For Which Refund Was Issued	*Code For General Refund**	*Code For Trade/Business Refund (Alpha Equivalent)**
1987	*7*	*G*
1988	*8*	*H*
1989	*9*	*I*
1990	*0*	*J*
1991	*1*	*A*
1992	*2*	*B*
1993	*3*	*C*
1994	*4*	*D*
1995	*5*	*E*
1996	*6*	*F*

***Be sure the distribution code reflects the tax year for which the REFUND was made, not the tax year of the Form 1099–G.**

	Crop Insurance Proceeds **(Form 1099-MISC only)**		**For Form 1099-MISC**, enter "1" (one) in position 4 if the payments reported for Amount Code 7 are crop insurance proceeds. Position 5 will be blank. ***Crop insurance proceeds are the only type of payment for Form 1099-MISC requiring a Document Specific/Distribution Code.***
4–5	*Distribution Code contd.* ***(Form 1099-MSA only)*** *(For a detailed explanation of the distribution codes, see the 1997 "Instructions for Forms 1099, 1098, 5498, and W-2G.)*	*2*	***For Form 1099-MSA**, enter the applicable code in position 4. Position 5 will be blank.*

Category	**Code**
Normal distribution	*1*
Excess contributions	*2*
Disability	*3*
Death	*4*
Prohibited transaction	*5*

Transmitter City	Transmitter State	Transmitter ZIP Code	*Payer Phone Number & Extension*	Blank	Blank or CR/LF
331–359	360–361	362–370	*371–385*	386–418	419–420

Sec. 8. Payee "B" Record — General Field Descriptions and Record Layouts

.01 The "B" Record contains the payment information from the information returns. When filing information returns, the format for the "B" Records will remain constant and is a fixed length of 420 positions. The record layout for positions 1 through 321 is the same for all "B" Records. Positions 322 through 420 vary for Forms 1099–A, 1099–B, 1099–C, *1099–LTC*, 1099–OID, 1099–S, and W–2G to accommodate variations within these forms. In the "A" Record, the amount codes that appear in positions 23 through 31 will be left-justified and filled with blanks. In the "B" Record, the filer **must** allow for all nine Payment Amount Fields. For those fields not used, enter "0s" (zeros). For example, a payer reporting on Form 1099–MISC, should enter "A" in field position 22 of the "A" Record, Type of Return. If reporting payments for Amount Codes 1, 2, 4, and 7, the payer would report field positions 23 through 31 of the "A" Record as "1247bbbbb." (In this example, "b" denotes blanks. Do not enter the letter "b") In the "B" Record:

Positions 51 through 60 for Payment Amount 1 will represent rents.
Positions 61–70 for Payment Amount 2 will represent royalties.
Positions 71–80 for Payment Amount 3 will be "0s" (zeros).
Positions 81–90 for Payment Amount 4 will represent Federal income tax withheld.
Positions 91–110 for Payment Amounts 5 and 6 will be "0s" (zeros).
Positions 111–120 for Payment Amount 7 will represent nonemployee compensation.
Positions 121–140 for Payment Amounts 8 and 9 will be "0s" (zeros).

.02 The following specifications include a field in the payee records called "Name Control" in which the first four characters of the payee's surname are to be entered by the filer.

.03 If filers are unable to determine the first four characters of the surname, the Name Control Field may be left blank. Compliance with the following will facilitate IRS computer programs in generating the name control:

(a) The surname of the payee whose TIN is shown in the "B" Record should always appear first. If, however, the records have been developed using the first name first, the filer must leave a blank space between the first and last names.

(b) In the case of multiple payees, only the surname of the payee whose TIN (SSN, EIN or ITIN) is shown in the "B" Record must be present in the First Payee Name Line. Surnames of any other payees may be entered in the Second Payee Name Line.

.04 See Part A, Sec. 14 for further information concerning Taxpayer Identification Numbers (TINs).

.05 A field is also provided in these specifications for Special Data Entries. This field may be used to record information required by state or local governments, or for the personal use of the filer. IRS does not use the data provided in the Special Data Entries Field; therefore, the IRS program does not check the content or format of the data entered in this field. It is the filer's option to use the Special Data Entry Field. If this field is coded, it will not affect the processing of the "B" Records.

.06 Those payers participating in the Combined Federal/State Filing Program must adhere to all of the specifications in Part A, Sec. 16, to participate in this program. Filers **may not file** Forms 1098, 1099–A, 1099–B, 1099–C, *1099–LTC*, *1099–MSA*, 1099–S, *5498–MSA*, and W–2G under the Combined Federal/State Filing Program.

.07 All alpha characters in the "B" Record must be uppercase.

.08 Do not use decimal points (.) to indicate dollars and cents. Ten dollars must appear as 0000001000 in the payment amount field.

.09 IRS strongly encourages transmitters to review the data for accuracy before submission to prevent issuance of erroneous notices. Transmitters should be especially careful that the names, TINs, account numbers, types of income, and income amounts are correct.

.10 When reporting Form 1098, Mortgage Interest Statement, the "A" Record will reflect the name and TIN of the recipient of the interest, the filer of the Form 1098 (the payer). The "B" Record will reflect the individual paying the interest (borrower/payer of record) and the amount paid. For Form 1099–S, the "A" Record will reflect the person responsible for reporting the transaction (the filer of the Form 1099–S) and the "B" Record will reflect the seller/transferor.

☞ **Note: For all fields marked Required, the transmitter must provide the information described under Description and Remarks. For those fields not marked Required, the transmitter must allow for the field, but may be instructed to enter blanks or zeros in the indicated position(s) and for the indicated length. All records are now a fixed length of 420 positions.**

291–330	Transmitter Mailing Address	40	**Required** if the payer and transmitter are not the same. Enter the mailing address of the transmitter. Street address should include number, street, apartment or suite number (or P.O. Box if mail is not delivered to street address). Left justify information, and fill unused positions with blanks. If the payer and transmitter are the same, this field may be blank.
331–359	Transmitter City	29	**Required** if the payer and transmitter are not the same. Enter the city, town, or post office of the transmitter. Left justify information and fill unused positions with blanks. If the payer and transmitter are the same, this field may be blank.
360–361	Transmitter State	2	**Required** if the payer and transmitter are not the same. Enter the valid U.S. Postal Service state abbreviation for states.
362–370	Transmitter ZIP Code	9	**Required** if the payer and transmitter are not the same. Enter the valid nine digit ZIP Code assigned by the U.S. Postal Service. If only the first five digits are known, left justify information and fill the unused positions with blanks.
371–385	*Payer's Phone Number and Extension*	*15*	*Enter the payer's phone number and extension.*
386–418	Blank	33	**Enter blanks.**
419–420	Blank	2	**Enter blanks** or carriage return/line feed (cr/lf).

Sec. 7. Payer/Transmitter "A" Record — Record Layout

Record Type	Payment Year	Reel Sequence Number	Payer's TIN	Payer Name Control	Last Filing Indicator
1	2–3	4–6	7–15	16–19	20

Combined Federal/State Filer	Type of Return	Amount Codes	Test Indicator	Service Bureau Indicator
21	22	23–31	32	33

Blank	Magnetic Tape Filer Indicator	Transmitter Control Code	Foreign Entity Indicator	First Payer Name Line	Second Payer Name Line
34–41	42–43	44–48	49	50–89	90–129

Transfer Agent Indicator	Payer Shipping Address	Payer City	Payer State	Payer ZIP Code	Transmitter Name
130	131–170	171–199	200–201	202–210	211–290

90–129	Second Payer Name Line	40	If the Transfer (or Paying) Agent Indicator (position 130) contains a "1" (one), this field must contain the name of the transfer (or paying) agent. If the indicator contains a "0" (zero), this field may contain either a continuation of the First Payer Name Line or blanks. Left justify information and fill unused positions with blanks.
130	Transfer Agent Indicator	1	**Required**. Identifies the entity in the Second Payer Name Line Field. (See Part A, Sec. 17 for a definition of transfer agent.) ***Code*** — ***Meaning*** 1 — The entity in the Second Payer Name Line Field is the transfer (or paying) agent. 0 (zero) — The entity shown is **not** the transfer (or paying) agent (*i.e.*,the Second Payer Name Line Field contains either a continuation of the First Payer Name Line Field or blanks).
131–170	Payer Shipping Address	40	**Required**. If the Transfer Agent Indicator in position 130 is a "1" (one), enter the shipping address of the transfer (or paying) agent. Otherwise, enter the **actual** shipping address of the payer. The street address should include number, street, apartment or suite number (or P. O. Box if mail is not delivered to street address). Left justify information, and fill unused positions with blanks.

For U.S. addresses, the payer city, state, and ZIP code must be reported as a 29, 2, and 9 position field, respectively. **Filers must adhere to the correct format for the payer city, state, and ZIP code. For foreign addresses,** filers may use the payer city, state, and ZIP code as a continuous 40 position field. Enter information in the following order: city, province or state, postal code, and the name of the country. When reporting a foreign address, the Foreign Entity Indicator in position 49 must contain a "1" (one).

171–199	Payer City	29	**Required**. If the Transfer Agent Indicator in position 130 is a "1" (one), enter the city, town, or post office of the transfer agent. Otherwise, enter the city, town, or post office of the payer. Left justify information, and fill unused positions with blanks. Do not enter state and ZIP code information in this field.
200–201	Payer State	2	**Required**. Enter the valid U.S. Postal Service state abbreviations for states.
202–210	Payer ZIP Code	9	**Required**. Enter the valid nine digit ZIP code assigned by the U.S. Postal Service. If only the first five digits are known, left justify information and fill the unused positions with blanks. For foreign countries, alpha characters are acceptable as long as the filer has entered a "1" (one) in the Foreign Entity Indicator, located in Field Position 49 of the "A" Record.
211–290	Transmitter Name	80	**Required** if the payer and the transmitter are not the same. Enter the name of the transmitter in the manner in which it is used in normal business. The name of transmitter **must** be reported in the same manner throughout the entire file. Left justify information, and fill unused positions with blanks. If the payer and transmitter are the same, this field may be blank.

method, or a link-chain method, to compute the LIFO value of its inventory pools. Under all three of these methods, automobile dealers use their own cost data to compute the index for each pool. Because of the nature of the items in their pools, automobile dealers generally use a link-chain method. The annual index for each pool under the link-chain method is computed by "double extending" (that is, pricing) the vehicles (or "items") in each inventory pool as of the close of the taxable year at the automobile dealer's own current year cost and at the automobile dealer's own prior-year cost. For each pool, the total current-year cost of the vehicles in ending inventory is divided by the total prior-year cost of the vehicles in ending inventory to compute the annual index for the current year. The vehicles used to determine the dealer's own prior-year cost of vehicles in the current year's ending inventory must be comparable to the vehicles used to compute the current-year cost of vehicles in the current year's ending inventory. For purposes of this revenue procedure, this is referred to as the § 1.472-8 "comparability requirement."

.05 *New alternative method.* In addition to the three general dollar-value LIFO methods briefly described in section 2.04 of this revenue procedure, this revenue procedure provides an additional dollar-value LIFO method for automobile dealers, the Alternative LIFO Method. This method is described in section 4 of this revenue procedure.

SECTION 3. SCOPE

The Alternative LIFO Method is available to any automobile dealer engaged in the business of retail sales of new automobiles or new light-duty trucks for its LIFO inventories of new automobiles and new light-duty trucks. Light-duty trucks are trucks with a gross vehicle weight of 14,000 pounds or less, which are also referred to as class 1, 2, or 3 trucks.

SECTION 4. ALTERNATIVE LIFO METHOD

.01 *In general.*

(1) The Alternative LIFO Method is a comprehensive dollar-value, link-chain LIFO method of accounting that encompasses several LIFO sub-methods and may only be used by an automobile dealer engaged in the trade or business of retail sales of new automobiles or new light-duty trucks to value its inventory of new automobiles and new light-duty trucks.

(2) The Alternative LIFO Method is designed to simplify the dollar-value computations of automobile dealers. Under the authority of § 1.446–1(c)(2)(ii), the Commissioner will waive strict adherence of the § 1.472–8 comparability requirement in applying the Alternative LIFO Method, provided a taxpayer uses the compensating sub-methods described in section 4.02 of this revenue procedure, which, in the opinion of the Commissioner, are necessary to ensure that the Alternative LIFO Method clearly reflects income. These sub-methods include requirements that (1) the current-year cost of a new item be used as the prior year cost for the new item, and (2) the automobile dealer use the manufacturer's base model codes to define items for purposes of § 1.472–8. Generally, the manufacturer's base model codes used in defining items and identifying new items under the Alternative LIFO Method have an average life of approximately five to seven years.

(3) The Alternative LIFO Method includes, by definition, all its sub-methods. Individual sub-methods used alone, or in combination with some but not all of the sub-methods of the Alternative LIFO Method, may not clearly reflect income. Therefore, use of the Alternative LIFO Method is conditioned upon an automobile dealer computing its LIFO inventory using all the sub-methods, definitions, and special rules provided in section 4.02 of this revenue procedure, and the computational methodology provided in section 4.03 of this revenue procedure.

(4) The Alternative LIFO Method will be accepted by the Commissioner as an appropriate method of computing an inventory index, and the use of the Alternative LIFO Method to compute the value of the inventory pool or pools will be accepted as accurate, reliable, and suitable. The automobile dealer's computations under the Alternative LIFO Method are, however, subject to verification by the district director upon examination of the automobile dealer's return.

.02 *Sub-methods, definitions, and special rules.*

(1) *LIFO pools.* For each separate trade or business, (a) all new automobiles (regardless of manufacturer), including those used as demonstrators, must be included in one dollar-value LIFO pool, and (b) all new light-duty trucks (regardless of manufacturer), including those used as demonstrators, must be included in another separate dollar-value LIFO pool.

(2) *Specific identification increment method.* The current-year cost of the items making up a pool must be determined by reference to the actual cost of the specific new automobiles or new light-duty trucks in ending inventory. Therefore, the actual cost of the specific vehicles on hand at year end will be the current-year cost of such vehicles.

(3) *Item of inventory.* An item of inventory ("item category") must be determined using the entire manufacturer's base model code number that represents the most detailed description of the base vehicle's characteristics, such as model line, body style, trim level, etc. The manufacturer's base model code numbers are almost always used as part of the vehicle identification on each dealer invoice (for example, a domestic model, trim level, 4-door sedan has a specific model code; a foreign model, 4-door sedan, trim level, 5-speed has a specific model code). In the case of conversion vans, an item of inventory must be determined using both (a) the entire manufacturer's base model code, as described in the preceding sentence, and (b) the most detailed conversion package designation.

(4) *Cost of the vehicle used for purposes of computing the pool index.* The actual base vehicle cost of each of the specific vehicles in ending inventory is used to compute the index under the Alternative LIFO Method. The base vehicle cost of each vehicle is not adjusted for any options, accessories, or other costs. The pool index computed from only the base vehicle cost of vehicles is applied to the total vehicle cost, including options, accessories, and other costs, of all vehicles in the pool at the end of the taxable year.

(5) *Definition of a new item.* A new item category, which is an item category not considered in existence in the prior taxable year, is one of the following: (a) any new or reassigned manufacturer's model code, as described in section 4.02(3) of this revenue procedure, that is

Index

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

Key to Abbreviations:

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

EMPLOYMENT TAX

EMPLOYMENT TAX—Continued

ESTATE TAX

EXCISE TAX

GIFT TAX

INCOME TAX

Name	Address	Designation	Date of Suspension
Pollard, E. Dwain	Idabell, OK	CPA	September 4, 1997 to August 3, 1999
Tamminga, Roland R.	Belmont, NH	Attorney	September 5, 1997 to December 4, 1997
Ayala, Simon	Oxnard, CA	Enrolled Agent	Indefinite from September 19, 1997
Balmer, Alan J.	Fairfield, IA	CPA	September 30, 1997 to August 29, 1999
Fox, Eugene	Rockville Centre, NY	CPA	October 1, 1997 to March 31, 1998
Sanford, Paul L.	Avon, CT	CPA	November 1, 1997 to July 31, 1997
Glemann, Richard P.	Jacksonville Beach, FL	CPA	November 1, 1997 to October 31, 1999
Rubey, Patrick J.	Chicago, IL	CPA	November 1, 1997 to January 31, 1999
Coverdale Jr., Alphonso	Philadelphia, PA	Enrolled Agent	December 1, 1997 to November 30, 2000

Announcement of the Consent Voluntary Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under 31 Code of Federal Regulations, Part 10, an attorney, certified public accountant, enrolled agent, or enrolled actuary, in order to avoid the institution or conclusion of a proceeding for his disbarment or suspension from practice before the Internal Revenue Service, may offer his consent to suspension from such practice. The Director of Practice, in his discretion, may suspend an attorney, certified public accountant, enrolled agent, or enrolled actuary in accordance with the consent offered.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under consent suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under consent suspension from practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Weksler, Mark R.	Arlington Heights, IL	CPA	June 16, 1997 to June 15, 2000
Womble, Bill R.	Dallas, TX	Attorney	Indefinite from June 19, 1997
Robinson II, Vaughn	Midland, TX	CPA	Indefinite from June 19, 1997
Kim, Kwang W.	Schaumburg, IL	CPA	June 30, 1997 to December 29, 1997
Tymas, George M.	Russellton, PA	CPA	July 1, 1997 to February 28, 1999
Rattet, Robert L.	New Rochelle, NY	Attorney	July 26, 1997 to June 25, 1998
Noles, R. Leon	N. Little Rock, AR	CPA	July 30, 1997 to October 29, 1997
Harbin, Glenn E.	Bakersfield, CA	CPA	July 31, 1997 to December 30, 1998
Harms, John G.	Lemont, PA	CPA	August 1, 1997 to November 30, 1997
Lewis, Craig S.	Savannah, GA	CPA	August 1, 1997 to July 31, 1998
Terranova, Michael P.	Lake Charles, LA	CPA	August 7, 1997 to May 6, 1998
Frantz, Barbara A.	Pontiac, IL	Attorney	August 8, 1997 to July 31, 1999
Smith, Glen L.	Edina, MN	Attorney	August 9, 1997 to November 8, 1997
Bayus Sr., Gerald A.	Hubbard, OH	CPA	August 11, 1997 to July 10, 1998
Winton, D. Michael	Clovis, NM	Enrolled Agent	August 15, 1997 to November 14, 1997
McNabb, Gerald	White Bear, MN	Attorney	August 22, 1997 to January 21, 2000
Ness, Stanley L.	Minneapolis, MN	CPA	August 25, 1997 to February 24, 1998
Culmer, Thomas A.	Devils Lake, ND	CPA	September 1, 1997 to November 30, 1997
Ziskind, Sherman	Dunlevy, PA	CPA	September 1, 1997 to February 28, 1999
Huston, James L.	Kingman, AZ	CPA	September 1, 1997 to December 31, 1997
Fulthorpe, Douglas R.	St. Petersburg, FL	CPA	September 1, 1997 to August 30, 1998
Suszko, Richard J.	La Mesa, CA	Enrolled Agent	September 1, 1997 to August 31, 1999
Bromagen, Kent E.	Dayton, OH	CPA	September 1, 1997 to February 28, 2000
Shawhan, David W.	Xenia, OH	CPA	September 1, 1997 to August 31, 1999
Kennedy Jr., Joseph	Santa Barbara, CA	Enrolled Agent	September 1, 1997 to May 31, 1998
Brummet, Richard E.	Hinsdale, IL	CPA	September 3, 1997 to January 2, 1998

Announcement of the Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents, or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been disbarred or suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been suspended from further practice before the Internal Revenue Service:

Name	Address	Designation	Date of Suspension
Makos, Deborah	Green Bay, WI	Enrolled Agent	June 20, 1997 to May 19, 2000
Friberg, John P.	Milwaukee, WI	CPA	July 20, 1997 to June 19, 2001

Announcement of the Disbarment of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under Section 330, Title 31 of the United States Code, the Secretary of the Treasury, after due notice and opportunity for hearing, is authorized to suspend or disbar from practice before the Internal Revenue Service any person who has violated the rules and regulations governing the recognition of attorneys, certified public accountants, enrolled agents, or enrolled actuaries to practice before the Internal Revenue Service.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or under suspension from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify such disbarred or suspended practitioners, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been disbarred or suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and the date of disbarment or period of suspension. This announcement will appear in the weekly Bulletin for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

After due notice and opportunity for hearing before an administrative law judge, the following individuals have been disbarred from further practice before the Internal Revenue Service:

Name	Address	Designation	Effective Date
Hoyt III, Walter J.	Burns, OR	Enrolled Agent	July 13, 1997
Lu, John S.	New York, NY	Enrolled Agent	July 21, 1997
McCue, William T.	Glen Rock, NJ	Attorney	July 21, 1997
Foster, Dennis S.	Pittsburgh, PA	CPA	September 8, 1997

Announcement of the Expedited Suspension of Attorneys, Certified Public Accountants, Enrolled Agents, and Enrolled Actuaries From Practice Before the Internal Revenue Service

Under title 31 of the Code of Federal Regulations, section 10.76, the Director of Practice is authorized to immediately suspend from practice before the Internal Revenue Service any practitioner who, within five years, from the date the expedited proceeding is instituted, (1) has had a license to practice as an attorney, certified public accountant, or actuary suspended or revoked for cause; or (2) has been convicted of any crime under title 26 of the United States Code or, of a felony under title 18 of the United States Code involving dishonesty or breach of trust.

Attorneys, certified public accountants, enrolled agents, and enrolled actuaries are prohibited in any Internal Revenue Service matter from directly or indirectly employing, accepting assistance from, being employed by, or sharing fees with, any practitioner disbarred or suspended from practice before the Internal Revenue Service.

To enable attorneys, certified public accountants, enrolled agents, and enrolled actuaries to identify practitioners under expedited suspension from practice before the Internal Revenue Service, the Director of Practice will announce in the Internal Revenue Bulletin the names and addresses of practitioners who have been suspended from such practice, their designation as attorney, certified public accountant, enrolled agent, or enrolled actuary, and date or period of suspension. This announcement will appear in the weekly Bulletin at the earliest practicable date after such action and will continue to appear in the weekly Bulletins for five successive weeks or for as many weeks as is practicable for each attorney, certified public accountant, enrolled agent, or enrolled actuary so suspended and will be consolidated and published in the Cumulative Bulletin.

The following individuals have been placed under suspension from practice before the Internal Revenue Service by virtue of the expedited proceeding provisions of the applicable regulations:

Name	Address	Designation	Date of Suspension
Booker, William G.	Winston-Salem, NC	CPA	Indefinite from June 12, 1997
Acevado, Gustavo	Laredo, TX	Attorney	Indefinite from July 23, 1997
Piotti, Wayne H.	Homer, NY	CPA	Indefinite from July 23, 1997
Burley, Franklin R.	Monroe, LA	CPA	Indefinite from July 23, 1997
Kent, William F.	Winston-Salem, NC	CPA	Indefinite from July 23, 1997
Levine, Jack	Phoenix, AZ	Attorney	Indefinite from July 23, 1997
Kapral, Stephen M.	Richmond, VA	Attorney	Indefinite from July 23, 1997
Bell, Abraham E.	St. Louis, MO	CPA	Indefinite from July 30, 1997
Jackson, Paul	Burley, ID	CPA	Indefinite from September 11, 1997
Clay, Henry	New York, NY	Attorney	Indefinite from September 11, 1997
Cooley, Donald	Springfield, MO	Attorney	Indefinite from September 11, 1997
Duke, Charla R.	Oakland, CA	Attorney	Indefinite from September 11, 1997
Devins, George	Munsey Park, NY	CPA	Indefinite from September 11, 1997
Williams, Ronald A.	Doylestown, PA	Enrolled Agent	Indefinite from September 11, 1997

holding under paragraph (b)(2)(i) of this section is not a determination that the accrued interest is not fixed or determinable annual or periodical income. See §1.61–7(c) regarding the character of payments received by the acquirer of an obligation subsequent to such acquisition (that is, as a return of capital or interest accrued after the acquisition).

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 14, 1997, 62 F.R. 53503)

extent it represents accrued unpaid interest as of the date of purchase as reflected in the new holder's basis for the obligation. Therefore, when the new holder receives a payment of the stated interest, the holder's tax liability is limited to the amount of interest accrued after the date of purchase (subject to additional adjustments reflecting possible acquisition premiums or market discounts). Because of the difficulty for a withholding agent to determine the amount accrued to the holder and other adjustments affecting the actual amount taxable to the holder, withholding on the entire amount of stated interest is required under the current withholding regulations under §1.1441–3(b)(1).

Commentators have asked that the withholding agent be permitted to withhold on the amount that it knows is taxable. The final withholding regulations did not modify the proposed regulations on this point because the Treasury and IRS consider that withholding on the entire amount is justified if withholding on sales of obligations between interest payment dates is not required. However, because these proposed regulations require withholding, the regulations permit a withholding agent to adjust the amount of withholding at the time of payment of stated interest to account for earlier withholding.

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) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 26, 1998, at 10 a.m. in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Ave, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic by January 5, 1998.

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.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In §1.1441–3, paragraph (b) is revised to read as follows:

§1.1441–3 Determination of amount to be withheld

* * * * *

(b) *Withholding on payments on certain obligations*—(1) *Withholding at time of payment of interest.* When making a payment on an interest-bearing obligation, a withholding agent must withhold under §1.1441–1 upon the gross amount of stated interest payable on the interest payment date, regardless of whether the payment constitutes a return of capital or the payment of income within the meaning of section 61, unless the withholding agent has knowledge of the actual amount of interest paid. For this purpose, the withholding agent may rely on information provided by the issuer (or its paying agent), on a representation from the beneficial owner, or on information that the withholding agent has in its records. To the extent an amount was withheld on an amount of capital rather than interest, see rules for adjustments, refunds, or credits under §1.1441–1(b)(8).

(2) *No withholding between interest payment dates*—(i) *General rule.* A withholding agent is not required to withhold under §1.1441–1 upon interest accrued on the date of a sale of debt obligations when that sale occurs between two interest payment dates (even though the amount is treated as interest under §1.61–7(c) or (d) and is subject to tax under section 871(a) or 881(a)), unless the withholding agent has knowledge of the amount paid as interest. For purposes of this paragraph (b)(2)(i), a withholding agent is treated as having knowledge in the same manner as a withholding agent has knowledge for purposes of §1.1441–2(b)(3)(ii), dealing with withholding on original issue discount. In addition, notwithstanding lack of knowledge (within the meaning of §1.1441–2(b)(3)(ii)), withholding is required on the entire amount of stated interest paid with respect to the obligation as determined as of the date of original issue if the withholding agent, pursuant to the provisions in §1.1441–1(b)(3), treats the payment as made to a foreign payee because it cannot associate the payment with required documentation and the amount would qualify as portfolio interest. See §1.1441–1(b)(8) for adjustments to any amount that has been overwithheld as a result of this provision.

(ii) *Applicable rules.* Any exemption from withholding pursuant to paragraph (b)(2)(i) of this section applies without a requirement that documentation be furnished to the withholding agent. However, documentation may have to be furnished for purposes of the information reporting provisions under section 6049 and backup withholding under section 3406. See §1.6045–1(c) for reporting requirements by brokers with respect to sale proceeds. Any exemption from with-

ture on a paper Form W–8. An electronic signature can be in any form that satisfies the foregoing requirements. The electronic signature must be the final entry in the person's Form W–8 submission.

(4) *Requests for electronic Forms W–8 data.* Upon request by the Internal Revenue Service during an examination, the withholding agent must supply a hard copy of the electronic Form W–8 and a statement that, to the best of the withholding agent's knowledge, the electronic Form W–8 was filed by the person whose name is on the form. The hard copy of the electronic Form W–8 must provide exactly the same information as, but need not be a facsimile of, the paper Form W–8.

(C) *Special requirements for transmission of Forms W–8 by an intermediary.* [Reserved].

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 14, 1997, 62 F.R. 53504)

Notice of Proposed Rulemaking and Notice of Public Hearing

Withholding on Interest in the Case of Sales of Obligations Between Interest Payment Dates

REG–114000–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This notice of proposed rulemaking provides guidance regarding the obligation to withhold on interest paid with respect to obligations in the case of the sale of obligations between interest payment dates. These regulations would affect United States and foreign withholding agents and recipients. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of oral comments to be presented at the public hearing scheduled for January 26, 1998, at 10 a.m. must be received by January 5, 1998.

ADDRESSES: Send submission to: CC:DOM:CORP:R (REG–114000–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20224. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (Reg–114000–97), Courier desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/ prod/tax_regs/comments.html. The hearing scheduled for January 26, 1998, will be held in the Commissioner's Conference Room, room 3313, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION

Background

In T.D. 8734, page 109, the IRS and Treasury published final withholding and reporting regulations under chapter 3 of the Internal Revenue Code (Code) and other sections of the Code. Section 1.1441–3(b)(2) of the final regulations provides that no withholding is required upon interest accrued on the date of a sale of debt obligations when the sale occurs between two interest payment dates, even though the amount is treated as interest under §1.61–7(c) or (d) and is subject to tax under section 871 or 881. In contrast, §1.1441–2(b)(3) of the final regulations provides that withholding is required on amounts of original issue discount in the event of a sale of an original issue discount obligation or a payment on such an obligation, subject to certain exceptions. The IRS and Treasury believe that, in view of these provisions, the exemption from withholding on non-OID amounts is no longer justified. A withholding agent that pays amounts to a foreign person in connection with the sale of an obligation between interest payments dates is in the same position as a withholding agent that pays amounts to a foreign person in connection with the sale of an original issue discount obligation. The withholding exemption for sale of debt obligations between interest payment dates provides an easy avenue for the avoidance of the documentation requirements imposed under sections 871(h) and 881(c) for purposes of qualifying interest on registered debt obligations as portfolio interest. For this reason, and in order to create parity with the tax treatment of original issue discount obligations under chapter 3 of the Code, it is no longer appropriate to continue this exemption.

Under §1.1441–2(b)(3), a withholding agent must withhold on an amount of original issue discount to the extent that it has actual knowledge of the proportion of the amount of the payment that is taxable to the beneficial owner under section 871(a)(1)(C) or 881(a)(3)(A). A withholding agent has actual knowledge if it knows how long the beneficial owner has held the obligation, the terms of the obligation, and the extent to which the beneficial owner purchased the obligation at a premium. A withholding agent is treated as having knowledge if the information is reasonably available. Special rules are provided for withholding agents with which the beneficial owner does not maintain a direct account relationship. Further, the regulations under §1.1441–2(b)(3) dealing with original issue discount provide that, in the case of an obligation that would qualify as portfolio interest if documentation were provided to the withholding agent, withholding is required on the entire amount of stated interest, if any, and original issue discount, if no such documentation is provided, irrespective of whether the withholding agent has knowledge of the portion of the payment representing taxable original issue discount. For this purpose, the withholding agent may rely upon the IRS "List of Original issue Discount Instruments" contained in IRS Publication 1212 (available from the IRS Distribution Centers).

In response to comments, the provisions in §1.1441–3(b)(1) are proposed to be modified to reduce the amount upon which withholding is required. No obligation to withhold is imposed under current law on the payment of stated interest on an obligation that was purchased between interest payment dates. Under §1.61–7(c), interest received on the interest payment date is treated as a return of basis to the

gated to assist in reducing burdens (in terms of cost and time) on withholding agents, payors, payees, and beneficial owners. The use of an electronic system for the transmission of Form W–8 is merely an alternative to the use of a paper form. Electronic transmission of Form W–8 is not mandatory. A withholding agent or payor may not mandate the use of electronic systems to receive or transmit the forms. Thus, a payee or beneficial owner may furnish a Form W–8 to the withholding agent or payor on paper.

4. *Signature Under Penalties of Perjury.*

Section 6061 generally provides that any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations shall be signed in accordance with forms or regulations prescribed by the Secretary. Section 301.6061–1(b) provides that the Secretary may prescribe in forms, instructions, or other appropriate guidance the method of signing any return, statement, or other document required to be made under any provision of the internal revenue laws or regulations. Section 6065 provides that, except as provided by the Secretary, any return, statement or other document shall contain or be verified by a written declaration that it is made under the penalties of perjury. These requirements apply to a Form W–8 (or such other form as the Internal Revenue Service may prescribe), including one that is filed electronically, as provided in §1.1441–1(e)-(2)(ii), (3)(ii), (3)(iii), and (3)(v), and §1.1441– 5(c)(2)(iv) and (3)(iii) of the final regulations. The proposed regulations, therefore, include guidance on the perjury statement and the signature requirements for Forms W–8 that are filed electronically.

5. *IRS Requests for Electronic Data.*

Upon request by the IRS in the course of an examination, a withholding agent or payor must supply a hard copy of the information contained on the electronically transmitted Form W–8 and a statement that, to the best of the withholding agent's knowledge, the electronic Form W–8 was furnished by the person whose name is on the form. The printout of the Form W–8 information must be provided to the IRS in English.

Proposed Effective Date

These regulations are proposed to become effective January 1, 1999.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the proposed 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 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 copies) that are submitted timely (in the manner described in the ADDRESSES portion of this preamble) to the IRS. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by any person that 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.**

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. In §1.1441–1, paragraph (e)(4)(iv) is revised to read as follows:

§1.1441–1 Requirement for the deduction and withholding of tax on payments to foreign persons.

* * * * *

(e) * * *

(4) * * *

(iv) *Electronic transmission of information*—(A) *In general.* A withholding agent may establish a system for beneficial owners or payees to furnish electronically Forms W–8 (or such other form as the Internal Revenue Service may prescribe). The system also may enable the withholding agent to electronically transmit Forms W–8 to another person. The system must meet the requirements described in paragraph (e)(4)(iv)(B) of this section.

(B) *Requirements*—(1) *In general.* The electronic system must ensure that the information received is the information sent, and must document all occasions of user access that result in the submission, renewal, or modification of a Form W–8. In addition, the design and operation of the electronic system, including access procedures, must make it reasonably certain that the person accessing the system and furnishing Form W–8 is the person named in the form.

(2) *Same information as paper Form W–8.* The electronic transmission must provide the withholding agent or payor with exactly the same information as the paper Form W–8.

(3) *Perjury statement and signature requirements.* The electronic transmission must be signed by way of an electronic signature by the person whose name is on the Form W–8 and the signature must be under penalties of perjury in the manner described in this paragraph (e)(4)(iv)(B)(3).

(i) *Perjury statement.* The perjury statement must contain the language that appears on the paper Form W–8. The electronic system must inform the person whose name is on the Form W–8 that the person must make the declaration contained in the perjury statement and that the declaration is made by signing the Form W–8. The instructions and the language of the perjury statement must immediately follow the person's certifying statements and immediately precede the person's electronic signature.

(ii) *Electronic signature.* The act of the electronic signature must be effected by the person whose name is on the electronic Form W–8. The signature must also authenticate and verify the submission. For this purpose, the terms *authenticate* and *verify* have the same meanings as they do when applied to a written signa-

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the submission of Form W–8, a withholding certificate, needed for purposes of chapters 3 and 61 of the Internal Revenue Code (Code) and other withholding or reporting provisions of the Code, such as section 3402, 3405, or 3406. The proposed regulations provide guidance to withholding agents and payors who wish to establish an electronic system for use by beneficial owners or payees in furnishing Form W–8. The proposed regulations state the general requirements that such an electronic system must satisfy so that a withholding agent or payor may rely on a Form W–8 transmitted through such a system. These regulations affect withholding agents and payors that establish electronic systems and beneficial owners and payees who use these systems.

DATES: Written comments and requests for a public hearing must be received by January 12, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–107872–97), room 5228, 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:DOM:CORP:R (REG–107872–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at www.irs.ustreas.gov/prod/tax_regs/comments.html.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under section 1441 of the Internal Revenue Code (Code). These amendments are proposed to provide general procedures for withholding agents and payors to establish acceptable electronic systems.

T.D. 8734, page 109, adds §1.1441–1(e)(4)(iv) which authorizes the electronic transmission of a Form W–8 described in §1.1441–1(e)(1)(i). In addition, by cross-reference contained in §1.6049–5(c)(2) (published as a final rule in T.D. 8734), the regulation authorizes electronic transmission of a Form W–8 furnished for purposes of chapter 61 of the Code (i.e., information reporting) or for purposes of another income tax withholding provision of the Code, such as section 3406.

Pursuant to chapter 3 (or, in certain cases, chapter 61) of the Code, a beneficial owner or a payee (i.e., a person who receives a payment) must furnish a withholding certificate to a withholding agent or payor in order to establish its status as a foreign person and entitlement to a reduced rate of withholding. By establishing foreign status, and other relevant characteristics, a beneficial owner or payee may be entitled to a reduction or exemption in the amount of withholding under chapter 3 of the Code or an exemption from information reporting under chapter 61 of the Code or from backup withholding under section 3406. The receipt of a withholding certificate affects the amount of tax that the withholding agent or payor may be required to withhold from the payment, and the type and form of information that it must provide to the IRS. The regulations under sections 1441 and 1443 specifically identify Form W–8 (or an acceptable substitute form) as the required form of the withholding certificate.

These proposed regulations apply to electronic transmission of Forms W–8. The regulations do not apply to Form 8233 for use by individuals who claim a reduced rate of withholding under an income tax convention for services performed in the United States. See §1.1441–4(b)(2). In addition, the regulations do not apply to documentary evidence (described in §1.6049–5(c)(1)) that may be substituted for the Form W–8 with respect to certain payments made to accounts maintained outside of the United States. However, the IRS and Treasury invite comments on any computer technology (e.g., imaging) that could make electronic transmission of documentary evidence possible.

Explanation of Provisions

1. *Type and Design of System Determined by Withholding Agent or Payor Subject to Specific Requirements.*

Under the proposed regulations, a withholding agent or payor may choose to establish an electronic system to receive or transmit Forms W–8 (or such other form as the IRS may prescribe), including a payor or withholding agent that is an intermediary. The withholding agent or payor may determine the type of system (such as telephone or computer) available for that purpose. The system must, however, (1) reliably identify the user, (2) ensure that the information received is the information sent, and (3) document occasions of user access that result in a submission, renewal, or modification of the withholding certificate. The proposed regulations envision that implementation of these specific requirements necessitates a direct relationship between the withholding agent or payor and the beneficial owner or payee. The proposed regulations reserve on applicable standards for systems used by intermediaries to transmit forms received from another payor or withholding agent. The IRS and Treasury recognize the importance of allowing the electronic transmission of Forms W–8 through one or more intermediaries (i.e., persons not acting for their own account). Therefore, comments are solicited regarding the logistical operation of an electronic transmission system for use by an intermediary satisfying the IRS requirements that the integrity, accuracy, and reliability of the original electronic transmission through an intermediary system is adequately protected.

2. *Relationship Between Paper and Electronic Withholding Certificate.*

The electronic transmission must contain exactly the same information as the paper Form W–8 (or such other form as the IRS may prescribe). Any guidance, such as regulations or instructions, that applies to the paper Form W–8 also applies to electronically transmitted forms.

3. *Electronic Filing Optional.*

Section 1.1441–1(e)(4)(iv) authorizing the use of electronic systems was promul-

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for §1.411(d)–4 to read as folows:

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

§1.411(d)–4 also issued under 26 U.S.C. 411(d)(6).* * *

Par. 2. Section 1.411(d)–4 is amended by adding Q&A–10 to read as follows:

§1.411(d)–4 Section 411(d)(6) protected benefits.

* * * * *

Q–10. If a plan provides for an age 70½ distribution option that commences prior to retirement from employment with the employer maintaining the plan, to what extent may the plan be amended to eliminate this distribution provision?

A–10. (a) *In general.* The right to commence benefit distributions in a particular form and at a particular time prior to retirement from employment with the employer maintaining the plan is a separate optional form of benefit within the meaning of section 411(d)(6)(B) and Q&A–1 of this section, even if the plan provision creating this right was included in the plan solely to comply with section 401(a)(9), as in effect for years before January 1, 1997. Therefore, except as otherwise provided in paragraph (b) of this A–10, a plan amendment violates section 411(d)(6) if it eliminates an age 70½ distribution option (within the meaning of paragraph (c) of this A–10) to the extent that it applies to benefits accrued as of the later of the adoption date or effective date of the amendment.

(b) *Permitted elimination of optional form.* An amendment of a plan will not violate the requiremnts of section 411(d)(6) merely because the amendment eliminates an age 70½ distribution option to the extent that the option provides for distribution to an employee prior to retirement from employment with the employer maintaining the plan, provided that—

(1) The amendment eliminating this optional form of benefit applies only to benefits with respect to employees who attain age 70½ in or after a calendar year, specified in the amendment, that begins after the later of—

(i) December 31, 1998; or

(ii) The adoption date of the amendment;

(2) The plan does not, except to the extent required by section 401(a)(9), preclude an employee who retires after the calendar year in which the employee attains age 70½ from receiving benefits in any of the same optional forms of benefit (except for the difference in the timing of the commencement of payments) that would have been available had the employee retired in the calendar year in which the employee attained age 70½; and

(3) The amendment is adopted no later than the last day of any remedial amendment period that applies to the plan for changes under the Small Business Job Protection Act of 1996 (110 Stat. 1755) (but in no event will the adoption of the amendment be required before December 31, 1998).

(c) *Age 70½ distribution option.* For purposes of this Q&A–10, an age 70½ distribution option is an optional form of benefit under which benefits payable in a particular distribution form (including any modifications that may be elected after benefit commencement) commence at a time during the period that begins on or after January 1 of the calendar year in which an employee attains age 70½ and ends April 1 of the immediately following calendar year.

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

Example 1. Plan A, a defined benefit plan, provides each participant with a qualified joint and survivor annuity (QJSA) that is available at any time after the later of age 65 or retirement. However, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan A provides that if an employee does not retire by the end of the calendar year in which the employee attains age 70½, then the QJSA commences on the following April 1. On October 1, 1998, Plan A is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence before the employee retires but must commence no later than the April 1 following the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. This amendment satisfies this Q&A–10 and does not violate section 411(d)(6).

Example 2. Plan B, a money purchase pension plan, provides each participant with a choice of a QJSA or a single sum distribution commencing at any time after the later of age 65 or retirement. In addition, in accordance with section 401(a)(9) as in effect prior to January 1, 1997, Plan B provides that benefits will commence in the form of a QJSA on April 1 following the calendar year in which the employee attains age 70½, except that, with spousal consent, a participant may elect to receive annual installment payments equal to the minimum amount necessary to satisfy section 401(a)(9) (calculated in accordance with a method specified in the plan) until retirement, at which time a participant may choose between a QJSA and a single sum distribution (with spousal consent). On June 30, 1998, Plan B is amended to provide that, for an employee who is not a 5-percent owner and who attains age 70½ after 1998, benefits may not commence prior to retirement but benefits must commence no later than April 1 after the later of the calendar year in which the employee retires or the calendar year in which the employee attains age 70½. The amendment further provides that the option described above to receive annual installment payments prior to retirement will not be available under the plan to an employee who is not a 5-percent owner and who attains age 70½ after 1998. This amendment satisfies this Q&A–10 and does not violate section 411(d)(6).

Example 3. Plan C, a profit-sharing plan, contains two distribution provisions. Under the first provision, in any year after an employee attains age 59½, the employee may elect a distribution of any specified amount not exceeding the balance of the employee's account. In addition, the plan provides a secion 401(a)(9) override provision under which, if, during any year following the year that the employee attains age 70½, the employee does not elect an amount at least equal to the minimum amount necessary to satisfy section 401(a)(9) (calculated in accordance with a method specified in the plan), Plan C will distribute the difference by December 31 of that year (or for the year the employee attains age 70½, by April 1 of the following year). On December 31, 1996, Plan C is amended to provide that, for an employee other than an employee who is a 5-percent owner in the year that the employee attains age 70½, in applying the section 401(a)(9) override provision, the later of the year of retirement, or year of attainment of age 70½, is substituted for the year that the employee attains age 70½. After the amendment, Plan C still permits each employee to elect to receive the same amount as was available before the amendment. Because this amendment does not eliminate an optional form of benefit, the amendment does not violate section 411(d)(6). Accordingly, the amendment is not required to satisfy the conditions of paragraph (b) of this A–10.

(e) This Q&A–10 applies to amendments adopted and effective after the publication of final regulations in the **Federal Register.**

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 1, 1997, 8:45 a.m., and published in the issue of the Federal Register for July 2, 1997, 62 F.R. 35752)

Notice of Proposed Rulemaking

Electronic Transmission of Form W–8

REG–107872–97

AGENCY: Internal Revenue Service (IRS), Treasury.

at the time of enactment of the SBJPA may have had an expectation of receiving preretirement distributions in the near future and may have made plans that took into account these expected distributions.

b. Optional Forms of Benefit for Participants Retiring After Age 70½

A plan using this relief generally may not preclude an employee who retires after the calendar year in which the employee attains age 70½ from receiving an optional form of benefit that would have been available if the employee had retired in the calendar year in which the employee attained age 70½ .

c. Timing of Plan Amendment

An amendment to eliminate a preretirement age 70½ distribution option may be adopted no later than the last day of any remedial amendment period that applies to the plan for changes under the SBJPA. However, in no event will the deadline for adopting such a plan amendment be before December 31, 1998. The relief provided is available only to employers that adopt the amendment within this specified time period because the relief is being provided to simplify the implementation of section 401(a)(9), as amended by the SBJPA, for employers that do not voluntarily provide preretirement distributions for an extended period after the enactment of the SBJPA.

3. Circumstances Under Which No Relief Is Required

Many employers do not need relief under section 411(d)(6) in order to implement the SBJPA change in the definition of required beginning date in their plans. The regulation includes an example of such a plan, a profit-sharing plan that permits an employee to elect distribution after age 59½ at any time and in any amount. The example illustrates that this plan may be amended to implement the SBJPA change in the definition of required beginning date without violating section 411(d)(6). In this example, the section 411(d)(6) relief proposed in this regulation is not required because the optional forms of benefit in the plan that reflect the pre-SBJPA mandatory distribution requirements of section 401(a)(9) are encompassed by the optional forms of benefit provided under the general elective distribution provisions. The right to commence distributions at age 70½ continues to be available under the plan even after the plan is amended to implement the SBJPA change in the required beginning date.

Effective Date

The guidance in these proposed regulations will only be effective after the date that final regulations are adopted and will only apply to amendments adopted and effective after that date. In order to provide employers with ample time to craft the appropriate plan amendment to implement the relief from section 411(d)(6) that would be provided when these regulations are finalized, the IRS and the Treasury intend to finalize these regulations on an expedited schedule after consideration of the comments received.

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) does not apply to these regulations. Further, it is hereby certified, pursuant to sections 603(a) and 605(b) of the Regulatory Flexibility Act, that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. The burden imposed by the collection of information is the burden of amending a plan to modify the provisions reflecting section 401(a)(9). The cost of the amendment varies depending upon whether the small entity involved maintains an individually designed plan or uses a master or prototype plan. For an individually designed plan, the small entity maintaining the plan will be responsible for arranging to have the amendment made. Most small entities with individually designed plans will have the amendment done by a skilled outside service provider, such as a consulting firm or law firm. The time required to make such an amendment is estimated at 30 minutes, which is not a significant economic impact, even for a very small entity. Moreover, most very small entities that maintain a qualified plan use a master or prototype plan. For master and prototype plans, the plan sponsor drafts a single amendment for all of the employers participating in the plan. The average time required for the amendment per employer participating in a master or prototype plan is estimated to be 10 minutes, which certainly is not a substantial economic impact. Therefore, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 28, 1997, at 10 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral arguments at the hearing must submit written comments and an outline of the topics to be discussed at the time devoted to each topic by September 30, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of speakers will be prepared after deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

* * * * *

Proposed Amendments to the Regulations

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

Estimated number of recordkeepers: 135,000.

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

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

Background

This notice contains proposed amendments to the income tax regulations (26 CFR Part 1) under section 411(d) of the Internal Revenue Code of 1986.

Section 411(d)(6) generally provides that a plan will not be treated as satisfying the requirements of section 411 if the accrued benefit of a participant is decreased by a plan amendment. Under section 411(d)(6)(B), a plan amendment that eliminates an optional form of benefit will be treated as reducing accrued benefits to the extent that the amendment applies to benefits accrued as of the later of the adoption date or the effective date of the amendment. However, section 411(d)(6)-(B) also permits the Secretary to provide in regulations that this rule will not apply to an amendment that eliminates an optional form of benefit.

Section 401(a)(9) provides that, in order for a plan to be qualified under section 401(a), distributions from the plan must commence no later than the "required beginning date." Prior to 1997, section 401(a)(9)(C) generally provided that the required beginning date is April 1 following the calendar year in which the employee attains age 70½. Consequently, in order to satisfy section 401(a)(9), qualified plans, other than certain church and governmental plans, have provided for distributions to commence no later than April 1 following the calendar year that an employee attains age 70½. These distributions commence without regard to whether the employee has retired from employment with the employer maintaining the plan.

Section 1404 of the Small Business Job Protection Act of 1996, Public Law 104–188 (SBJPA), amended the definition of required beginning date that applies to an employee who is not a 5-percent owner. Section 401(a)(9)(C)(i), as amended, provides that, in the case of such an employee, the required beginning date is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70½ or the calendar year in which the employee retires. Accordingly, except for 5-percent owners, a plan is no longer required to provide for distributions that commence prior to retirement in order to satisfy section 401(a)(9).

The right to commence benefit distributions in any form at a particular time is an optional form of benefit within the meaning of section 411(d)(6)(B) and §1.411(d)–4 Q&A–1(b). In enacting section 1404 of the SBJPA, Congress did not alter the application of section 411(d)(6). Thus, except to the extent authorized by regulations, a plan amendment that eliminates the right to commence preretirement benefit distributions in a plan after age 70½ (or restricts the right by adding an additional condition) violates section 411(d)(6) if the amendment applies to benefits accrued as of the later of the adoption or effective date of the amendment.

Notice 96–67 (1996–53 I.R.B. 12) provided questions and answers addressing certain issues relating to the amendment of section 401(a)(9)(C) by the SBJPA and requested comments concerning the extent to which relief from section 411(d)(6) would be appropriate for plan amendments that eliminate preretirement distributions after age 70½ (e.g., by limiting section 411(d)(6) protection to employees above a certain age).

Overview

1. Permitted Elimination of Preretirement Distributions After Age 70½

The legislative history to section 1404 of the SBJPA indicates that the reason for amending the definition of required beginning date was that it is inappropriate to require all participants to commence distributions by age 70½ without regard to whether the participant is still employed by the employer. Because section 1404 did not alter the application of section 411(d)(6) to plan provisions allowing or requiring preretirement distributions after age 70½, an employer's choices for amending its plan to implement the SBJPA change to the definition of required beginning date are limited unless the IRS and Treasury grant relief from section 411(d)(6).

As one choice, in accordance with the guidance in Announcement 97–24 (1997–11 I.R.B. 24) March 13, 1997, the employer may give employees the option of commencing distributions at age 70½ or deferring commencement until after retirement. As a second alternative, the employer may amend the plan to eliminate the right to preretirement distributions solely with respect to future accruals. However, under this second approach, each current participant would retain the right to receive preretirement distributions after age 70½ with respect to a portion of his or her accrued benefit.

The IRS and Treasury recognize the potential complexity of administering plans (particularly defined benefit plans) that adopt either of these choices. In addition, an employer may not have voluntarily chosen to offer preretirement distributions to employees who have attained age 70½ but instead may have included these provisions in its plan solely to comply with section 401(a)(9) prior to its amendment by the SBJPA. Therefore, after consideration of the comments received in response to Notice 96–67 and subject to the conditions described below, the proposed regulations would provide relief from section 411(d)(6) for certain plan amendments that eliminate preretirement distributions commencing at age 70½.

2. Conditions on the Relief From Section 411(d)(6)

a. Protection for Employees Who Are Near Age70½

Under the proposed regulation, an amendment to eliminate a preretirement age 70½ distribution option may apply only to benefits with respect to employees who attain age 70½ in or after a calendar year, specified in the amendment, that begins after the later of December 31, 1998, or the adoption date of the amendment. The relief from section 411(d)(6) is limited to distributions to employees who attain age 70½ after calendar year 1998 because employees who were near age 70½

Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

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

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.401(b)–1 is amended by:

1. Revising paragraphs (b)(3), (c) and (d)(1)(iv).

2. Adding paragraph (d)(1)(v).

The addition and revisions read as follows:

§1.401(b)–1 Certain retroactive changes in plan.

[The text of proposed paragraphs (b)(3), (c), (d)(1)(iv) and (v) is the same as the text of §1.401(b)–1T(b)(3), (c), (d)(1)(iv) and (v) published in T.D. 8727.]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on July 31, 1997, 8:45 a.m., and published in the issue of the Federal Register for August 1, 1997, 62 F.R. 41322)

Notice of Proposed Rulemaking and Notice of Public Hearing

Permitted Elimination of Preretirement Optional Forms of Benefit

REG–107644–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations that would permit an amendment to a qualified plan that eliminates certain preretirement optional forms of benefit. These regulations affect employers that maintain qualified plans, plan administrators of qualified plans and participants in qualified plans. This document provides notice of a public hearing on these proposed regulations.

DATES: Written comments and outlines of the topics to be discussed at the public hearing must be received by September 30, 1997. A public hearing is scheduled for October 28, 1997.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–107644–97), Room 5228, 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:DOM:CORP:R (REG–107644–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. A public hearing is scheduled to be held in the Auditorium, Internal Revenue Building, 111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by September 2, 1997. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation is in §1.411(d)–4. This information is required for a taxpayer who wants to amend a qualified plan to eliminate certain preretirement optional forms of benefit. This information will be used to determine whether taxpayers have amended a qualified plan. The collection of information is voluntary to obtain a benefit. The likely recordkeepers are businesses or other for-profit organizations and non-profit institutions.

Estimated total recordkeeping burden: 48,800 hours.

Estimated average burden per recordkeeper: For Master and Prototype Plan Employers: 10 minutes. For Master and Prototype Plan Sponsors: 30 minutes. For Employers with Individually Designed Plans: 30 minutes.

(5) *Effective date.* This paragraph (f) applies as of the date the final regulations are published in the **Federal Register**.

(g) *Elective changes in classification—*(1) *Deemed treatment of elective change—*(i) *Partnership to association.* If an eligible entity classified as a partnership elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The partnership contributes all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners.

(ii) *Association to partnership.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be classified as a partnership, the following is deemed to occur: The association distributes all of its assets and liabilities to its shareholders in liquidation of the association, and immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership.

(iii) *Association to disregarded entity.* If an eligible entity classified as an association elects under paragraph (c)(1)(i) of this section to be disregarded as an entity separate from its owner, the following is deemed to occur: The association distributes all of its assets and liabilities to its single owner in liquidation of the association.

(iv) *Disregarded entity to an association.* If an eligible entity that is disregarded as an entity separate from its owner elects under paragraph (c)(1)(i) of this section to be classified as an association, the following is deemed to occur: The owner of the eligible entity contributes all of the assets and liabilities of the entity to the association in exchange for stock of the association.

(2) *Effect of elective changes.* The tax treatment of a change in the classification of an entity for federal tax purposes by election under paragraph (c)(1)(i) of this section is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine.

(3) *Timing of election.* An election under paragraph (c)(1)(i) of this section that changes the classification of an eligible entity for federal tax purposes is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur under this paragraph (g) as a result of a change in classification are treated as occurring immediately before the close of the day before the election is effective. For example, if an election is made to change the classification of an entity from an association to a partnership effective on January 1, the deemed transactions specified in paragraph (g)(1)(ii) of this section (including the liquidation of the association) are treated as occurring immediately before the close of December 31 and must be reported by the owners of the entity on December 31. As a result, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

(4) *Effective date.* This paragraph (g) applies to elections that are filed on or after the date the final regulations are published in the **Federal Register**.

(h) *Effective date—*(1) *In general.* Except as otherwise provided in this section, the rules of this section are applicable as of January 1, 1997.

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Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 27, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 28, 1997, 62 F.R. 55768)

Notice of Proposed Rulemaking

Remedial Amendment Period

REG–106043–97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

SUMMARY: T.D. 8727, page 47, the IRS is issuing temporary regulations relating to the remedial amendment period during which a sponsor of a qualified retirement plan or an employer that maintains a qualified retirement plan can make retroactive amendments to the plan to eliminate certain qualification defects for the entire period. The text of those temporary regulations also serves as the text of these proposed regulations. These proposed regulations will affect sponsors of qualified retirement plans, and employers that maintain qualified retirement plans.

DATES: Written comments and requests for a public hearing must be received by October 30, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–106043–97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–106043–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

SUPPLEMENTARY INFORMATION:

Background

Final and temporary regulations in T.D. 8727 amend the Income Tax Regulations (26 CFR part 1) relating to section 401(b). The regulations provide guidance to clarify the scope of the Commissioner's authority to provide relief from plan disqualification under section 401(b) and the regulations.

The text of T.D. 8727 the temporary regulations also serves as the text of these proposed regulations. The preamble to the final and temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility

(i) * * *

Finland, Julkinen Osakeyhtio/Publikt Aktiebolag

* * * * *

Malta, Public Limited Company

* * * * *

Norway, Allment Aksjeselskap

* * * * *

(ii) *Clarification of list of corporations in paragraph (b)(8)(i) of this section*—(A) *Exceptions in certain cases.* * * *

* * * * *

(*3*) With regard to Malaysia, a Sendirian Berhad.

(B) *Inclusions in certain cases.* With regard to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable).

(iii) *Public companies.* For purposes of paragraph (b)(8)(i) of this section, with regard to Cyprus, Hong Kong, Jamaica, and Trinidad and Tobago, the term Public Limited Company includes any Limited Company that is not defined as a private company under the corporate laws of those jurisdictions. In all other cases, where the term Public Limited Company is not defined, that term shall include any Limited Company defined as a public company under the corporate laws of the relevant jurisdiction.

(iv) *Limited companies.* For purposes of this paragraph (b)(8), any reference to a Limited Company includes, as the case may be, companies limited by shares and companies limited by guarantee.

* * * * *

(e) *Effective date.* Except as otherwise provided in this paragraph (e), the rules of this section apply as of January 1, 1997. The reference to the Finnish, Maltese, and Norwegian entities in paragraph (b)(8)(i) of this section is applicable on the date the final regulations are published in the **Federal Register**. Any Maltese or Norwegian entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on the date final regulations are published in the **Federal Register** may elect (within 75 days of the date final regulations are published in the **Federal Register**) to be classified for federal tax purposes as an entity other than a corporation retroactive to any period from and including January 1, 1997. Any Finnish entity that becomes an eligible entity as a result of paragraph (b)(8)(i) of this section in effect on the date final regulations are published in the **Federal Register** may elect (within 75 days of the date final regulations are published in the **Federal Register**) to be classified for federal tax purposes as an entity other than a corporation retroactive to any period from and including September 1, 1997.

Par. 6. Section 301.7701–3 is amended as follows:

1. A sentence is added at the end of paragraph (c)(1)(iv).

2. Paragraph (c)(2)(iii) is added.

3. A heading is added to paragraph (d)(1).

4. Paragraph (f) is redesignated as paragraph (h) and newly designated paragraph (h)(1) is revised.

5. Paragraphs (f) and (g) are added.

The revision and additions read as follows:

§301.7701–3 Classification of certain business entities.

* * * * *

(c) * * *

(1) * * *

(iv) *Limitation.* * * * An election by a newly-formed eligible entity that is effective on the date of formation is not considered a change for purposes of this paragraph (c)(1)(iv).

* * * * *

(2) * * *

(iii) *Changes in classification.* For purposes of paragraph (c)(2)(i) of this section, if an election under paragraph (c)(1)(i) of this section is made to change the classification of an entity, each person who was an owner on the date that any transactions under paragraph (g) of this section are deemed to occur, and who is not an owner at the time the election is filed, must also sign the election. This paragraph (c)(2)(iii) applies to elections filed on or after the date final regulations are published in the **Federal Register**.

(d) *Special rules for foreign eligible entities*—(1) *Definition of relevance.* * * *

* * * * *

(f) *Changes in number of members of an entity*—(1) *Associations.* The classification of an eligible entity as an association is not affected by any change in the number of members of the entity.

(2) *Partnerships and single member entities.* An eligible entity classified as a partnership is disregarded as an entity separate from its owner as of the date the entity has only one member. A single member entity disregarded as an entity separate from its owner is classified as a partnership as of the date the entity has more than one member.

(3) *Effect on sixty month limitation.* A change in the number of members of an entity does not result in the creation of a new entity for purposes of the sixty month limitation on elections under paragraph (c)(1)(iv) of this section.

(4) *Examples.* The following examples illustrate the application of this paragraph (f):

Example 1. (i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and X does not make an election to be classified as a partnership. A subsequently purchases all of B's interest in X.

(ii) Under paragraph (f)(1) of this section, X continues to be classified as an association. X, however, can subsequently elect to be disregarded as an entity separate from A. The sixty month limitation of paragraph (c)(1)(iv) of this section does not prevent X from making an election because X has not made a prior election under paragraph (c)(1)(i) of this section.

Example 2. (i) On April 1, 1998, A and B, U.S. persons, form X, a foreign eligible entity. X is treated as an association under the default provisions of paragraph (b)(2)(i) of this section, and X does not make an election to be classified as a partnership. On January 1, 1999, X elects to be classified as a partnership effective on that date. Under the sixty month limitation of paragraph (c)(1)(iv) of this section, X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after the effective date of the election to be classified as a partnership).

(ii) On June 1, 1999, A purchases all of B's interest in X. After A's purchase of B's interest, X can no longer be classified as a partnership because X has only one member. Under paragraph (f)(2) of this section, X is disregarded as a separate entity as of the date A becomes the only member of X. X, however, is not treated as a new entity for purposes of paragraph (c)(1)(iv) of this section. As a result, the sixty month limitation of paragraph (c)(1)(iv) of this section continues to apply to X and X cannot elect to be classified as an association until January 1, 2004 (i.e., sixty months after January 1, 1999, the effective date of the election by X to be classified as a partnership).

2615, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic by (preferably a signed original and eight (8) copies) January 26, 1998.

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.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.743-2 is added under the undesignated centerheading "Transfer of Interests in a Partnership" to read as follows:

§1.743–2 Transfer of property to a corporation.

(a) *Basis in transferred property.* A corporation's adjusted tax basis in property transferred to the corporation by a partnership in a transfer described in section 351 is determined with reference to any special basis adjustment to the property under section 743(b) (other than any special basis adjustment that reduces a partner's gain under paragraph (b) of this section).

(b) *Partnership gain.* The amount of gain, if any, recognized by a partnership on a transfer of property by the partnership to a corporation in a transfer described in section 351 is determined without reference to any special basis adjustment to the transferred property under section 743(b). The amount of gain, if any, recognized by the partnership on the transfer that is allocated to a partner with a special basis adjustment in the transferred property is adjusted to reflect the partner's special basis adjustment in the transferred property.

(c) *Basis in stock.* The partnership's adjusted tax basis in stock received from a corporation in a transfer described in section 351 is determined without reference to the special basis adjustment in property transferred to the corporation in the section 351 exchange. A partner with a special basis adjustment in property transferred to the corporation, however, has a special basis adjustment in the stock received by the partnership in the section 351 exchange in an amount equal to the partner's special basis adjustment in the transferred property, reduced by any special basis adjustment that reduced the partner's gain under paragraph (b) of this section.

(d) *Effective date.* This section applies to transfers that occur on or after the date final regulations are published in the **Federal Register**.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. Section 301.6109-1 is amended as follows:

1. Paragraph (d)(2)(ii) is removed and reserved.

2. Paragraph (h) is redesignated as paragraph (i) and the first sentence of newly designated paragraph (i)(1) is amended by removing the language "paragraph (h)" and adding "paragraph (i)" in its place.

3. A new paragraph (h) is added.

The addition reads as follows:

§301.6109-1 Identifying numbers.

* * * * *

(h) *Special rules for certain entities under §301.7701–3*—(1) *General rule.* Any entity that has an employer identification number (EIN) will retain that EIN if its federal tax classification changes under §301.7701–3.

(2) *Special rules for entities that are disregarded as entities separate from their owners*—(i) *When an entity becomes disregarded as an entity separate from its owner.* Except as otherwise provided in regulations or other guidance, a single owner entity that is disregarded as an entity separate from its owner under §301.7701–3, must use its owner's taxpayer identifying number (TIN) for federal tax purposes.

(ii) *When an entity that was disregarded as an entity separate from its owner becomes recognized as a separate entity.* If a single owner entity's classification changes so that it is recognized as a separate entity for federal tax purposes, and that entity had an EIN, then the entity must use that EIN and not the TIN of the single owner. If the entity did not already have its own EIN, then the entity must acquire an EIN and not use the TIN of the single owner.

(3) *Effective date.* This paragraph (h) applies to changes in classification that occur on or after the date on which these regulations are published as final regulations in the **Federal Register**.

Par. 5. Section 301.7701–2 is amended as follows:

1. Paragraph (b)(8)(i) is amended by revising the entries for Finland, Malta, and Norway.

2. Paragraph (b)(8)(ii)(A) is redesignated as paragraph (b)(8)(ii)(A)(*1*) and the language "and" at the end of the paragraph is removed.

3. Paragraph (b)(8)(ii)(B) is redesignated as paragraph (b)(8)(ii)(A)(*2*) and the period at the end of the paragraph is removed and the language "; and " is added in its place.

4. Paragraph (b)(8)(ii) heading and introductory text are redesignated as paragraph (b)(8)(ii)(A) heading and introductory text, and a new paragraph heading is added for paragraph (b)(8)(ii).

5. Paragraphs (b)(8)(ii)(A)(*3*) and (b)(8)(ii)(B) are added.

6. Paragraphs (b)(8)(iii), (b)(8)(iv), and (e) are revised.

The revisions and additions read as follows:

§301.7701–2 Business entities; definitions.

* * * * *

(b) * * *

(8) * * *

certain cases where the statute does not provide a defined name. To minimize any uncertainty, however, the provisions of §301.7701–2(b)(8)(iii) and (iv) were included in the final regulations to address this issue. In response to comments from taxpayers, these subsections of the final regulations are clarified to provide guidance on the terms used in the final regulations. Furthermore, the regulations clarify that the term Berhad used with regard to Malaysia does not include a "Sendirian Berhad" (the equivalent of a private limited company). The regulations also clarify that, in relation to Mexico, the term Sociedad Anonima includes a Sociedad Anonima that chooses to apply the variable capital provision of Mexican corporate law (Sociedad Anonima de Capital Variable). The fact that capital may be varied does not make this a different type of entity from a Sociedad Anonima that does not choose to apply the variable capital provision. These clarifications are not intended to change the interpretation of the final regulations.

The proposed regulations also clarify the treatment of the Finnish, Maltese, and Norwegian entities specified in the final regulations. Effective January 1, 1996, Maltese and Norwegian corporate law recognized a distinction between public and private companies, and the proposed regulations reflect this change. The proposed regulations also provide that the rules of the final regulations with regard to the Maltese and Norwegian entities may be applied (when these proposed regulations are finalized) as though the entities specified in the proposed regulations had been included in the final regulations issued on December 18, 1996. Thus, a Maltese or Norwegian entity that is no longer treated as a per se corporation under the regulations would be able to make an election within 75 days of the date these proposed regulations are finalized, and such election could be effective as of January 1, 1997. Finnish law, since September 1, 1997, has recognized a similar distinction between public and private companies. It is proposed that a Finnish entity that is no longer treated as a per se corporation under the regulations would be able to make an election within 75 days of the date these proposed regulations are finalized, and such election could be effective as of September 1, 1997.

Special Basis Adjustments Under Section 743

Section 743 provides that the basis of partnership property is not adjusted as the result of a transfer of an interest in the partnership by sale or exchange unless the partnership has made an election under section 754. If a section 754 election is made, the transferee partner is treated as having a special basis adjustment with respect to partnership property. This adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee partner only. Some uncertainty has remained as to the treatment of this special basis adjustment upon the contribution of the partnership property to a corporation in a section 351 exchange, and because the proposed regulations provide for a deemed contribution by the partnership to a corporation in an elective conversion to an association, the proposed regulations address this uncertainty.

The proposed regulations provide that a corporate transferee's basis in property transferred by a partnership in a transfer described in section 351 includes any special basis adjustment under section 743. The special basis adjustment is also taken into account in determining the partner's basis in the stock received in the exchange. For example, assume a partnership owns Property X, which has a common basis of $100 for the partnership and in which Partner A has a $5 special basis adjustment under section 743(b). Subsequently, the partnership validly elects to be classified as an association. The partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association, and immediately thereafter, the partnership liquidates by distributing the stock of the association to its partners. If the transfer of the assets to the association would be a transfer described in section 351, then under the proposed regulations, the association's basis in Property X includes Partner A's $5 special basis adjustment. Thus, the association has a $105 basis in Property X (Partner A's $5 special basis adjustment plus the partnership's $100 common basis). Partner A's basis in the association's stock will reflect the $5 special basis adjustment previously on Property X.

The proposed regulations also provide, however, that the amount of gain, if any, recognized by the partnership on the transfer is determined without reference to any special basis adjustment. The partner with the special basis adjustment can then use the special basis adjustment to reduce its share of any gain recognized by the partnership. This approach of determining gain at the partnership level and allowing the partner to use the special basis adjustment as an offset is similar to the treatment of a sale of property with a special basis adjustment.

Proposed Effective Date

Except as otherwise specified, these regulations are proposed to apply as of the date the final regulations are published in the **Federal Register**.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 24, 1998, at 10 a.m., in room

tity with a single member can elect to be classified as an association or as an entity that is disregarded as an entity separate from its owner. An eligible entity may also elect to change its classification, except that an election may not be made more than once in any sixty month period. An eligible entity that does not make an election is classified under certain default provisions.

Explanation of Provisions

Characterization of Elective Changes in Classification

The proposed regulations describe how elective changes in an entity's classification will be treated for federal tax purposes. Under the final regulations, there are four possible changes in classification by election: (i) a partnership elects to be an association; (ii) an association elects to be a partnership; (iii) an association elects to be a disregarded entity; and (iv) a disregarded entity elects to be an association. There are two other possible ways in which an entity's classification could change (a partnership converts to a disregarded entity or a disregarded entity converts to a partnership) but these changes occur only as a result of a change in the number of members, not as the result of an elective change. The proposed regulations do not address the form of these two possible types of changes.

The proposed regulations provide a specific characterization for each of the four possible elective changes. In each case, the characterization provided in the proposed regulations attempts to minimize the tax consequences of the change in classification and achieve administrative simplicity. The proposed regulations provide that if an association elects to be classified as a partnership, the association is deemed to liquidate by distributing its assets and liabilities to its shareholders. Then, the shareholders are deemed to contribute all of the distributed assets and liabilities to the partnership. This characterization of an elective change from an association to a partnership is consistent with Rev. Rul. 63–107 (1963–1 C.B. 71).

If a partnership elects to be classified as an association, the partnership is deemed to contribute all of its assets and liabilities to the association in exchange for stock in the association. Then, the partnership is deemed to liquidate by distributing stock in the association to its partners. The proposed regulations do not affect the holdings in Rev. Rul. 84–111 (1984–2 C.B. 88), in which the IRS ruled that it would respect the particular form undertaken by the taxpayers when a partnership converts to a corporation.

If an association elects to be disregarded as an entity separate from its owner, the association is deemed to liquidate by distributing its assets and liabilities to its sole owner. Conversely, if an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to contribute all of the assets and liabilities of that entity to the association in exchange for stock of the association.

The proposed regulations also provide that the tax treatment of an elective change in classification is determined under all relevant provisions of the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. This provision in the proposed regulations is intended to ensure that the tax consequences of an elective change will be identical to the consequences that would have occurred if the taxpayer had actually taken the steps described in the proposed regulations. The IRS and Treasury request comments on the application of general principles of tax law to the transactions that are deemed to occur on an elective change in classification.

Change in Number of Members of Entity

The proposed regulations address the effect of a change in the number of members on the classification of an entity. Under the proposed regulations, if there is a change in the number of members of an association, the classification of the entity is not affected. If an eligible entity classified as a partnership subsequently has only one member (and is still treated as an entity under local law), the entity will be disregarded as an entity separate from its owner. If a single member entity that is disregarded as an entity separate from its owner subsequently has more than one member, the entity is classified as a partnership as of the date the entity has more than one member. The classifications provided in the proposed regulations can be changed by election, assuming that the entity is not subject to the sixty month limitation on elections.

Timing of Elective Changes in Classification

The proposed regulations provide that an election to change the classification of an entity is treated as occurring at the start of the day for which the election is effective. Any transactions that are deemed to occur as a result of the change in classification are treated as occurring immediately before the close of the day before the effective date of the election. For example, if an election is made to convert from an association to a partnership effective on January 1, the entity is treated as a partnership on January 1, and the deemed transactions specified in the proposed regulations are treated as occurring immediately before the close of December 31. As a result, the last day of the association's taxable year will be December 31 and the first day of the partnership's taxable year will be January 1.

Treatment of Foreign Eligible Entities

Any eligible entity, including a foreign eligible entity whose classification is not relevant for federal tax purposes, may elect to change its classification. The IRS and Treasury request comments on the appropriateness of allowing such a foreign eligible entity to make a classification election, and comments on what the federal tax consequences of such an election should be (e.g., with respect to the basis of property held by the entity).

Foreign Per Se Entities

The final regulations provide a list of the names of certain foreign business entities that are treated as corporations for federal tax purposes. In most cases, the name by which an entity will be known is provided by the statutory corporate law of the relevant jurisdiction. In certain cases, however, the corporate law does not provide a statutory name. In these jurisdictions, taxpayers and practitioners often fill the statutory void with a name derived from a number of the statutory characteristics of the entity. In an effort to make the list of foreign per se corporations more accessible, the final regulations use the commonly used non-statutory term in

cant 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 Administratifve Procedure Act (5 U.S.C. chapter 5) doe snot apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulaitons are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 24, 1997, at 10 a.m. in the Commissioner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restricitons, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit comments and an outline of the topics to be discussed and the time to be devoted to each topic by September 3, 1997.

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.

Proposed Effective Date

This amendment is proposed to apply to payments received by an entity on or after January 1, 1998.

* * * * *

Proposed Amendments to the Regulaitons

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

PART 1—INCOME TAXES

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

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

Par. 2. In §1.894–1, paragraph (d) is added to read as follows:

§1.894–1 Income affected by treaty.

* * * * *

[The text of proposed paragraph (d) is the same as the text of §1.894–1T(d) published in T.D. 8722, page 81.]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on June 30, 1997, 12:19 p.m., and published in the issue of the Federal Register for July 2, 1997, 62 F.R. 35755).

Notice of Proposed Rulemaking and Notice of Public Hearing

Qualified Nonrecourse Financing Under Section 465(b)(6)

REG–105160–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 465(b)(6) regarding qualified nonrecourse financing. The proposed regulations address whether the personal liability of an entity prevents financing from being treated as qualified nonrecourse financing and whether qualified nonrecourse financing may be secured by property that is incidental to the activity of holding real property. The proposed regulations would affect partnerships and their partners. This document also gives notice of a public hearing scheduled for December 10, 1997.

DATES: Written comments and requests to speak (with outlines of oral comments) at the public hearing scheduled for December 10, 1997, must be received by November 19, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–105160–97), 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:R (REG–105160–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option of the IRS Home Page, or by submitting comments directly to the IRS Internet site at: http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Introduction

This document contains proposed regulations under section 465(b)(6) of the Internal Revenue Code (Code). Section 465, which applies to individuals and certain corporations, limits a taxpayer's loss deduction for an activity to the amount of the taxpayer's amount at risk in the activity at the close of the taxable year. A taxpayer's amount at risk generally includes the amount of any cash and the adjusted tax basis of any property contributed by the taxpayer to the activity plus any amounts borrowed for use in the activity to the extent the taxpayer is personally liable for repayment.

For the activity of holding real property, a taxpayer may also include as an amount at risk the taxpayer's share of any "qualified nonrecourse financing" that is secured by real property used in the activity of holding real property, even though the taxpayer is not personally liable for repayment of the financing. Section 465(b)(6) defines qualified nonrecourse financing as any financing that (i) is borrowed by the taxpayer for the activity of holding real property; (ii) is borrowed by the taxpayer from a qualified person or

termined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, March 4, 1998, at 10:00 a.m. in Room 2615. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by February 23, 1998 and submit requests to speak and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by February 11, 1998.

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.

* * * * *

Proposed Amendments to the Regulations

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

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.6109–1 also issued under 26 U.S.C. 6109;

Section 301.6109–3 also issued under 26 U.S.C. 6109; * * *

Par. 2. Section 301.6109–1 is amended by revising paragraphs (a)(1)(i), (a)(1)(ii) introductory text, (a)(1)(ii)(A), and (a)(1)(ii)(B) to read as follows:

§301.6109–1 Identifying numbers.

(a) * * * (1) *Taxpayer identifying numbers*—(i) [The text of proposed paragraph (a)(1)(i) is the same as the text of §301.6109–1T(a)(1)(i) published in T.D. 8739.]

(ii) [The text of proposed paragraph (a)(1)(ii) introductory text is the same as the text of §301.6109–1T(a)(1)(ii) introductory text published in T.D. 8739.]

(A) and (B) [The text of proposed (a)(1)(ii)(A) and (B) are the same as the text of §301.6109–1T(a)(1)(ii)(A) and (B) published in T.D. 8739.]

* * * * *

Par. 3. Section 301.6109–3 is added to read as follows:

§301.6109–3 IRS adoption taxpayer identification numbers.

[The text of this proposed section is the same as the text of §301.6109–3T published in T.D. 8739.]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 21, 1997, at 8:45 a.m., and published in the issue of the Federal Register for November 24, 1997, 62 F.R. 62538).

Notice of Proposed Rulemaking and Notice of Public Hearing

Guidance Regarding Claims for Income Tax Convention Benefits

REG–104893–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In T.D. 8722, page 81, the IRS is issuing temporary regulations regarding rules for determining whether U.S. source payments made to entities, including entities that are fiscally transparent in the United States and/or the applicable treaty jurisdiction, are eligible for treaty-reduced tax rates. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulaitons.

DATES: Comments and outlines of topics to be discussed at the public hearing scheduled for September 24, 1997, at 10 a.m. must be received by September 3, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–104893–97), room 5228, 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:DOM:CORP:R (REG–104893–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the Commissiner's Conference Room, room 3313, Internal Revenue Building, 1111 Constitutin Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

T.D. 8722 amends the Income Tax Regulations (26 CFR part 1) relating to section 894. The temporary regulaitons contain rules income tax conventions for payments to flow-through entities or arrangements.

The text of T.D. 8722 also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that the notice of proposed rulemaking is not a signifi-

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

Par. 2. Section 301.7623–1 is revised to read as follows:

§301.7623–1 Rewards for information relating to violations of internal revenue laws.

[The text of this proposed revised section is the same as the text of §301.7623–1T published in T.D. 8737.]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 10, 1997, 8:45 a.m., and published in the Federal Register for October 14, 1997, 62 F.R. 53274.)

Notice of Proposed Rulemaking and Notice of Public Hearing

IRS Adoption Taxpayer Identification Numbers

REG–103330–97

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In T.D. 8739, page 251, the IRS is issuing temporary regulations under section 6109 relating to taxpayer identifying numbers. The temporary regulations provide rules for obtaining and using IRS adoption taxpayer identification numbers. The temporary regulations assist individuals who are in the process of adopting children and wish to claim certain tax benefits with respect to these children. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by February 23, 1998. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for March 4, 1998, at 10:00 a.m., must be received by February 11, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–103330–97), room 5228, 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:DOM:CORP:R (REG–103330–97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC.

Taxpayers may also submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in Room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by February 23, 1998. Comments are specifically requested concerning:

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

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

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

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

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

The collection of information in this proposed regulation is in §301.6109–3T(c). This information is required by the IRS to assign IRS adoption taxpayer identification numbers (ATINs) to children who are in the process of being adopted. Unless an ATIN is assigned to a prospective adoptive child, the prospective adoptive parent cannot claim a dependency exemption for the child under section 151, a dependent care credit for the child under section 21, or, for taxable years beginning after December 31, 1997, a child tax credit under section 24. The collection of information in §301.6109–3T is thus required to obtain a benefit. The likely respondents are individuals.

The collection of information in §301.6109–3T is satisfied by including the required information on Form W–7A or other form as may be prescribed by the IRS to apply for an ATIN. The burden for this requirement is reflected in the burden estimate for Form W–7A.

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

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

Background

Temporary regulations in T.D. 8739 amend the Regulations on Procedure and Administration (26 CFR part 301) relating to section 6109. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been de-

SUMMARY: In T.D. 8737, page 273, the IRS is issuing temporary regulations relating to rewards for information that relates to violations of the internal revenue laws. The text of the temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments and requests for a public hearing must be received by January 16, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:T:R (REG–252936–96), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (REG–252936–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at:http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collections of information should be received by December 15, 1997. Comments are specifically requested concerning: Whether the proposed collections of information are necessary for the proper performance of the functions of the **Internal Revenue Service,** including whether the information will have practical utility; the accuracy of the estimated burden associated with the proposed collections of information (see below); how the quality, utility, and clarity of the information to be collected may be enhanced; how the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and estimates of capital or start-up costs and costs of operation, maintenance, and purchase of service to provide information.

The collections of information in this proposed regulation are in §§301.7623–1T(b)(3), 301.7623–1T(d), and 301.7623–1T(f). The collections of information are required to provide information relating to violations of the internal revenue laws, and to identify the proper claimant of a reward. The collection of information is voluntary with respect to the provision of information relating to violations of the internal revenue laws. The collections of information are required to obtain a benefit with respect to filing a claim for reward. The likely respondents are individuals, although non-individual claimants are also allowed.

Estimated total annual reporting burden: 30,000 hours.

Estimated average annual burden hours per respondent: 3 hours.

Estimated number of respondents: 10,000.

Estimated annual frequency of responses: on occasion.

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

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

Background

Temporary regulations in T.D. 8737 amend the Procedure and Administration Regulations (26 CFR part 301) relating to section 7623. The temporary regulations contain rules relating to rewards for information that relates to violations of the internal revenue laws. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

It is hereby certified that the regulations in this document will not have a significant economic impact on a substantial number of small entities. This certification is based on a determination that in the past approximately 10,000 persons have filed claims for reward on an annual basis. Of these persons, almost all have been individuals. Accordingly, a regulatory flexibility analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comments on its impact on small businesses.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing may be scheduled if requested in writing by any person who timely submits written or electronic comments. If a public hearing is scheduled, notice of the date, time, and place for the hearing will be published in the Federal Register.

* * * * *

Proposed Amendments to the Regulations

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

PART 301—PROCEDURE AND ADMINISTRATION

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

located entirely to U.S. Co.'s business activity. Forty-seven dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($80) plus possessions sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The remaining $53 is sourced in the United States.

Example 2. (i) Assume the same facts as in *Example 1*, except that A manufactures X outside the possession.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income is allocated entirely to U.S. Co.'s business activity. Five dollars of U.S. Co.'s gross income is sourced in the possession. [Possession expenses ($10) plus possession purchases ($0) plus possession sales ($0), divided by total expenses ($10) plus total purchases ($80) plus total sales ($100).] The $80 purchase is not included in the numerator used to determine U.S. Co.'s business activity in the possession, since product X was not manufactured in the possession. The remaining $95 is sourced in the United States.

(4) *Determination of source of taxable income.* Once the source of gross income has been determined under paragraph (f)(2) or (3) of this section, the taxpayer must properly allocate and apportion separately under §§1.861–8 through 1.861–14T the amounts of its expenses, losses, and other deductions to its respective amounts of gross income from Section 863 Possession Sales determined separately under each method described in paragraph (f)(2) or (3) of this section. In addition, if the taxpayer deducts expenses for research and development under section 174 that may be attributed to its Section 863 Possession Sales under §1.861–8(e)(3), the taxpayer must separately allocate or apportion expenses, losses, and other deductions to its respective amounts of gross income from each relevant product category that the taxpayer uses in applying the rules of §1.861–8(e)(3)(i)(A). In the case of gross income from Section 863 Possession Sales determined under the IFP method or books and records method, a taxpayer must apply the rules of §§1.861–8 through 1.861–14T to properly allocate or apportion amounts of expenses, losses and other deductions, allocated and apportioned to such gross income, between gross income from sources within and without the United States. In the case of gross income from Possession Production Sales determined under the possessions 50/50 method or gross income from Possession Purchase Sales computed under the business activity method, the amounts of expenses, losses, and other deductions allocated and apportioned to such gross income must be apportioned between sources within and without the United States pro rata based on the relative amounts of gross income from sources within and without the United States determined under those methods.

(5) *Special rules for partnerships.* In applying the rules of this paragraph (f) to transactions involving partners and partnerships, the rules of paragraph (g) of this section apply.

(6) *Election and reporting rules*—(i) *Elections under paragraph (f)(2) or (3) of this section.* If a taxpayer does not elect one of the methods specified in paragraph (f)(2) or (3) of this section, the taxpayer must apply the possession 50/50 method in the case of Possession Production Sales or the business activity method in the case of Possession Purchase Sales. The taxpayer may elect to apply a method specified in either paragraph (f)(2) or (3) of this section by using the method on a timely filed original return (including extensions). Once a method has been used, that method must be used in later taxable years unless the Commissioner consents to a change. Permission to change methods from one year to another year will be granted unless the change would result in a substantial distortion of the source of the taxpayer's income.

(ii) *Disclosure on tax return.* A taxpayer who uses one of the methods described in paragraph (f)(2) or (3) of this section must fully explain in a statement attached to the tax return the methodology used, the circumstances justifying use of that methodology, the extent that sales are aggregated, and the amount of income so allocated.

* * * * *

(h) *Effective dates.* * * * However, the rules of paragraph (f) of this section apply to taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

Par. 3. In §1.936-6, paragraph (a)(5) Q&A 7a is added to read as follows:

§1.936-6 Intangible property income when an election out is made: Cost sharing and profit split options; covered intangibles.

* * * * *

(a) * * *

(5) * * *

Q.7a: What is the source of the taxpayer's gross income derived from a sale in the United States of a possession product purchased by the taxpayer (or an affiliate) from a corporation that has an election in effect under section 936, if the income from such sale is taken into account to determine benefits under cost sharing for the section 936 corporation? Is the result different if the taxpayer (or an affiliate) derives gross income from a sale in the United States of an integrated product incorporating a possession product purchased by the taxpayer (or an affiliate) from the section 936 corporation, if the taxpayer (or an affiliate) processes the possession product or an excluded component in the United States?

A.7a: Under either scenario, the income is U.S. source, without regard to whether the possession product is a component, end-product, or integrated product. Section 863 does not apply in determining the source of the taxpayer's income. This Q&A 7a is applicable for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on October 9, 1997, 8:45 a.m., and published in the issue of the Federal Register for October 10, 1997, 62 F.R. 52953)

Notice of Proposed Rulemaking

Rewards for Information Relating to Violations of Internal Revenue Laws

REG–252936–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations.

(A) *Possession 50/50 method.* Under the possession 50/50 method, gross income from Possession Production Sales is allocated between production activity and business sales activity as described in this paragraph (f)(2)(i)(A). Under the possession 50/50 method, one-half of the taxpayer's gross income will be considered income attributable to production activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(A) of this section. The remaining one-half of such gross income will be considered income attributable to business sales activity and the source of that income will be determined under the rules of paragraph (f)(2)(ii)(B) of this section.

(B) *IFP method.* In lieu of the possession 50/50 method, a taxpayer may elect the independent factory price (IFP) method. Under the IFP method, gross income from Possession Production Sales is allocated to production activity or sales activity using the IFP method, as described in paragraph (b)(2) of this section, if an IFP is fairly established under the rules of paragraph (b)(2) of this section. See paragraphs (f)(2)(ii)(A) and (C) of this section for rules for determining the source of gross income attributable to production activity and sales activity.

(C) *Books and Records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, if it has received in advance the permission of the District Director having audit responsibility over its return. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from production, business sales, and sales activity*—(A) *Gross income attributable to production activity.* The source of gross income from production activity is determined under the rules of paragraph (c)(1) of this section, except that the term possession is substituted for foreign country wherever it appears.

(B) *Gross income attributable to business sales activity*—(*1*) *Source of gross income.* Gross income from the taxpayer's business sales activity is sourced in the possession in the same proportion that the amount of the taxpayer's business sales activity for the taxable year within the possession bears to the amount of the taxpayer's business sales activity for the taxable year both within the possession and outside the possession, with respect to Possession Production Sales. The remaining income is sourced in the United States.

(2) *Business sales activity.* For purposes of this paragraph (f)(2)(ii)(B), the taxpayer's business sales activity is equal to the sum of—

(*i*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Production Sales (other than amounts that are nondeductible under section 263A, interest, and research and development); and

(*ii*) Possession Production Sales for the taxable period.

(*3*) *Location of business sales activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*i*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*ii*) *Expenses.* Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(C) *Gross income attributable to sales activity.* The source of the taxpayer's income that is attributable to sales activity, as determined under the IFP method or the books and records method, will be determined under the provisions of paragraph (c)(2) of this section.

(3) *Allocation or apportionment for Possession Purchase Sales*—(i) *Methods for determining the source of gross income for Possession Purchase Sales*—(A) *Business activity method.* Gross income from Possession Purchase Sales is allocated in its entirety to the taxpayer's business activity, and is then apportioned between U.S. and possession sources under paragraph (f)(3)(ii) of this section.

(B) *Books and records method.* A taxpayer may elect to allocate gross income using the books and records method described in paragraph (b)(3) of this section, subject to the conditions set forth in paragraph (b)(3) of this section. See paragraph (f)(2)(ii) of this section for rules for determining the source of gross income.

(ii) *Determination of source of gross income from business activity*—(A) *Source of gross income.* Gross income from the taxpayer's business activity is sourced in the possession in the same proportion that the amount of the taxpayer's business activity for the taxable year within the possession bears to the amount of the taxpayer's business activity for the taxable year both within the possession and outside the possession, with respect to Possession Purchase Sales. The remaining income is sourced in the United States.

(B) *Business activity.* For purposes of this paragraph (f)(3)(ii), the taxpayer's business activity is equal to the sum of—

(*1*) The amounts for the taxable period paid for wages, salaries, and other compensation of employees, and other expenses attributable to Possession Purchase Sales (other than amounts that are nondeductible under section 263A, interest, and research and development);

(*2*) Cost of goods sold attributable to Possession Purchase Sales during the taxable period; and

(*3*) Possession Purchase Sales for the taxable period.

(C) *Location of business activity.* For purposes of determining the location of the taxpayer's business activity within a possession, the following rules apply:

(*1*) *Sales.* Receipts from gross sales will be attributed to a possession under the provisions of paragraph (c)(2) of this section.

(*2*) *Cost of goods sold.* Payments for cost of goods sold will be properly attributable to gross receipts from sources within the possession only to the extent that the property purchased was manufactured, produced, grown, or extracted in the possession (within the meaning of section 954(d)(1)(A)).

(*3*) *Expenses.* Expenses will be attributed to a possession under the rules of §§1.861–8 through 1.861–14T.

(iii) *Examples.* The following examples illustrate the rules of paragraph (f)(3)(ii) relating to the determination of source of gross income from business activity:

Example 1. (i) U.S. Co. purchases in a possession product X for $80 from A. A manufactures X in the possession. Without further production, U.S. Co. sells X in the United States for $100. Assume U.S. Co. has sales and administrative expenses in the possession of $10.

(ii) To determine the source of U.S. Co.'s gross income, the $100 gross income from sales of X is al-

posed effective date concerning the treatment of transactions involving sales of property purchased from a section 936 corporation entered into before the regulations are applicable.

Proposed Effective Dates

These regulations are proposed to be effective for taxable years beginning on or after the date that is 30 days after the date of publication of final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It is hereby certified that these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the rules of this section principally impact large multinationals who pay foreign taxes on substantial foreign operations and therefore the rules will impact very few small entities. Moreover, in those few instances where the rules of this section impact small entities, the economic impact on such entities is not likely to be significant. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely (in the manner described under the ADDRESSES caption) to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 29, 1998, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit comments and an outline of topics to be discussed and the time to be devoted to each topic (in the manner described under the ADDRESSES caption of this preamble) by January 8, 1998.

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.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entry for "Section 1.863-3", removing the entry for "Sections 1.936-4 through 1.936-7" and adding entries in numerical order to read as follows:

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

Section 1.863-3 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).***

Section 1.936-4 also issued under 26 U.S.C. 936(h).

Section 1.936-5 also issued under 26 U.S.C. 936(h).

Section 1.936-6 also issued under 26 U.S.C. 863(a) and (b), and 26 U.S.C. 936(h).

Section 1.936-7 also issued under 26 U.S.C. 936(h).***

Par. 2 Section 1.863-3 is amended as follows:

1. Paragraph (f) is revised.

2. Paragraph (h) is amended by adding a sentence at the end of the paragraph.

The revision and addition read as follows:

§1.863-3 Allocation and apportionment of income from certain sales of inventory.

* * * * *

(f) *Income partly from sources within a possession of the United States*—(1) *In general.* This paragraph (f) relates to gains, profits, and income, which are treated as derived partly from sources within the United States and partly from sources within a possession of the United States (Section 863 Possession Sales). This paragraph (f) applies to determine the source of income derived from the sale of inventory produced (in whole or in part) by the taxpayer within the United States and sold within a possession, or produced (in whole or in part) by a taxpayer in a possession and sold within the United States (Possession Production Sales). It also applies to determine the source of income derived from the purchase of personal property within a possession of the United States and its sale within the United States (Possession Purchase Sales). A taxpayer subject to this paragraph (f) must divide gross income from Section 863 Possession Sales using one of the methods described in either paragraph (f)(2)(i) of this section (in the case of Possession Production Sales) or paragraph (f)(3)(i) of this section (in the case of Possession Purchase Sales). Once a taxpayer has elected a method, the taxpayer must separately apply that method to the applicable category of Section 863 Possession Sales in the United States and to those in a possession. The source of gross income from each type of activity must then be determined under either paragraph (f)(2)(ii) or (3)(ii) of this section, as appropriate. The source of taxable income from Section 863 Possession Sales is determined under paragraph (f)(4) of this section. The taxpayer must apply the rules for computing gross and taxable income by aggregating all Section 863 Possession Sales to which a method in this section applies after separately applying that method to Section 863 Possession Sales in the United States and to Section 863 Possession Sales in a possession. This section does not apply to determine the source of a taxpayer's gross income derived from a sale of inventory purchased from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936 for the section 936 corporation. For rules to be applied to determine the source of such income, see §1.936-6(a)(5) Q&A 7a and (b)(1) Q&A 13.

(2) *Allocation or apportionment for Possession Production Sales*—(i) *Methods for determining the source of gross income for Possession Production Sales*—

possession. Treasury and the Internal Revenue Service anticipate that if a taxpayer acts in the reasonable belief that the products were manufactured in the possession, the taxpayer could act on that basis in preparing its tax return. As modified, the business activity fraction reflects the view of Treasury and the Internal Revenue Service that section 863(b)(3)'s purchase rule was intended to apply only to purchase and resale transactions, where the goods purchased are created or derived from the possession.

ii. Books and records method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to revised §1.863–3(b)(3) in applying the method to Possession Purchase Sales.

2. Determination of source of gross income

Unlike the current regulations which provide specific rules for determining the source of income attributable to production activity and business activity only for purposes of the 50/50 method, the proposed regulations adopt rules applicable to each of the methods. Under the proposed regulations, once gross income attributable to production activity, business activity, or sales activity has been determined under one of the prescribed methods, the source of the gross income is determined separately for each type of income. The source of gross income attributable to production activity (when applying the possession 50/50 method) is determined under paragraph (c)(1), based on the location of production assets. The source of gross income attributable to sales activity (when applying the IFP method or the books and records method) is determined under paragraph (c)(2), based generally on the location of the sale. The source of gross income attributable to business sales activity (when applying the possession 50/50 method) is determined under paragraph (f)(2)(ii)(B), based on expenses, and gross sales attributable to Possession Production Sales. The source of gross income attributable to business activity (when applying the business activity method) is determined under paragraph (f)(3)(ii), based on expenses, cost of goods sold, and gross sales attributable to Possession Purchase Sales.

3. Determination of source of taxable income

Once the source of gross income is determined under paragraph (f)(2) or (3), taxpayers then determine the source of taxable income. Under proposed paragraph (f)(4), taxpayers must allocate or apportion under §§1.861–8 through 1.861–14T the amounts of expenses, losses and other deductions to gross income determined under each of the prescribed methods. In the case of amounts of expenses, losses and other deductions allocated or apportioned to gross income determined under the IFP method or the books and records method, the taxpayer must apply the rules of §§1.861–8 through 1.861–14T to allocate or apportion these amounts between gross income from sources within the United States and within a possession. For expenses, losses and other deductions allocated or apportioned to gross income determined under the possessions 50/50 method, taxpayers must apportion expenses and other deductions pro rata based on the relative amounts of U.S. and possession source gross income. The research and experimental (R&E) expense allocation rules in §1.861–17 apply to taxpayers using the 50/50 method, so that the R&E set aside (described in §1.861–17) remains available to such taxpayers.

4. Treatment of gross income derived from certain purchases from a corporation that has an election in effect under section 936

The proposed regulations clarify that section 863 does not apply to determine the source of a taxpayer's gross income derived from a purchase of inventory from a corporation that has an election in effect under section 936, if the taxpayer's income from sales of that inventory is taken into account to determine benefits under section 936(h)(5)(C) for the section 936 corporation.

5. Treatment of partners and partnerships

The proposed regulations rely on the rules in §1.863–3(g) for determining the appropriate treatment in transactions involving partnerships. Under those rules, the aggregate approach applies to a partnership's production and sales activity for two purposes only. First, the aggregate approach applies in determining the character of a partner's distributive share of partnership income. Second, the aggregate approach applies in sourcing income from sales of inventory property that is transferred in-kind from or to a partnership.

6. Election and reporting rules

Under paragraph (f)(6)(i) of the proposed regulations, a taxpayer must use the 50/50 method to determine the source of income from Possession Production Sales unless the taxpayer elects to use the IFP method, or elects the books and records method. For Possession Purchase Sales, a taxpayer must use the business activity method, unless the taxpayer elects the books and records method. The taxpayer makes an election by using the method on its timely filed original tax return. That method must be used in later taxable years unless the Commissioner or his delegate consents to a change. Permission to change methods in later years will not be withheld unless the change would result in a substantial distortion of the source of income.

A taxpayer must fully explain the methodology used in applying either paragraph (f)(2) or (3), and the amount of income allocated or apportioned to U.S. and foreign sources, in a statement attached to its tax return.

II. *Income Derived From Certain Purchases From a Corporation That Has an Election in Effect Under Section 936*

These proposed regulations clarify that where a taxpayer purchases a product from a corporation that has an election in effect under section 936, the source of the taxpayer's gross income derived from sales of that product (in whatever form sold) in the United States is U.S. source, if the taxpayer's income from sales of that product is taken into account to determine benefits under section 936(h)(5)(C)(i) for the section 936 corporation. The taxpayer's income is U.S. source without regard to whether a possession product is a component, end-product form, or integrated product. No inference should be drawn from the pro-

more consistent with the other regulations governing the source of income from cross-border sales of inventory, and to address certain ambiguities and problems in the existing regulations.

C. Proposed Regulations

Section 1.863-3(f) generally retains the methods of the current regulations for dividing income between the United States and a possession of the United States, with several modifications.

1. Methods to allocate gross income to activities of the taxpayer

a. Property produced and sold

i. The possession 50/50 method

Consistent with the final regulations under §1.863–3, paragraph (f)(2)(i)(A) of the proposed regulations makes the 50/50 method the general rule to allocate gross income from Possession Production Sales between production and business sales activity, so that the income from each type of activity can then be apportioned between U. S. and foreign sources. The taxpayer, however, may elect to apply the IFP method (described in paragraph (f)(2)(i)(B)), or, with the consent of the District Director, the books and records method (described in paragraph (f)(2)(i)(C)).

Under the possession 50/50 method, the proposed regulations allocate half of the taxpayer's gross income from Possession Production Sales to production activity and half to business sales activity. The income is then apportioned between U.S. and possession sources based on a property fraction and a business sales activity fraction. As described below, the proposed regulations make certain changes to the existing property fraction and to the existing business activity fraction.

The proposed regulations apply the property fraction in §1.863–3(c) to apportion the half of a taxpayer's income allocated to production activity. Thus, income is apportioned to the United States or to a possession based on the location of the taxpayer's production assets. In a change from the current regulations, and consistent with the changes made to the regulations under §1.863–3(c), production assets are defined as tangible and intangible assets owned directly by the taxpayer that are directly used by the taxpayer to produce inventory sold in Possession Production Sales, instead of all its assets that produce income from Possession Production Sales. Production assets are included in the fraction at their adjusted tax basis.

The other half of the taxpayer's gross income is apportioned according to a business sales activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business sales activity of the taxpayer in the possession, and the denominator being the business sales activity of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States. Although some of the business sales activity factors not incurred in a possession may be incurred in a foreign country, Treasury and the Internal Revenue Service believe that the business sales activity fraction is only intended to source the business sales activity portion of Possession Production Sales outside the United States to the extent of business sales activity located in a possession.

The proposed regulations make some modifications to the factors in the fraction representing the business sales activity of the taxpayer. Business sales activity is measured by the sum of certain expenses, including amounts paid for labor, materials, advertising, and marketing (but excluding any expenses or other amounts that are nondeductible under section 263A, interest, and research and development), plus receipts for the sale of goods. This formula is intended to reflect better the business sales activity producing the income by including more of the factors responsible for producing that income. Cost of goods sold is also excluded from the business sales activity fraction apportioning income from Possession Production Sales, because such costs generally reflect production activity. Production activity is already represented in the formula by the one-half of the taxpayer's income apportioned according to the location of production assets.

Finally, the proposed regulations provide more explicit guidance for attributing business sales activity between the United States and a possession. Expenses are allocated and apportioned between the United States and a possession based on the rules in §§1.861–8 through 1.861–14T. Gross sales are allocated to the United States or a possession based on the place of sale.

ii. The IFP method

The proposed regulations make the IFP method elective, and thus eliminate any bias against taxpayers choosing to export through independent distributors. The regulations rely upon the revised regulations under §1.863–3 for rules in applying the IFP method.

iii. Books and records method

The proposed regulations retain the books and records method of the existing regulations, permitting taxpayers to request permission from the District Director to use their books and records to determine the source of their income. The proposed regulations refer to revised §1.863–3(b)(3) in applying the method to Possession Production Sales.

b. Property purchased and sold

i. The business activity method

Paragraph (f)(3)(i)(A) makes the business activity method the general rule to apportion income from Possession Purchase Sales between the United States and a possession. The taxpayer may, however, elect to apply, with consent of the District Director, the books and records method.

The proposed regulations retain the structure of the existing regulations by apportioning the taxpayer's income from Possession Purchase Sales on the basis of a business activity fraction. The portion of this income that is possession source income is determined by multiplying the income by a fraction, the numerator being the business of the taxpayer in the possession, and the denominator being the business of the taxpayer within the possession and outside the possession. The remaining income is sourced in the United States.

The business activity fraction is similar to that discussed previously, used to apportion the taxpayer's income in Possession Production Sales, except that the fraction applies only to expenses, cost of goods sold, and sales attributable to Possession Purchase Sales. In addition, the business activity fraction apportioning Possession Purchase Sales includes amounts paid for cost of goods sold. Such costs are attributed to the possession, however, only to the extent the property purchased is manufactured, produced, grown, or extracted in the

must apply the rules of §1.863–3A(c) in allocating and apportioning income derived from sources partly within the United States and partly within a possession of the United States. These proposed regulations would modify the existing rules for allocating and apportioning income between the United States and a possession.

1. Property produced and sold

Currently, income derived from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States (Possession Production Sales), is allocated or apportioned between the United States and a possession according to one of three methods. Such income is allocated under the independent factory price method, apportioned under an apportionment method, or, with permission of the District Director, allocated or apportioned on the basis of the taxpayer's books and records.

Under the current regulations, if an independent factory or production price (IFP) exists for Possession Production Sales, taxpayers must use the IFP method to determine the income attributable to production activities in both the sale establishing the IFP and in sales of similar products.

If an IFP does not exist, the current possessions regulations provide that the taxable income from Possession Production Sales is first computed and then apportioned between the United States and the possession. One-half of the taxable income is apportioned on the basis of the taxpayer's property within the United States and within the possession. In applying the property fraction, the taxpayer's property includes property held or used to produce income derived from Possession Production Sales. The other half of the taxpayer's taxable income is apportioned between U.S. and possession sources on the basis of the business of the taxpayer within the United States and within the possession. Currently, business of the taxpayer is measured by the sum of certain expenses, including amounts paid for labor, and the purchase of certain supplies, plus receipts from Possession Production Sales. Finally, as a third method, the existing regulations allow a taxpayer to request permission from the District Director to use the taxpayer's books and records to allocate or apportion income to sources within or without the United States if those books reflect more clearly than the other methods the taxable income derived from sources within the United States.

2. Property purchased and sold

The second type of possession transaction governed by the existing regulations is the sale of inventory purchased in a possession and sold in the United States (Possession Purchase Sales) as described in section 863(b)(3). Under the current regulations, the income from such sales is divided between the United States and possession sources under one of two methods. The income can be apportioned, or, with permission of the District Director, allocated or apportioned on the basis of the taxpayer's books and records.

Under the apportionment method, taxable income is first determined, and then apportioned by a fraction, the numerator being the business of the taxpayer in the United States, the denominator being the total business of the taxpayer in the United States and in the possession. The fraction is computed in the same manner as the business fraction discussed previously, except that such expenses, purchases, and sales are limited to those attributable to Possession Purchase Sales.

B. Issues Under Current Regulations

The IRS and Treasury believe the rules for allocating and apportioning income between the United States and the possessions of the United States should be amended to reflect certain changes made to the regulations under §1.863–3 governing cross-border sales of inventory involving the United States and a foreign country (other than those involving possessions). Thus, for example, under the apportionment method provided in the proposed regulations, the property and business activity fractions apportioning income between the United States and a possession are modified to apportion gross income attributable to an activity, rather than to apportion net income.

The IRS and Treasury also believe certain ambiguities exist in the current regulations. The possessions rules were originally promulgated in 1926, and may not reflect current business practices. The current regulations use examples to illustrate methods for allocating or apportioning income between the United States and a possession, and should be modified to state rules.

Further, although the apportionment method for allocating Possession Production Sales income under the existing possessions regulations treats half of the income as production income, the production formula is not necessarily limited to production assets. The current inclusion of sales assets in the formula apportioning production income results in excessive income being allocated to sales activities. The production income formula should only take into account assets directly involved in production of inventory. In addition, the IRS and Treasury have reexamined the business activity fraction, and have concluded it should be revised to more clearly reflect the taxpayer's business other than production. The current fraction, for example, omits certain investments or expenses, such as marketing and advertising expenses, although income attributable in part to such expenses or investments is then included in the income apportioned by the fraction. The current regulations also take into account production expenses in the business activity fraction apportioning income from Possession Production Sales. The Service and Treasury believe that this is inappropriate in the context of Possession Production Sales because the business activity fraction is not intended to determine the source of income attributable to production activity. In the proposed regulations, the fraction apportioning Possession Production Sales is renamed the business sales activity fraction and excludes factors reflecting production activity.

The current regulations also do not address issues in attributing to the United States or to the possession, the activities reflected in the business activity fraction. For example, the current regulations provide no guidance on whether a particular expense should be represented in the fraction as attributable to the United States or to a possession.

Accordingly, the IRS and Treasury are issuing proposed regulations under section 863 to make the possessions rules

inventory in a possession and sell in the United States, as well as persons who purchase inventory in a possession and sell in the United States. This document also contains proposed regulations under section 936 governing the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. This document also provides notice of a public hearing on these proposed regulations.

DATES: Comments and outlines of oral comments to be presented at the public hearing scheduled for January 29, 1998, at 10 a.m. must be received by January 8, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (INTL–0003–95), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–251985–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC, or electronically, via the IRS Internet site at: http://www.irs ustreas.gov/prod/tax_regs/comments.html .The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget (OMB) for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)).

Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collection of information should be received by December 9, 1998. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

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

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

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

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

The collection of information requirements are in proposed §1.863–3(f)(6). This information is required by the IRS to monitor compliance with the federal tax rules for determining the source of income from the sale of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States, or from the sale of inventory purchased in a possession of the United States and sold in the United States. The likely respondents are taxpayers who produce inventory in the United States and sell in a possession, or who produce inventory in a possession and sell in the United States, or who purchase inventory in a possession and sell in the United States. Responses to this collection of information are required to properly determine the source of a taxpayer's income from such sales.

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.

Estimated total annual reporting burden: 500 hours. The estimated annual burden per respondent varies from 1 hour to 5 hours, depending on individual circumstances, with an estimated average of 2.5 hours.

Estimated number of respondents: 200

Estimated annual frequency of responses: One time per year.

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

Background

These proposed regulations contain rules under section 863 relating to the source of income from cross-border sales of certain property. These regulations also contain rules under section 936 relating to the source of income of a taxpayer from the sale in the United States of property purchased from a corporation that has an election under section 936 in effect. These regulations are proposed to be effective for taxable years beginning 30 days after publication of final regulations.

Explanation of Provisions

I. *Income Partly From Sources Within a Possession*

A. Current Regulations

Section 863 authorizes the Secretary to promulgate regulations allocating or apportioning to sources within or without the United States all items of gross income, expenses, losses, and deductions other than those items specified in sections 861(a) and 862(a).

Guidance to determine the source of possession income is divided into two types of transactions: transactions described in section 863(b)(2) for property produced in the United States and sold in a possession (or vice versa), and transactions described in section 863(b)(3) for property purchased in a possession and sold in the United States (collectively, Section 863 Possession Sales).

Section 1.863–3 of the income tax regulations contains rules for determining the source of income derived from sales of certain property. These regulations were published in the **Federal Register** on November 29, 1996 (61 F.R. 60540), and the prior regulations were renumbered §§1.863–3A and 1.863–3AT. The new regulations retain the prior rules for Section 863 Possession Sales by providing in paragraph §1.863–3(f) that taxpayers

tion's name, address, employer identification number, and the name, address and telephone number of the person to contact regarding the application, and describing in detail the facts and circumstances that the organization believes support a determination that the organization is subject to a harassment campaign. The organization may suspend compliance with respect to any request for a copy of its documents based on its reasonable belief that such request is part of a harassment campaign, provided that the organization files an application for a determination within 5 days from the day the organization first suspends compliance with respect to a request that is part of the alleged campaign. In addition, the organization may suspend compliance with any request it reasonably believes to be part of a harassment campaign until it receives a response to its application for a harassment campaign determination.

(e) *Effect of a harassment determination.* If the appropriate key district director determines that a tax-exempt organization is the subject of a harassment campaign, such organization is not required to comply with any request for copies that it reasonably believes is part of the campaign. This determination may be subject to other terms and conditions set forth by the key district director. A person (as defined in section 6652(c)-4)(C)) shall not be liable for any penalty under sections 6652(c)(1)(C), (D) or 6685 for failing to timely provide a copy of documents in response to a request covered in a request for a harassment determination if the organization fulfills the request within 30 days of receiving a determination from the key district director that the organization is not subject to a harassment campaign. Notwithstanding the preceding sentence, if the key district director further determines that the organization did not have a reasonable basis for requesting a determination that it was subject to a harassment campaign or reasonable belief that a request was part of the campaign, the person (as defined in section 6652(c)(4)(C)) remains liable for any penalties that result from not providing the copies in a timely fashion.

(f) *Examples.* The provisions of this section may be further illustrated by the following examples.

Example 1. V, a tax-exempt organization, receives an average of 25 requests per month for copies of its three most recent information returns. In the last week of May, V is mentioned in a national news magazine story that discusses information contained in V's 1996 information return. From June 1 through June 30, 1997 V receives 200 requests for a copy of its documents. Other than the sudden increase in the number of requests for copies, there is no other evidence to suggest that the requests are part of an organized campaign to disrupt V's operations. Although fulfilling the requests will place a burden on V, the facts and circumstances do not show that V is subject to a harassment campaign. Therefore, V must respond timely to each of the 200 requests it receives in June.

Example 2. Y is a tax-exempt organization that receives an average of 10 requests a month for copies of its annual information returns. From March 1, 1997 to March 31, 1997, Y receives 25 requests for copies of its documents. Fifteen of the requests come from individuals Y knows to be active members of the board of organization X. In the past X has opposed most of the positions and policies that Y advocates. None of the requesters have asked for copies of documents from Y during the past year. Y has no other information about the requesters. Although the facts and circumstances show that some of the individuals making requests are hostile to Y, they do not show that the individuals have organized a campaign that will place enough of a burden on Y to disrupt its activities. Therefore, Y must respond to each of the 25 requests it receives in March.

Example 3. The facts are the same as in *Example 2,* except that during March 1997, Y receives 100 requests. In addition to the fifteen requests from members of organization X's board, 75 of the requests are similarly worded form letters. Y discovers that several individuals associated with X have urged the X's members and supporters, via the Internet, to submit as many requests for a copy of Y's annual information returns as they can. The message circulated on the Internet provides a form letter that can be used to make the request. Both the appeal via the Internet and the requests for copies received by Y contain hostile language. During the same year but before the 100 requests were received, Y provided copies of its annual information returns to the headquarters of X. The facts and circumstances show that the 75 form letter requests are coordinated for the purpose of disrupting Y's operations, and not to collect information that has already been provided to an association representing the requesters' interests. Thus, the fact and circumstances show that Y is the subject of an organized harassment campaign. To confirm that it may disregard the 90 requests that constitute the harassment campaign, Y must apply to the district director for a determination. Y may disregard the 90 requests while the application is pending and after the determination is received. However, it must respond within the applicable time limits to the 10 requests it received in March that were not part of the harassment campaign.

Example 4. The facts are the same as in *Example 3,* except that Y receives 5 additional requests from representatives of the news media. In the past, some of these representatives have published articles criticizing Y. Some of these articles were hostile to Y. Normally, the Internal Revenue Service will not consider a tax-exempt organization to be reasonable under paragraph (d) of this section if it disregards requests from members of the news media. There are no additional facts that demonstrate that Y could reasonably believe the requests from the news media to be part of X's harassment campaign. Thus, although Y is the subject of a harassment campaign, it must respond within the applicable time limits to the 5 requests that it received from representatives of the news media.

(g) *Effective date.* This section is effective beginning 60 days after its publication as a final regulation in the Federal Register.

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on September 25, 1997, 8:45 a.m., and published in the issue of the Federal Register for September 26, 1997, 62 F.R. 50533)

Notice of Proposed Rulemaking and Notice of Public Hearing

Source of Income From Sales of Inventory Partly From Sources Within a Possession of the United States; Also, Source of Income Derived From Certain Purchases From a Corporation Electing Section 936

REG–251985–96

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 863 governing the source of income from sales of inventory produced in the United States and sold in a possession of the United States or produced in a possession of the United States and sold in the United States. It also contains proposed regulations under section 863 governing the source of income from sales of inventory purchased in a possession of the United States and sold in the United States. This document affects persons who produce (in whole or in part) inventory in the United States and sell in a possession, or produce (in whole or in part)

for enforcement action, the individual may provide a statement to the Director, Exempt Organizations Division, CP:E:EO, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, D.C. 20224 that describes the reason why the individual believes the denial was in violation of the requirements of section 6104(e).

(g) *Effective date.* This section is effective beginning 60 days after its publication as a final regulation in the **Federal Register.**

§301.6104(e)–2 Making applications and returns widely available.

(a) *In general.* A tax-exempt organization is not required to comply with a request for a copy of its application for tax exemption or an annual information return pursuant to §301.6104(e)–1(a) if the organization has made the requested application or return widely available in accordance with paragraph (b) of this section. An organization that makes its application or return widely available must nevertheless make the application or return available for public inspection as required under §301.6104(d)–1 or §301.6104(e)–1, as applicable.

(b) *Widely available*—(1) *In general.* A tax-exempt organization makes its application for tax exemption and/or an annual information return widely available if the organization uses a method specified in paragraph (b)(2) of this section or in a revenue procedure or other form of guidance issued by the Commissioner, and if the organization satisfies the requirements of paragraph (b)(3) of this section.

(2) *Internet posting.* A tax-exempt organization can make its application for tax exemption and/or an annual information return widely available by posting the application or return on a World Wide Web page that the tax-exempt organization establishes and maintains or by having the application or return posted, as part of a database of similar documents of other tax-exempt organizations, on a World Wide Web page established and maintained by another entity. In order for the application or return to be widely available through an Internet posting, the entity maintaining the World Wide Web page must have procedures for ensuring the reliability and accuracy of the application or return that it posts on the page and must take reasonable precautions to prevent alteration, destruction or accidental loss of the application or return posted on its page. Furthermore, the application or return will be considered widely available only if—

(i) it is posted in the same format used by the Internal Revenue Service to post forms and publications on the Internal Revenue Service World Wide Web page;

(ii) the World Wide Web page through which it is available clearly informs readers that the document is available and provides instructions for downloading it;

(iii) when downloaded and printed in hard copy, the application or return is in substantially the same form as the original application or return, and contains the same information provided in the original application or return filed with the Internal Revenue Service (except information withheld pursuant to §301.6104(e)–1(b)(4)(i)(the names and addresses of contributors listed on the annual information), Schedule A of Form 990–BL and information on the application for tax exemption required to be withheld under section 6104(a)(1)(D) and §301.6104(e)–1(b)(3)(trade secrets and similar information)); and

(iv) a person can access and download the application or return without payment of a fee to the organization maintaining the World Wide Web page.

(3) *Notice requirement.* If a tax-exempt organization has made its application for tax exemption and/or an annual information return otherwise widely available it must tell any individual requesting a copy where the documents are available (including the address on the World Wide Web, if applicable). If the request is made in person, the organization shall provide such notice to the individual immediately. If the request is made in writing, the notice shall be provided within 7 days of receiving the request.

(c) *Effective date.* This section is effective beginning 60 days after its publication as a final regulation in the **Federal Register.**

§301.6104(e)–3 Tax-exempt organization subject to harassment campaign.

(a) *In general.* If the key district director for the district where the organization's principal office is located determines that the organization is the subject of a harassment campaign and compliance with the requests that are part of the harassment campaign would not be in the public interest, a tax-exempt organization is not required to fulfill a request (as otherwise required by §301.6104(e)–1(a)) for a copy that it reasonably believes is part of the campaign.

(b) *Harassment.* A group of requests for an organization's application for tax exemption or annual information returns is indicative of a harassment campaign if the requests are part of a single coordinated effort to disrupt the operations of a tax-exempt organization rather than to collect information about the organization. Whether a group of requests constitutes a harassment campaign depends on the relevant facts and circumstances. Facts and circumstances that indicate the organization is the subject of a harassment campaign include: a sudden increase in the number of requests; an extraordinary number of requests made through form letters or similarly worded correspondence; evidence of a purpose to deter significantly the organization's employees or volunteers from pursuing the organization's exempt purpose; requests that contain language hostile to the organization; direct evidence of bad faith by organizers of the purported harassment campaign; evidence that the organization has already provided the requested documents to a member of the purported harassing group; and a demonstration by the tax-exempt organization that it routinely provides copies of its documents upon request.

(c) *Special rule for multiple requests from a single individual or address.* A tax-exempt organization may disregard any request for copies of all or part of any document beyond the first two received within any 30-day-period or the first four received within any one-year-period from the same individual or the same address, regardless of whether the key district director has determined that the organization is subject to a harassment campaign.

(d) *Harassment determination procedure.* A tax-exempt organization may apply for a determination that it is the subject of a harassment campaign by submitting a signed application to the key district director for the key district where the organization's principal office is located. The application shall consist of a written statement giving the organiza-

the postmark. Requests transmitted to the organization by electronic mail or facsimile shall be deemed received the day the request is transmitted successfully. Copies are deemed provided on the date of the postmark or private delivery mark (or if sent by certified or registered mail, the date of registration or the date of the postmark on the sender's receipt). If an individual making a request consents, a tax-exempt organization may provide a copy of the requested document exclusively by electronic mail. In such case, the material is provided on the date the organization successfully transmits the electronic mail.

(B) *Agents for providing copies.* A tax-exempt organization subject to the requirements of this section may retain an agent to process written requests for copies of its documents. The agent shall provide the copies within the time and under the conditions that apply to the organization itself. For example, if the organization received the request first (e.g. before the agent), the deadline for providing a copy in response to a request shall be determined in reference to when the organization received the request, not when the agent received the request. An organization that transfers a request for a copy to such an agent is not required to respond further to the request. However, if the organization's agent fails to provide the documents as required under section 6104(e), the penalty provisions of sections 6652(c)(1)(C), 6652(c)(1)(D), and 6685 continue to apply to the tax-exempt organization.

(3) *Request for a copy of parts of document.* A tax-exempt organization must fulfill a request for a copy of the organization's entire application for tax exemption or annual information return or any identifiable part, attachment or supporting paper of its application or return. A request for a copy of less than its entire application or less than its entire return must describe the information desired in sufficient detail to enable the organization to identify the desired part of the applicable document without placing an unreasonable burden upon the organization. For example, a request may be limited to those parts of an organization's annual information return that relates to the compensation of the organization's officers and managers.

(4) *Fees for copies*—(i) *In general.* A tax-exempt organization charges a reasonable fee for providing copies only if it charges no more than the per-page copying charge stated in §601.702(f)(5)(iv)(B) of this chapter (fee charged by the Internal Revenue Service for providing copies to a requester), plus no more than the actual postage costs incurred by the organization to provide the copies. An organization may require that an individual requesting copies of documents pay the fee before the documents are provided. If the organization has provided an individual making a request with notice of the fee, and the individual has not paid the fee within 30 days, or if the individual pays the fee by check and the check does not clear when deposited, the organization may disregard the request.

(ii) *Form of payment*—(A) *Request made in person.* If a tax-exempt organization charges a fee for copying as permitted under paragraph (d)(4)(i) of this section, it shall accept payment by cash and money order for requests made in person. The organization may accept other forms of payment, such as personal checks or credit cards.

(B) *Request made in writing.* If a tax-exempt organization charges a fee for copying and postage as permitted under paragraph (d)(4)(i) of this section, it shall accept payment by certified check, personal check and money order for requests made in writing. The organization may accept other forms of payment, such as credit cards.

(iii) *Avoidance of unexpected fees.* Where a tax-exempt organization does not require prepayment and a requester does not enclose prepayment with a request, an organization must receive consent from a requester before providing copies for which the fee charged for copying and postage under paragraph (d)(4)(i) of this section is in excess of $20.

(iv) *Responding to inquiries of fees charged.* In order to facilitate a requester's ability to receive copies promptly, a tax-exempt organization shall respond to any questions from potential requesters concerning its fees for copying and postage. For example, the organization shall inform the requester of its charge for copying and mailing its application for exemption and each annual information return, with and without attachments, so that a requester may include payment with the request for copies.

(e) *Rules relating to documents to be provided by regional and district offices, and local and subordinate organizations*—(1) *Documents to be provided by regional and district offices.* A regional or district office of a tax-exempt organization must satisfy the same rules as the principal office with respect to public inspection and providing copies of its application for tax exemption and annual information returns. However, a regional or district office is not required to make its annual information return available for inspection or for providing copies until 30 days after the date the return is required to be filed (including any extension of time that is granted for filing such return) or is actually filed, whichever is later.

(2) *Documents to be provided by local and subordinate organizations.* A local organization that does not file its own annual information return (because it is affiliated with a central organization that files a group return pursuant to §1.6033-2(d)) must make available the applicable annual information returns filed by the central organization. However, a local organization is not required to make its annual information return available for inspection or for providing copies until 30 days after the date the return is required to be filed (including any extension of time that is granted for filing such return) or is actually filed by the central organization, whichever is later. If a subordinate organization is covered by a group exemption letter, the application for tax exemption the subordinate organization must make available for public inspection and furnish in response to requests for copies is the application submitted to the Internal Revenue Service by its parent or supervisory organization to obtain the group exemption letter, as well as any additional documents submitted in order to cover the subordinate organization under the group exemption letter.

(f) *Failure to comply with public inspection or copying requirements.* If a tax-exempt organization denies an individual's request for inspection or a copy of an application for tax exemption or an annual information return as required under section 6104(e) and this section, and the individual wants to alert the Internal Revenue Service to the possible need

vate foundation. See §301.6104(d)–1 for requirements relating to public disclosure of private foundation annual returns.

(ii) *Returns more than 3 years old.* The term *annual information* return does not include any return after the expiration of 3 years from the date the return is required to be filed (including any extension of time that has been granted for filing such return) or is actually filed, whichever is later. If an organization has filed an amended return, however, the amended return must be made available for a period of 3 years beginning on the date it is filed with the Internal Revenue Service.

(5) *Regional or district offices*—(i) *In general.* A regional or district office is any office of a tax-exempt organization, other than its principal office, that has—

(A) 3 or more paid full-time employees; or

(B) Paid employees, whether part-time or full-time, whose aggregate number of paid hours a week are normally at least 120.

(ii) *Site not considered a regional or district office.* A site is not considered a regional or district office, however, if—

(A) The only services provided at the site further exempt purposes (such as day care, health care or scientific or medical research); and

(B) The site does not serve as an office for management staff, other than managers involved solely in managing the exempt function activities at the site.

(c) *Special rules relating to public inspection*—(1) *Permissible conditions on public inspection.* A tax-exempt organization may have an employee present in the room during an inspection. The organization, however, must allow the individual conducting the inspection to take notes freely during the inspection, and to photocopy the document at no charge, if the individual provides the photocopying equipment at the place of inspection.

(2) *Organizations that do not maintain permanent offices.* If a tax-exempt organization does not maintain a permanent office, the organization shall comply with the public inspection requirements of paragraph (a) of this section by making its application for tax exemption and its annual information returns, as applicable, available for inspection at a reasonable location of its choice. Such an organization shall permit public inspection within a reasonable amount of time after receiving a request for inspection (normally not more than 2 weeks) and at a reasonable time of day. At the organization's option, it may mail, within 2 weeks of receiving the request, a copy of its application for tax exemption and annual information returns to the requester in lieu of allowing an inspection. The organization may charge the requester for copying and actual postage costs only if the requester consents to the charge. An organization that has a permanent office, but has no office hours or has very limited hours during certain times of the year, shall make its documents available during those periods when office hours are limited or not available as though it were an organization without a permanent office.

(d) *Special rules relating to copies*—(1) *Time and place for providing copies in response to requests made in-person*—(i) *In general.* A tax-exempt organization shall provide copies of the documents it is required to provide under section 6104(e) in response to a request made in person at the time and place that it makes its documents available for inspection under paragraph (a) of this section. Except as provided in paragraph (d)(1)(ii) of this section, an organization shall provide such copies to a requester on the day the request is made.

(ii) *Unusual circumstances.* Where unusual circumstances exist such that fulfilling a request on the same business day places an unreasonable burden on the tax-exempt organization, the organization may provide the copies in response to a request made in person on the next business day following the day of the request. Unusual circumstances may include, but are not limited to, receipt of a volume of requests that exceeds the organization's daily capacity to make copies; requests received shortly before the end of regular business hours that require an extensive amount of copying; or requests received on a day when the organization's managerial staff is conducting special duties, such as student registration, rather than its regular administrative duties.

(iii) *Agents for providing copies.* A principal, regional or district office of a tax-exempt organization subject to the requirements of this section may retain a local agent, within reasonable proximity of the applicable office, to process in person requests for copies of its documents. An agent that receives a request for copies must provide the copies within the time and under the conditions that apply to the organization itself. For example, an agent must provide a copy to a requester on the day the agent receives the request. However, an office using such an agent that receives an in-person request for a copy must immediately provide the name, address and telephone number of the local agent to the requester. An organization that notifies an in-person requester of such an agent is not required to respond further to the requester. However, the penalty provisions of sections 6652(c)(1)-(C), 6652(c)(1)(D), and 6685 continue to apply to the tax-exempt organization if the organization's agent fails to provide the documents as required under section 6104(e).

(2) *Request for copies in writing*—(i) *In general.* A tax-exempt organization must honor a written request for a copy of documents that the organization is required to provide under section 6104(e) if the request—

(A) Is addressed to, and delivered by mail, electronic mail, facsimile, a private delivery service as defined in section 7502(f), or in person, to the principal, regional or district office of the organization; and

(B) Sets forth the address to which the copy of the documents should be sent.

(ii) *Time and manner of fulfilling written requests*—(A) *In general.* A tax-exempt organization receiving a written request for a copy shall mail the copy of the requested documents (or the requested parts of documents) within 30 days from the date it receives the request. If a tax-exempt organization requires payment in advance, it shall provide the copies within 30 days from the date it receives payment. If an organization requiring payment in advance receives a written request without payment or an insufficient payment, the organization must, within 7 days from the date it receives the request, notify the requester of its prepayment policy and the amount due. A request or payment that is mailed shall be deemed (in the absence of evidence to the contrary) to be received by an organization 7 days after the date of

fices, and local and subordinate organizations.

(1) Documents to be provided by regional and district offices.

(2) Documents to be provided by local and subordinate organizations.

(f) Failure to comply with public inspection or copying requirements.

(g) Effective date.

§301.6104(e)-2 Making applications and returns widely available.

(a) In general.

(b) Widely available.

(1) In general.

(2) Internet posting.

(3) Notice requirement.

(c) Effective date.

§301.6104(e)–3 Tax-exempt organization subject to harassment campaign.

(a) In general.

(b) Harassment.

(c) Special rule for multiple requests from a single individual or address.

(d) Harassment determination procedure.

(e) Effect of a harassment determination.

(f) Examples.

(g) Effective date.

§301.6104(e)–1 Public inspection and distribution of annual information returns of tax-exempt organizations (other than private foundations) and applications for tax exemption.

(a) *In general.* Except as otherwise provided in this section, a tax-exempt organization, including one that is a private foundation, shall make its application for tax exemption (as defined in paragraph (b)(3) of this section) available for public inspection without charge at its principal, regional and district offices during regular business hours. A tax-exempt organization, other than a private foundation, shall make its annual information returns (as defined in paragraph (b)(4) of this section) available for public inspection without charge in the same offices during regular business hours. Each annual information return shall be made available for a period of three years beginning on the date the return is required to be filed (determined with regard to any extension of time for filing) or is actually filed, whichever is later. In addition, except as provided in §301.6104(e)–2 and §301.6104(e)–3, an organization shall provide a copy without charge, other than a reasonable fee for reproduction and actual postage costs, of all or any part of any application or return required to be made available for public inspection under this paragraph to any individual who makes a request for such copy in person or in writing. See paragraph (d)(4) of this section for rules relating to fees for copies.

(b) *Definitions.* For purposes of section 6104(e) and the regulations thereunder, the following definitions apply:

(1) *Tax-exempt organization.* The term *tax-exempt organization* means any organization that is described in section 501(c) or section 501(d) and is exempt from taxation under section 501(a).

(2) *Private foundation.* The term private foundation means a private foundation as defined in section 509(a).

(3) *Application for tax exemption*—(i) *In general.* The term *application for tax exemption* includes any prescribed application form (such as Form 1023 or Form 1024), all documents and statements the Internal Revenue Service requires an applicant to file with the form, any statement or other supporting document submitted by an organization in support of its application, and any letter or other document issued by the Internal Revenue Service concerning the application (such as a favorable determination letter or a list of questions from the Internal Revenue Service about the application). For example, a legal brief supporting an application, or a response to questions from the Internal Revenue Service during the application process, is a supporting document.

(ii) *No prescribed application form.* If no form is prescribed for an organization's application for tax exemption, the application for tax exemption includes—

(A) The application letter and copy of the articles of incorporation, declaration of trust, or other similar instrument that sets forth the permitted powers or activities of the organization;

(B) The organization's bylaws or other code of regulations;

(C) The organization's latest financial statements, as of the date the application is submitted, showing assets, liabilities, receipts and disbursements;

(D) Statements describing the character of the organization, the purpose for which it was organized, and its actual activities;

(E) Statements showing the sources of the organization's income and receipts and their disposition; and

(F) Any other statements or documents the Internal Revenue Service required the organization to file with, or that the organization submitted in support of, the application letter.

(iii) *Exceptions.* The term *application for tax exemption* does not include—

(A) Any application for tax exemption filed by an organization that has not yet been recognized, on the basis of the application, by the Internal Revenue Service as exempt from taxation for any taxable year;

(B) Any application for tax exemption filed before July 15, 1987 unless the organization filing the application had a copy of the application on July 15, 1987; or

(C) Any material, including the material listed in §301.6104(a)–1(i) and information that the Secretary would be required to withhold from public inspection, that is not available for public inspection under section 6104.

(4) *Annual information return*—(i) *In general.* The term *annual information return* includes an exact copy of any return filed by a tax-exempt organization pursuant to section 6033. It also includes any amended return filed with the Internal Revenue Service after the date the original return is filed. The copy must include all information furnished to the Internal Revenue Service on Form 990, Return of Organization Exempt From Income Tax, or any version of Form 990 (such as Forms 990–EZ or 990–BL except Form 990–T) and Form 1065, as well as all schedules, attachments and supporting documents, except for the name or address of any contributor to the organization. For example, the annual information return includes Schedule A of Form 990 containing supplementary information on section 501(c)(3) organizations, and those parts of the return that show compensation paid to specific persons (Part VI of Form 990 and Parts I and II of Schedule A of Form 990). The term *annual information return* does not include Schedule A of Form 990–BL, Form 990–T, Exempt Organization Business Income Tax Return or Form 1120–POL, U.S. Income Tax Return For Certain Political Organizations. For purposes of this section and the regulations thereunder, an annual information return does not include the return of a pri-

Special Analyses

Pursuant to sections 603(a) and 605(b) of the Regulatory Flexibility Act, it is certified that the collection of information referenced in this notice of proposed rulemaking will not have a significant economic impact on a substantial number of small entities. Although a substantial number of small entities will be subject to the collection of information requirements in these regulations, the requirements will not have a significant economic impact on these entities. The average time required to maintain and disclose the information required under these regulations is estimated to be 30 minutes for each tax-exempt organization. This estimate is based on the assumption that, on average, a tax-exempt organization will receive one request per year to inspect or provide copies of its application for tax exemption and its annual information returns. Less than 0.001 percent of the tax-exempt organizations affected by these regulations will be subject to the reporting requirements contained in the regulations. It is estimated that annually, approximately 1,000 tax-exempt organizations will make its documents widely available by posting them on the Internet. In addition, it is estimated that annually, approximately 50 tax-exempt organizations will file an application for a determination that they are the subject of a harassment campaign such that a waiver of the obligation to provide copies of their applications for tax exemption and their annual information returns is in the public interest. The average time required to complete, assemble and file an application describing a harassment campaign is expected to be 5 hours. Because applications for a harassment campaign determination will be filed so infrequently, they will have no effect on the average time needed to comply with the requirements in these regulations. In addition, a tax-exempt organization is allowed in these regulations to charge a reasonable fee for providing copies to requesters. Therefore, it is estimated that on average it will cost tax-exempt organizations less than $10 per year to comply with these regulations, which is not a significant economic impact.

Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 4, 1998, beginning at 10 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Service Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time devoted to each topic (signed original and eight (8) copies) by December 26, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the schedule of 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.

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Proposed Amendments to the Regulations

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

PART 301—PROCEDURE AND ADMINISTRATION

Paragraph 1. The authority citation for 26 CFR part 301 is amended by adding entries in numerical order to read as follows:

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

Section 301.6104(e)–2 also issued under 26 U.S.C. 6104(e)(3);

Section 301.6104(e)–3 also issued under 26 U.S.C. 6104(e)(3); * * *

Par. 2. Sections 301.6104(e)–0, 301.6104(e)–1, 301.6104(e)–2, and 301.6104(e)–3 are added to read as follows:

§301.6104(e)–0 Table of contents.

This section lists captions contained in §§301.6104(e)–1, 301.6104(e)–2, and 301.6104(e)-3.

§301.6104(e)–1 Public inspection and distribution of annual information returns of tax-exempt organizations (other than private foundations) and applications for tax exemption.

(a) In general.
(b) Definitions.
(1) Tax-exempt organization.
(2) Private foundation.
(3) Application for tax exemption.
(i) In general.
(ii) No prescribed application form.
(iii) Exceptions.
(4) Annual information return.
(i) In general.
(ii) Returns more than 3 years old.
(5) Regional or district offices.
(i) In general.
(ii) Site not considered a regional or district office.
(c) Special rules relating to public inspection.
(1) Permissible conditions on public inspection.
(2) Organizations that do not maintain permanent offices.
(d) Special rules relating to copies.
(1) Time and place for providing copies in response to requests made in person.
(i) In general.
(ii) Unusual circumstances.
(iii) Agents for providing copies.
(2) Request for copies in writing.
(i) In general.
(ii) Time and manner of fulfilling written requests.
(A) In general.
(B) Agents for providing copies.
(3) Request for a copy of parts of document.
(4) Fees for copies.
(i) In general.
(ii) Form of payment.
(A) Request made in person.
(B) Request made in writing.
(iii) Avoidance of unexpected fees.
(iv) Responding to inquiries of fees charged.
(e) Rules relating to documents to be provided by regional and district of-

the proposed regulations provide that an office of an organization will be considered a regional or district office only if it has three or more paid full-time employees (or paid employees, whether part-time or full-time, whose aggregate number of paid hours per week is at least 120). The rules exclude certain sites where the organization's employees perform solely exempt function activities from being treated as a regional or district office. In addition, the proposed regulations prescribe how an organization that does not maintain a permanent office or whose office has very limited hours during certain times of the year can comply with the public inspection requirements. The proposed regulations also provide rules concerning the conditions the organization may impose on public inspections that are consistent with Notice 88–120.

Requirement to Furnish Copy to a Requester

The proposed regulations require that a tax-exempt organization accept requests for copies made in person at the same place and time that the information must be available for public inspection. They also generally require an organization to provide the copies on the day of the request. In unusual circumstances, an organization will be permitted to provide the requested copies on the next business day.

When a request is made in writing, the proposed regulations require that a tax-exempt organization furnish the copies within 30 days from the date it receives the request. If an organization, however, requires advance payment of a reasonable fee for copying and mailing, it may provide the copies within 30 days from the date it receives payment, rather than from the date of the initial request.

The proposed regulations provide guidance as to what constitutes a request, when a request is considered received, and when copies are considered provided. The proposed regulations provide that, instead of requesting a copy of an entire application for tax exemption or annual information return, individuals may request a specific part of either document. Finally, the proposed regulations permit a principal, regional, or district office of an organization to use an agent to process requests for copies.

Reasonable Fee for Providing Copies

The proposed regulations provide that the reasonable fee a tax-exempt organization is permitted to charge for copies may be no more than the fees charged by the IRS for copies of tax-exempt organization tax returns and related documents (currently $1.00 for the first page and $.15 for each subsequent page), plus actual postage costs. The proposed regulations permit an organization to collect payment in advance of providing the requested copies. If an organization receives a written request for copies with no payment enclosed, and the organization requires payment in advance, the organization must request payment within 7 days from the date it receives the request. Payment will be deemed to occur on the day an organization receives the cash, check (provided the check subsequently clears) or money order. The proposed regulations require an organization to accept payment made by cash or money order, and when the request is made in writing, also accept payment made by personal check. An organization is permitted, though not required, to accept other forms of payment. To protect requesters from unexpected fees where a tax-exempt organization does not require prepayment and where a requester does not enclose prepayment with a request, an organization must receive consent from a requester before providing copies for which the fee charged for copying and postage is in excess of $20.

Making Applications and Information Returns Widely Available

The proposed regulations provide that a tax-exempt organization is not required to comply with requests for copies if the organization has made the requested documents widely available. The proposed regulations specify that an organization can make its application for tax exemption and/or an annual information return widely available by posting the applicable document on the organization's World Wide Web page on the Internet or by having the applicable document posted on another organization's page as part of a database of similar materials. In addition, the proposed regulations provide that the Commissioner may prescribe, by revenue procedure or other guidance, other methods that an organization can use to make its application and/or its return widely available. An organization that makes its application and/or its return widely available must inform individuals who request copies how and where to obtain the requested document. The Treasury and the IRS are interested in comments on additional methods by which applications and returns could be made widely available, including the use of a clearinghouse that maintains a large inventory of documents from many organizations.

Harassment Campaigns

The proposed regulations provide guidance in determining whether a tax-exempt organization is the subject of a harassment campaign. Generally, a harassment campaign exists where an organization receives a group of requests, and the relevant facts and circumstances show that the purpose of the group of requests was to disrupt the operations of the tax-exempt organization rather than to obtain information. The proposed regulations also contain examples that evaluate whether particular situations constitute a harassment campaign and whether an organization has a reasonable basis for believing that a request is part of the harassment campaign. For example, the IRS will not allow organizations to suspend compliance with a request for copies from a representative of the news media even though the organization believes that request is part of a harassment campaign. The proposed regulations also permit an organization to disregard requests in excess of two per month or four per year made by a single individual or sent from a single address. Finally, the proposed regulations provide procedures for requesting a determination that an organization is subject to a harassment campaign, the treatment of requests for copies while a request for a determination is pending, and the effect of such a determination.

Proposed Effective Date

These regulations are proposed to be effective beginning 60 days after publication of these regulations as final regulations.

private foundation, to allow public inspection at the organization's principal office (and certain regional or district offices) of its three most recent annual information returns. Each return must be made available for a 3-year period beginning on the date the return is required to be filed or is actually filed, whichever is later. Notice 88–20 (1988–2 C.B. 454), provided tax-exempt organizations with guidance for complying with the section 6104(e) public inspection requirements.

The Taxpayer Bill of Rights 2 (TBOR2), enacted on July 30, 1996, amended section 6104(e) by adding additional requirements. As amended, section 6104(e) requires each tax-exempt organization, including one that is a private foundation, to comply with requests, made either in writing or in person, for copies of the organization's application for recognition of tax-exempt status. Section 6104(e) also requires each tax-exempt organization, other than one that is a private foundation, to comply with requests, made either in writing or in person, for copies of the organization's three most recent annual information returns. The organization must fulfill these requests without charge, other than a reasonable fee for reproduction and mailing costs. If the request for copies is made in person, the organization must provide the requested copies immediately. If the request for copies is made in writing, the organization must provide the copies within 30 days. Section 6104(e) also provides that an organization is relieved of its obligation to provide copies upon request if, in accordance with regulations to be promulgated by the Secretary of the Treasury, (1) the organization has made the requested documents widely available or (2) the Secretary of the Treasury determines, upon application by the organization, that the organization is subject to a harassment campaign such that a waiver of the obligation to provide copies would be in the public interest.

In Notice 96–48 (1996–39 I.R.B. 8), the IRS invited comments on the changes made by TBOR2. Twenty-two comments were received and considered in the drafting of this notice of proposed rulemaking. The comments addressed a range of issues, although they made several suggestions in common. Several commentators requested that the guidance on the new disclosure requirements follow the existing guidance on the public inspection requirements provided in Notice 88–120. Several commentators also recommended that the fee charged by the IRS for copies of organization documents be used to establish a reasonable fee for an organization to charge when fulfilling requests for copies of the documents. A number of comments were received concerning the Internet. Most, but not all, of these comments urged that posting an organization's documents on the Internet be treated as making those documents widely available. Finally, several commentators asked for guidance in determining when an organization is subject to a harassment campaign, how to apply for a harassment determination, what kind of relief is available while such an application is pending and the effect of a determination that the organization is the subject of a harassment campaign.

Explanation of Provisions

Overview

The proposed regulations provide guidance concerning the application and returns a tax-exempt organization must make available for public inspection and must supply in response to requests for copies. The proposed regulations also provide guidance on (1) the place and time for making these documents available for public inspection, (2) conditions that may be placed on requests for copies of documents, and (3) the amount, form and time of payment of any fees that may be charged. The regulations also prescribe how an organization can make its application for tax exemption and annual information returns widely available. Finally, the proposed regulations provide guidance on the standards that apply in determining whether an organization is the subject of a harassment campaign and on the applicable procedures for obtaining relief.

Material Required to be Made Available for Public Inspection and Supplied in Response to a Request for Copies

The proposed regulations specify the documents that a tax-exempt organization must make available for public inspection or supply in response to a request for copies. A tax-exempt organization, including one that is a private foundation, must make its application for tax exemption available. An application for tax exemption includes the application form (such as Form 1023 or Form 1024) and any supporting documents filed by the organization in support of its application. It also includes any letter or document issued by the IRS in connection with the application. Consistent with the guidance provided in Notice 88–120, if an organization filed its application before July 15, 1987, the proposed regulations provide that the organization is required to make available a copy of its application only if it had a copy of the application on July 15, 1987.

A tax-exempt organization, other than one that is a private foundation, must make its three most recent annual information returns available. Generally, an annual information return includes Forms 990, 990–EZ, 990–BL, and Form 1065. It also includes all schedules and attachments filed with the IRS. An organization is not required, however, to disclose the parts of the return that identify names and addresses of contributors to the organization, nor is it required to disclose Form 990–T. The proposed regulations provide rules concerning the documents that must be made available by an organization that is recognized as tax-exempt under a group exemption letter or that files a group return pursuant to §1.6033–2(d) and Rev. Proc. 80–27, 1980–1 C.B. 677 (or any successor provision). Finally, the proposed regulations provide guidance to an individual denied inspection, or a copy, of an application or a return. In such a case, the individual may provide the IRS with a statement that describes the reason why the individual believes the denial was in violation of legal requirements.

Place and Time Documents Must Be Available for Public Inspection

The proposed regulations provide that a tax-exempt organization must make the specified documents available for public inspection at its principal, regional and district offices. The specified documents generally must be available for inspection on the day of the request during the office's normal business hours. Consistent with section 6104(e) and Notice 88–120,

tions address the standards that apply in determining whether a tax-exempt organization is the subject of a harassment campaign and guidance on the applicable procedures to obtain relief. This document also provides notice of a public hearing.

DATES: Written comments and requests to speak (with outlines of oral comments) at the public hearing scheduled for February 4, 1998, beginning at 10 a.m. must be submitted by December 26, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–246250–96), 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:DOM:CORP:R (REG–246250–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Service Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the **Office of Management and Budget,** Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service,** Attn: IRS Reports Clearance Officer, T:FP, Washington, DC 20224. Comments on the collections of information should be received by November 25, 1997. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the **Internal Revenue Service,** including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections of information;

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

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

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

The collections of information in these proposed regulations are in §§301.6104(e)–1, 301.6104(e)–2, and 301.6104(e)–3. This information is required to enable a tax-exempt organization to comply with section 6104(e) of the Internal Revenue Code. Under section 6104(e), a tax-exempt organization is required to make its application for tax exemption and its annual information returns available for public inspection. In addition, a tax-exempt organization is required to comply with requests made in writing or in person from individuals who seek a copy of those documents or, in the alternative, to make its documents widely available. The requirement that a tax-exempt organization make its application for tax exemption and annual information returns available for public inspection and comply with requests made in writing or in person from individuals who seek a copy of those documents or, in the alternative, make the documents widely available, will enable the public to obtain information about the tax-exempt organization. Under section 6104(e), a tax-exempt organization is permitted to file an application for relief from the requirement to provide copies if the organization reasonably believes it is the subject of a harassment campaign. The information a tax-exempt organization provides when filing an application for a determination that it is subject to a harassment campaign will be used by the IRS to make such determination. The collection of information is required to obtain relief from the requirement to comply with requests for copies if such requests are part of the harassment campaign. The likely respondents and/or recordkeepers are tax-exempt organizations. The burden for recordkeeping and for reporting is reflected below.

Estimated total annual recordkeeping burden: 551,000 hours.

Estimated average annual burden per recordkeeper: 30 minutes.

Estimated number of recordkeepers: 1,100,000.

Estimated total annual reporting burden: 500 hours.

Estimated average annual reporting burden per respondent: 29 minutes.

Estimated number of respondents: 1050.

Estimated annual frequency of responses: on occasion.

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

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

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 301) relating to the section 6104(e) disclosure requirements affecting tax-exempt organizations (organizations described in sections 501(c) or (d) and exempt from taxation under section 501(a)). Section 10702 of the Omnibus Budget Reconciliation Act of 1987 (OBRA '87) added subsection (e) to section 6104 of the Internal Revenue Code (Code). Section 6104(e) requires each tax-exempt organization, including one that is a private foundation, to allow public inspection of the organization's application for recognition of tax exemption. Section 6104(e) also requires each tax-exempt organization, other than one that is a

published on March 7, 1989 (54 FR 9460) is withdrawn.

* * * * *

Amendments Previously Proposed Rules

Accordingly, the proposed rules published on May 7, 1984 (49 FR 19321) and March 7, 1989 (54 FR 9460) are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. In §1.125–1, as proposed May 7, 1984 (49 FR 19321), in Q&A–8, Q–8 is republished and A–8 is amended by revising the last sentence to read as follows:

§1.125–1 Questions and answers relating to cafeteria plan.

* * * * *

Q–8: What requirements apply to participants' elections under a cafeteria plan?

A–8: *** However, except for benefit elections relating to accident or health plans and group-term life insurance coverage, a cafeteria plan may permit a participant to revoke a benefit election after the period of coverage has commenced and to make a new election with respect to the remainder of the period of coverage if both the revocation and the new election are on account of and consistent with a change in family status (e.g., marriage, divorce, death of spouse or child, birth or adoption of child, and termination of employment of spouse).

* * * * *

Par. 2. In §1.125–2, as proposed March 7, 1989 (54 FR 9460), in Q&A–6, Q–6 is republished and A 6 is amended by revising A–6(c) and (d) to read as follows:

§1.125–2 Miscellaneous cafeteria plan questions and answers.

* * * * *

Q–6: In what circumstance may participants revoke existing elections and make new elections under a cafeteria plan?

A–6: ***

* * * * *

(c) Certain Changes in Family Status. Except as otherwise provided, in the case of benefits other than accident or health plan coverage and group-term life insurance coverage, a cafeteria plan may permit a participant to revoke a benefit election during a period of coverage and to make a new election for the remaining portion of the period if the revocation and new election are both on account of a change in family status and are consistent with such change in family status. For purposes of this paragraph (c) of Q&A–6, examples of changes in family status for which a benefit election change may be permitted include the marriage or divorce of the employee, the death of the employee's spouse or a dependent, the birth or adoption of a child of the employee, the termination of employment (or the commencement of employment) of the employee';s spouse, the switching from part-time to full-time employment status or from full-time to part-time status by the employee or the employee's spouse, and the taking of an unpaid leave of absence by the employee or the employee's spouse. Benefit election changes are consistent with family status changes only if the election changes are necessary or appropriate as a result of the family status changes. In the case of accident or heath plans, election changes are permitted where there has been a significant change in the health coverage of the employee or spouse attributable to the spouse's employment. For additional rules governing cafeteria plan election changes with respect to accident or health plan coverage and group-term life insurance coverage, see §1.125–4T.

(d) Separation from Service. Except with respect to accident or health plan coverage and group-term life insurance coverage, a cafeteria plan may permit an employee who separates from the service of the employer during a period of coverage to revoke existing benefit elections and terminate the receipt of benefits for the remaining portion for the coverage period. The plan must prohibit the employee, if the employee should return to service for the employer, from making new benefit elections for the remaining portion of the period of coverage. For rules governing cafeteria plan election changes with respect to accident or health plan coverage and group-term life insurance coverage, see §1.125–4T.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAX

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

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

Par. 2. Section 1.125–4 is added to read as follows:

[The text of this proposed section is the same as the text of §1.125–4T published in T.D. 8738.]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on November 6, 1997, 8:45 a.m., and published in the issue of the Federal Register for November 7, 1997, 62 F.R. 60196)

Notice of Proposed Rulemaking and Notice of Public Hearing

Public Disclosure of Material Relating to Tax-Exempt Organizations

REG–246250–96

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 public disclosure requirements of section 6104(e) of the Internal Revenue Code. The proposed regulations provide guidance for a tax-exempt organization required to make its application for tax exemption and annual information return available for public inspection. The proposed regulations also provide guidance for a tax-exempt organization required to comply with requests made in writing or in person from individuals who seek a copy of those documents. The proposed regulations describe how a tax-exempt organization can make those documents widely available and, therefore, not be required to provide copies in response to individual requests. The proposed regula-

Notice of Proposed Rulemaking and Partial Withdrawal of Notice of Proposed Rulemaking

Tax Treatment of Cafeteria Plans

REG–243025–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Partial withdrawal of notice of proposed rulemaking, amendment to notice of proposed rulemaking, and notice of proposed rulemaking by cross reference to temporary regulations.

SUMMARY: This document withdraws portions of the notice of proposed rulemaking published in the **Federal Register** (54 FR 9460) on March 7, 1989 and amends proposed regulations relating to change in family status. In T.D. 8738, page 16, the IRS is issuing temporary regulations that provide guidance on the circumstances under which a cafeteria plan participant may revoke an existing election and make a new election during a period of coverage. The text of those temporary regulations also serves as the text of these proposed regulations.

DATES: Written comments and requests for public hearing must be received by February 5, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–243025–96), 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:DOM:CORP:R (REG–243025–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

SUPPLEMENTARY INFORMATION:

Background

Q&A–8 of §1.125–1[1] and Q&A–6(c) and (d) of §1.125–2[2] provide that a participant may make benefit election changes pursuant to changes in family status and separation from service. The temporary regulations set forth the standards under which a cafeteria plan can allow an employee to change his or her health coverage election during a period of coverage to conform with the special enrollment rights under the Health Insurance Portability and Accountability Act of 1996, and to change his or her health coverage or group-term life insurance coverage in a variety of other change in status situations. Thus, these proposed regulations modify A&A–8 of §1.125–1 and Q&A–6(c) and (d) of §1.125–2, and clarify that the "change in family status rules" in the existing proposed regulations continue to apply to qualified benefits (including dependent care assistance under section 129 and adoption assistance under section 137) other than accident or health coverage and group-term life insurance coverage. Election changes continue to be permitted where there has been a significant change in the health coverage of the employee or spouse attributable to the spouses's employment.

In addition, the temporary regulations provide that the rules of section 401(k) and (m), rather than the rules in the temporary regulations that apply to other qualified benefits, govern election changes under a qualified cash or deferred arrangement (within the meaning of section 401(k)) or with respect to employee contributions under section 401(m). Therefore, the proposed regulations withdraw Q&A–7(f) of §1.125–2.

T.D. 8738 amends the Income Tax Regulations (26 CFR part 1) relating to section 125. The temporary regulations contain rules relating to the circumstances under which a cafeteria plan participant may revoke an existing election and make a new election during a period of coverage.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

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

Comments and Public Hearing

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

Partial Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §1.125–2 Q&A–6(f) in the notice of proposed rulemaking that was

[1]Published as a proposed rule at 49 FR 19321 (May 7, 1984).

[2]Published as a proposed rule at 54 FR 9460 (March 7, 1989).

Notice of Proposed Rulemaking and Notice of Public Hearing

Rules for Property Produced in a Farming Business

REG-208151-91

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: In T.D. 8729 on page 35 of this Bulletin, the IRS is issuing temporary regulations relating to the application of section 263A of the Internal Revenue Code of 1986 to property produced in a farming business. The regulations affect taxpayers engaged in the business of farming that grow or raise plants or animals. The text of T.D. 8729 also serves as the text of these proposed regulations. This document provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by November 20, 1997. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 19, 1997, must be received by October 29, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-208151–91), 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:DOM:CORP:R (REG-208151–91), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS internet site at http://www.irs.ustreas.gov/prod/tax_regs/comment.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

SUPPLEMENTARY INFORMATION:

Background

T.D. 8729 amends Regulations on Income Taxes (26 CFR part 1). The regulations provide guidance with respect to the application of section 263A to property produced in a farming business.

The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Wednesday, November 19, 1997, at 10 a.m., at the Internal Revenue Building, 1111 Constitution Ave., NW, Washington, DC, 20224. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by November 20, 1997 and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 29, 1997.

A period of ten 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.

* * * * *

Proposed Amendments to the Regulations

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

PART 1—INCOME TAXES

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

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

Par. 2. Section 1.263A–0 is amended by:

1. Revising the introductory text.
2. Adding the entries for §1.263A–4.

The addition and revision read as follows:

§1.263A–0 Outline of regulations under section 263A.

This section lists the paragraphs in §§1.263A–1 through 1.263A–4 and §§1.263A–8 through 1.263A-15.

* * * * *

§1.263A–4 Rules for property produced in a farming business.

[The text of the proposed entries for §1.263A–4 in §1.263A–0 is the same as the text of the entries for §1.263A–4T in §1.263A–0T published in T.D. 8729].

* * * * *

Par. 3. Section 1.263A–4 is amended by revising the section heading and adding new text to read as follows:

§1.263A–4 Rules for property produced in a farming business.

[The proposed text of §1.263A–4 is the same as the text in §1.263A–4T published in T.D. 8729.]

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on August 21, 1997, 8:45 a.m., and published in the issue of the Federal Register for August 22, 1997, 62 F.R. 44607)

Notice of Proposed Rulemakings

CONTENTS

The "Proposed regulations" heading in the index contains a list of Code sections affected, the subject matter and the number and page.

the base that would have been effective under the Act without the enactment of the 1977 amendments. The base is computed under section 230(b) of the Act as it read prior to the 1977 amendments.

The "old-law" contribution and benefit base is used by:

(a) the Railroad Retirement program to determine certain tax liabilities and tier II benefits payable under that program to supplement the tier I payments which correspond to basic Social Security benefits,

(b) the Pension Benefit Guaranty Corporation to determine the maximum amount of pension guaranteed under the Employee Retirement Income Security Act (as stated in section 230(d) of the Social Security Act),

(c) Social Security to determine a year of coverage in computing the special minimum benefit, as described earlier, and

(d) Social Security to determine a year of coverage (acquired whenever earnings equal or exceed 25 percent of the "old-law" base for this purpose only) in computing benefits for persons who are also eligible to receive pensions based on employment not covered under section 210 of the Act.

Domestic Employee Coverage Threshold

General. Section 2 of the "Social Security Domestic Employment Reform Act of 1994" (Pub. L. 103–387) increased the threshold for coverage of a domestic employee's wages paid per employer from $50 per calendar quarter to $1,000 in calendar year 1994. The statute holds the coverage threshold at the $1,000 level for 1995 and then increases the threshold in $100 increments for years after 1995. The formula for increasing the threshold is provided in section 3121(x) of the Internal Revenue Code.

Computation. Under the formula, the domestic employee coverage threshold amount for 1998 shall be equal to the 1995 amount of $1,000 multiplied by the ratio of the national average wage index for 1996 to that for 1993. If the amount so determined is not a multiple of $100, it shall be rounded to the next lower multiple of $100.

Domestic Employee Coverage Threshold Amount. The ratio of the national average wage index for 1996, $25,913.90, compared to that for 1993, $23,132.67, is 1.1202295. Multiplying the 1995 domestic employee coverage threshold amount of $1,000 by the ratio of 1.1202295 produces the amount of $1,120.23, which must then be rounded to $1,100. Accordingly, the domestic employee coverage threshold amount is determined to be $1,100 for 1998.

.08 Failure to respond within either of the 30-day periods described in sections 13.03 and 13.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

.09 If an application for participation in the Form 1040 On-Line Filing Program is denied, the applicant is ineligible to submit a new application for two years from the application date of the denied application.

SECTION 14. ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE FORM 1040 ON-LINE FILING PROGRAM

.01 An On-Line Filer that has been suspended from participation in the Form 1040 On-Line Filing Program has the right to an administrative review. During the administrative review process, the suspension remains in effect.

.02 If an On-Line Filer receives a suspension letter, the On-Line Filer may mail or deliver, within 30 calendar days of the date of the suspension letter, a detailed written explanation, with supporting documentation, of why the suspension letter should be withdrawn. This written response should be sent to the district office or service center that issued the suspension letter.

.03 Upon receipt of the On-Line Filer's written response, the district office or service center will reconsider its suspension of the On-Line Filer. The district office or service center may either (1) withdraw its suspension letter, or (2) affirm the suspension.

.04 If the On-Line Filer receives a letter affirming the suspension, the On-Line Filer is entitled to an appeal, in writing, to the Director of Practice.

.05 The appeal must be mailed or delivered to the district office or service center that issued the suspension letter within 30 calendar days of the date of the letter affirming the suspension. The On-Line Filer's written appeal must contain detailed reasons, with supporting documentation, for reversal of the suspension.

.06 The district office or service center whose decision to suspend is being appealed will, upon receipt of a written appeal to the Director of Practice, forward its file on the On-Line Filer to the Director of Practice. The district office or service center will also forward to the Director of Practice the material described in section 14.05 of this revenue procedure. The district office or the service center will forward these materials within 15 calendar days of the receipt of an On-Line Filer's written request for appeal.

.07 Failure to appeal within either of the 30-day periods described in sections 14.02 and 14.05 of this revenue procedure irrevocably terminates an On-Line Filer's right to an appeal.

SECTION 15. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96–62, 1996–2 C.B. 412, is superseded.

SECTION 16. EFFECTIVE DATE

This revenue procedure is effective December 29, 1997.

SECTION 17. INTERNAL REVENUE SERVICE OFFICE CONTACT

All questions regarding the electronic filing aspects of the Form 1040 On-Line Filing Program should be directed to the IRS Headquarters Electronic Filing Office. The telephone number for this purpose is (202) 283-0531 (not a toll-free number). All questions regarding the on-line aspects of this program should be directed to the IRS Headquarters Form 1040 On-Line Filing Program Analyst. The telephone number for this purpose is (202) 283-0265 (not a toll-free number). The address for the IRS Headquarters Form 1040 On-Line Filing Program Analyst is T:ETA:O:P, 5000 Ellin Road, Lanham, MD 20706.

SECTION 18. PAPERWORK ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1513.

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

The collections of information in this revenue procedure are in sections 4, 5, 8, and 11 of the revenue procedure. This information is required by the IRS to implement the Form 1040 On-Line Filing Program and to enable taxpayers to file their individual income tax returns electronically through the Form 1040 On-Line Filing Program. The information will be used to ensure that taxpayers receive accurate and essential information regarding the filing of their return through the Form 1040 On-Line Filing Program and to identify the persons involved in the filing of a return through the Form 1040 On-Line Filing Program. The collections of information are required to retain the benefit of participating in the Form 1040 On-Line Filing Program. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and recordkeeping burden is 5,926 hours.

The estimated annual burden per respondent/recordkeeper varies from eight (8) minutes to 455 hours, depending on individual circumstances, with an estimated average of 423 hours (or approximately two (2) minutes per on-line electronically filed return). The estimated number of respondents and recordkeepers is 14.

The estimated annual frequency of responses is on occasion.

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.

Social Security Contribution and Benefit Base

Under authority contained in the Social Security Act ("the Act"), the Commissioner, Social Security Administration, has determined and announced (62 F.R. 58762, dated October 30, 1997) that the contribution and benefit base for remuneration paid in 1998, and self-employment income earned in taxable years beginning in 1998 is $68,400.

"Old-Law" Contribution and Benefit Base

General. The 1998 "old-law" contribution and benefit base is $50,700. This is

enue procedure. Before suspending an On-Line Filer, the Service may issue a warning letter that describes specific corrective action for deviations from this revenue procedure. However, the Service can immediately suspend, without notice, an On-Line Filer from the Form 1040 On-Line Filing Program. In most circumstances, a suspension from participation in the Form 1040 On-Line Filing Program is effective as of the date of the letter informing the On-Line Filer of the suspension.

.02 If a Principal or Responsible Official is suspended from the Form 1040 On-Line Filing Program, every entity that listed the suspended Principal or Responsible Official on its Form 8633 may also be suspended.

.03 The Service will monitor the timely receipt of Forms 8453–OL.

.04 The Service will monitor the quality of an On-Line Filer's transmissions throughout the filing season. The Service will also monitor the electronic portion of returns and tabulate rejections, errors, and other defects. If quality deteriorates, the On-Line Filer will receive a warning from the Service.

.05 The Service will monitor complaints about an On-Line Filer and issue a warning or suspension letter as appropriate.

.06 The Service reserves the right to suspend an On-Line Filer from participation in the Form 1040 On-Line Filing Program for violating any provision of this revenue procedure. Generally, the Service will advise a suspended On-Line Filer concerning the requirements for reacceptance into the Form 1040 On-Line Filing Program. The following reasons may lead to a warning letter and/or suspension of an On-Line Filer from the Form 1040 On-Line Filing Program (this list is not all-inclusive):

(1) the reasons listed in section 4.15 of this revenue procedure;

(2) deterioration in the format of individual transmissions;

(3) unacceptable cumulative error or rejection rate;

(4) stockpiling returns at any time while participating in the Form 1040 On-Line Filing Program;

(5) failure on the part of a Transmitter to retrieve acknowledgement files within two work days of transmission by the Service;

(6) failure on the part of a Transmitter to notify the taxpayer, as prescribed in section 5.19 of this revenue procedure, of the status of a transmitted return within two work days of receipt of the acknowledgement files from the Service;

(7) failure on the part of an On-Line Service Provider to ensure that no more than three tax returns are filed electronically by one subscriber;

(8) failure on the part of a Transmitter to ensure that it does not transmit or accept for transmission more than three electronic returns originating from one software package;

(9) significant complaints about an On-Line Filer;

(10) failure on the part of an On-Line Filer to ensure against the unauthorized use of its EFIN and/or ETIN;

(11) failure on the part of an On-Line Filer to cooperate with the Service's efforts to investigate electronic filing abuse;

(12) violation of the advertising standards described in section 11 of this revenue procedure;

(13) failure to maintain and make available records as described in section 5.20 of this revenue procedure;

(14) failure to supply a taxpayer with an accurate DCN;

(15) failure to give effective instructions to a taxpayer concerning the entry of the DCN on Form 8453–OL; or

(16) failure to timely submit a revised Form 8633 (or a letter containing the same information contained in a revised Form 8633) notifying the Service of changes described in section 4.03 or 4.04 of this revenue procedure.

.07 The Service may list in the Internal Revenue Bulletin, district office listings, district office newsletters, and on the EFS Bulletin Board the name and owner(s) of any entity suspended from the Form 1040 On-Line Filing Program and the effective date of the suspension.

.08 If a participant is suspended from participating in the Form 1040 On-Line Filing Program, the period of suspension includes the remainder of the calendar year in which the suspension occurs plus the next two calendar years. A suspended participant may submit a new application for the application period immediately preceding the end of the suspension.

SECTION 13. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE FORM 1040 ON-LINE FILING PROGRAM

.01 An applicant that has been denied participation in the Form 1040 On-Line Filing Program has the right to an administrative review. During the administrative review process, the denial of participation remains in effect.

.02 In response to the submission of a Form 8633, the Andover Service Center will either (1) accept an applicant into the Form 1040 On-Line Filing Program, or (2) issue a proposed letter of denial that explains to the applicant why the service center proposes to reject the application to participate in the Form 1040 On-Line Filing Program.

.03 An applicant who receives a proposed letter of denial may mail or deliver, within 30 calendar days of the date of the proposed letter of denial, a written response to the Andover Service Center. The applicant's response must address the service center's reason(s) for proposing the denial to participate.

.04 Upon receipt of an applicant's written response, the Andover Service Center will reconsider its proposed letter of denial. The service center may either (1) withdraw its proposed letter of denial and admit the applicant into the Form 1040 On-Line Filing Program, or (2) finalize the proposed denial letter.

.05 If an applicant receives a final denial letter from the Andover Service Center, the applicant is entitled to an appeal, in writing, to the Director of Practice.

.06 The appeal must be mailed or delivered to the Andover Service Center within 30 calendar days of the date of the final denial letter. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be reversed.

.07 The Andover Service Center will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the applicant and the material described in section 13.06 of this revenue procedure. The service center will forward these materials to the Director of Practice within 15 calendar days of receipt of the applicant's written appeal.

.03 *Substitute Form 8453–OL.* If a substitute Form 8453–OL is used, it must be approved by the Service prior to use. See Rev. Proc. 96–48, 1996–2 C.B. 339.

SECTION 8. INFORMATION AN ON-LINE FILER MUST PROVIDE TO THE TAXPAYER

01 The Transmitter must advise a taxpayer to retain a complete copy of the return and any supporting material.

.02 The Transmitter must advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center that would handle the taxpayer's paper return.

.03 The Transmitter must give the taxpayer the Declaration Control Number (DCN) for the taxpayer's Form 8453–OL and instructions to the taxpayer for entering the DCN on Form 8453–OL.

.04 If a taxpayer inquires about the status of a refund, the Transmitter, or On-Line Service Provider if the taxpayer is a subscriber, must advise the taxpayer that the taxpayer can call the local IRS TeleTax number to inquire about the status of the taxpayer's refund. The Transmitter or On-Line Service Provider should also advise the taxpayer to wait at least three weeks from the date the Service gave notification that the electronic portion of the taxpayer's return was accepted for processing before calling the TeleTax number.

.05 The Transmitter must inform the taxpayer that the address on the electronic portion of the return, once processed, will be used to update the taxpayer's address of record. The Internal Revenue Service uses the taxpayer's address of record for various notices that are required to be sent to a taxpayer's "last known address" under the Internal Revenue Code and for refunds of overpayments of tax (unless otherwise specifically directed by the taxpayer, such as by Direct Deposit).

SECTION 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service will ordinarily process a request for Direct Deposit but reserves the right to issue a paper refund check.

.02 The Service does not guarantee a specific date by which a refund will be directly deposited into the taxpayer's financial institution account.

.03 Neither the Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error, negligence, or malfeasance on the part of the taxpayer, On-Line Filer, financial institution, or any of their agents.

SECTION 10. BALANCE DUE RETURNS

.01 An on-line electronically filed balance due return is transmitted to the appropriate service center in the same manner that a refund or zero balance return is filed. A balance due return is not complete unless and until the Service receives Form 8453–OL completed and signed by the taxpayer.

.02 The Transmitter must furnish Form 1040–V, Payment Voucher, to a taxpayer who electronically files a balance due return.

.03 To expedite the crediting of a tax payment, a taxpayer who electronically files a balance due return should mail his or her tax payment with either Form 1040–V or the scannable payment voucher that is included in some tax packages. Each of these options has specific mailing instructions.

.04 A taxpayer who electronically files a balance due return must make a full and timely payment of any tax that is due. Failure to make full payment of any tax that is due on or before April 15, 1998, will result in the imposition of interest and may result in the imposition of penalties.

SECTION 11. ADVERTISING STANDARDS FOR ON-LINE FILERS

.01 An On-Line Filer shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. Any claims concerning faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 An On-Line Filer must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting.

.03 An On-Line Filer must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An On-Line Filer must not use improper or misleading advertising in relation to the Form 1040 On-Line Filing Program (including the time frames for refunds).

.05 An On-Line Filer using electronic filing promotional materials or logos provided by the Service must comply with all Service instructions pertaining to the promotional materials or logos.

.06 Use of Direct Deposit name and logo.

(1) The name "Direct Deposit" will be used with initial capital letters or all capital letters.

(2) The logo/graphic for Direct Deposit will be used whenever feasible in advertising copy.

(3) The color or size of the Direct Deposit logo/graphic may be changed when used in advertising pieces.

.07 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.08 Advertising for a cooperative electronic return filing project (public/private sector) must clearly state the names of all cooperating parties.

.09 If an On-Line Filer uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The On-Line Filer must keep a copy of the pre-recorded advertisement for a period of at least 36 months from the date of the last transmission or use.

.10 If an On-Line Filer uses direct mail or fax communications to advertise, the On-Line Filer must retain a copy of the actual mailing or fax, along with a list or other description of firms, organizations, or individuals to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.11 Acceptance to participate in the Form 1040 On-Line Filing Program does not imply endorsement by the Service, FMS, or the Treasury Department of the software or quality of services provided.

SECTION 12. MONITORING AND SUSPENSION OF AN ON-LINE FILER

.01 The Service will monitor an On-Line Filer for conformity with this rev-

(1) sending an electronic transmission to the taxpayer within two work days of retrieving the acknowledgement file; or

(2) mailing a written notification to the taxpayer within one work day of retrieving the acknowledgement file.

.20 A Transmitter must make available to the Service upon request all items required by this section to be retained until the end of the calendar year in which a return was filed. The Transmitter must make this material available either at the business address of the Transmitter or from the contact representative named on Form 8633.

.21 A Transmitter is responsible for ensuring that stockpiling does not occur. Stockpiling means collecting returns from taxpayers prior to official acceptance into the Form 1040 On-Line Filing Program, or, after official acceptance into the Form 1040 On-Line Filing Program, waiting more than three calendar days to transmit a return to the Service after receiving the information necessary for an electronic transmission of a tax return.

.22 An On-Line Filer may not offer, nor in any way participate in or facilitate, a Refund Anticipation Loan (RAL) in connection with any return filed under the Form 1040 On-Line Filing Program. A RAL is money borrowed by a taxpayer that is based on a taxpayer's anticipated income tax refund.

.23 An On-Line Filer may not charge a separate fee for a Direct Deposit. See section 9 of this revenue procedure.

.24 In addition to the specific responsibilities described in this section, an On-Line Filer must meet all the requirements in this revenue procedure to keep the privilege of participating in the Form 1040 On-Line Filing Program.

SECTION 6. PENALTIES

.01 *Penalties for Disclosure or Use of Information.*

(1) An On-Line Filer, except a Software Developer that performs no other function in the Form 1040 On-Line Filing Program but software development, is a tax return preparer (Preparer) under the definition of § 301.7216–1(b) of the Regulations on Procedure and Administration. A Preparer is subject to a criminal penalty for unauthorized disclosure or use of tax return information. See § 7216 of the Internal Revenue Code and § 301.7216–1(a). In addition, § 6713 establishes civil penalties for unauthorized disclosure or use of tax return information.

(2) Under § 301.7216–2(h), disclosure of tax return information among accepted On-Line Filers for the purpose of preparing a return is permissible. For example, an On-Line Service Provider may pass on tax return information to a Transmitter for the purpose of having an on-line electronic return formatted and transmitted to the Service. However, if the tax return information is disclosed or used in any other way, an On-Line Filer may be subject to the penalties described in section 6.01(1) of this revenue procedure.

.02 *Other Preparer Penalties.*

(1) Preparer penalties may be asserted against an individual or firm meeting the definition of an income tax return preparer under § 7701(a)(36) and § 301.7701–15. Preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in §§ 6694, 6695, and 6713.

(2) Under § 301.7701–15(d), an On-Line Filer is not an income tax return preparer for the purpose of assessing most preparer penalties as long as the On-Line Filer's services are limited to "typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund."

(3) If an On-Line Filer alters the return information in a nonsubstantive way, this alteration will be considered to come under the "mechanical assistance" exception described in § 301.7701–15(d)(1). A nonsubstantive change is a correction or change limited to a transposition error, misplaced entry, spelling error, or arithmetic correction that falls within the following tolerances:

(a) the amount of "Total tax", "Federal income tax withheld", "Refund", or "Amount you owe" on Form 8453–OL differs from the corresponding amount on the electronic portion of the tax return by no more than $7;

(b) the amount of "Total income" shown on Form 8453–OL differs from the corresponding amount on the electronic portion of the tax return by no more than $25; or

(c) dropping cents and rounding to whole dollars.

(4) If an On-Line Filer alters the return information in a substantive way, rather than having the taxpayer alter the return, the On-Line Filer will be considered to be an income tax return preparer for purposes of § 7701(a)(36).

(5) If an On-Line Filer goes beyond mechanical assistance, the On-Line Filer may be held liable for income tax return preparer penalties. See Rev. Rul. 85–189, 1985–2 C.B. 341 (which describes a situation where a Software Developer was determined to be an income tax return preparer and subject to certain preparer penalties).

.03 *Other Penalties.* In addition to the above specified provisions, the Service reserves the right to assert all appropriate preparer, nonpreparer, and disclosure penalties against an On-Line Filer as warranted under the circumstances.

SECTION 7. FORM 8453–OL, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ON-LINE FILING

.01 *Procedures for Completing Form 8453–OL.*

(1) Form 8453–OL must be completed by the taxpayer in accordance with the instructions for that form.

(2) The taxpayer(s)'s name, address, social security number(s), tax return information, and direct deposit of refund information in the electronic transmission must be identical to the information on the Form 8453–OL that the taxpayer(s) signs and will mail to the appropriate service center.

(3) If the electronic portion of a return was filed as a joint return, both spouses' signatures are required on Form 8453–OL.

(4) The taxpayer's Form 8453–OL must be sent to the address of the appropriate service center within one work day after the taxpayer is provided notification that the electronic portion of the taxpayer's return has been accepted for processing.

.02 *Missing Form 8453–OL.* If the Service determines that a Form 8453–OL is missing, the taxpayer must provide the Service with a replacement. A taxpayer must also provide a copy of any Form W–2, Wage and Tax Statement, Form W–2G, Certain Gambling Winnings, Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., and all other attachments to Form 8453–OL.

(2) promptly distribute any software correction;

(3) ensure that its software package cannot be used to transmit more than three electronic returns;

(4) ensure that its software package contains a Form 8453–OL format that can be printed and used by a taxpayer to file with the Service;

(5) ensure that its software package contains a consent to disclosure statement; and

(6) not incorporate into its software a Service-assigned production password.

.11 An On-Line Filer that participates as a Transmitter must:

(1) assign (as prescribed in Publication 1345) a Declaration Control Number (DCN) to the electronic portion of each return received from a taxpayer;

(2) include the assigned DCN in the transmission of the electronic portion of a return;

(3) transmit all electronic returns within three calendar days of receipt to the appropriate service center based on the state code in the taxpayer's return address;

(4) retrieve the acknowledgement file (in which the Service states whether it accepts or rejects the electronic portion of a taxpayer's return) within two work days of transmission;

(5) match the acknowledgement file to the original transmission file and notify the taxpayer of the status of a transmitted return as prescribed in section 5.18 of this revenue procedure;

(6) retain, until the end of the calendar year in which a return was filed, the acknowledgement file received from the Service;

(7) retain, until the end of the calendar year in which a return was filed, the complete copy of the electronic portion of the return (may be retained on magnetic media) that can be readily and accurately converted into an electronic transmission that the Service can process;

(8) immediately contact the Electronic Filing Unit at the appropriate service center for further instructions if an acknowledgement of acceptance for processing has not been received by the Transmitter within two work days of transmission or if the Transmitter receives an acknowledgement for a return that was not transmitted on the designated transmission;

(9) promptly correct any transmission error that causes an electronic transmission to be rejected;

(10) contact the Electronic Filing Unit at the appropriate service center for assistance if a return has been rejected after three transmission attempts;

(11) ensure the security of all transmitted data;

(12) ensure that it does not transmit or accept for transmission more than three electronic returns originating from one software package;

(13) ensure that the electronic portion of a return contains a completed consent to disclosure statement; and

(14) ensure that it does not use software that has a Service-assigned production password built into the software.

.12 A Transmitter must include an On-Line Service Provider's EFIN on each return that the Transmitter accepts from an On-Line Service Provider.

.13 A Transmitter must enter the letter "O" in Field #15 (Transmission Type Code) when transmitting the electronic portion of an on-line electronically filed return to the Service. See Part II, Section 1, page 4, of Publication 1346.

.14 A Transmitter must ensure that it does not combine the electronic portion of an on-line electronically filed return with the electronic portion of any other return within the same transmission to the Service.

.15 A Transmitter must ensure that it does not use an EFIN or ETIN obtained through the Form 1040 ELF Program in a transmission of the electronic portion of a taxpayer's return as part of the Form 1040 On-Line Filing Program.

.16 If the Service accepts the electronic portion of a taxpayer's return, the Transmitter must notify the taxpayer (as prescribed in section 5.19 of this revenue procedure) of the following:

(1) the date the transmission was accepted;

(2) the DCN;

(3) where to put the DCN on Form 8453–OL;

(4) the requirement to properly complete and timely submit a Form 8453–OL with accompanying paper documents (including Form W–2, Wage and Tax Statement) within one work day;

(5) the appropriate service center's address to which Form 8453–OL with accompanying paper documents must be sent;

(6) that a Form 8453–OL must be received by the Service before an on-line electronically filed return is complete; and

(7) that the taxpayer's failure to timely submit a Form 8453-OL with accompanying paper documents could result in the Service not allowing the taxpayer to file a tax return through the Form 1040 On-Line Filing Program in the future.

.17 If the Service informs the Transmitter (in an acknowledgement file) that the electronic portion of a taxpayer's return has been rejected, the Transmitter must notify the taxpayer, as prescribed in section 5.19 of this revenue procedure, of the following:

(1) that the Service rejected the electronic portion of the taxpayer's return;

(2) the date of the rejection;

(3) what the reject code(s) means;

(4) what steps the taxpayer needs to take to correct the error that caused the rejection; and

(5) the information contained in section 5.18 of this revenue procedure.

.18 If the taxpayer chooses not to have the electronic portion of the return corrected and transmitted to the Service, or if the electronic portion of the return cannot be accepted for processing by the Service, the taxpayer, in order to file a timely return, must file a paper return by the later of:

(1) the due date of the return; or

(2) ten calendar days after the date the Service gives notification that the electronic portion of the return is rejected or that the electronic portion of the return cannot be accepted for processing.

The paper return should include an explanation of why the return is being filed after the due date.

.19 A Transmitter that transmits a return of a taxpayer who is a subscriber of an On-Line Service Provider must notify the taxpayer by sending an electronic transmission to the On-Line Service Provider within two work days of retrieving the acknowledgement file. A Transmitter that transmits a return of a taxpayer who is not a subscriber of an On-Line Service Provider must notify the taxpayer by:

.14 If an On-Line Filer is a Software Developer that performs no other function in the Form 1040 On-Line Filing Program but software development, no Principal or Responsible Official needs to pass a suitability check.

.15 The Service may reject an application to participate in the Form 1040 On-Line Filing Program for the following reasons (this list is not all-inclusive). These reason apply to any firm, organization, Principal, or Responsible Official listed on Form 8633:

(1) conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust;

(2) failure to file timely and accurate tax returns, including returns indicating that no tax is due;

(3) failure to timely pay any tax liabilities;

(4) assessment of tax penalties;

(5) suspension/disbarment from practice before the Service;

(6) disreputable conduct or other facts that would reflect adversely on the Form 1040 On-Line Filing Program;

(7) misrepresentation on an application;

(8) suspension or rejection from either the Form 1040 On-Line Filing Program or the Form 1040 Electronic Filing (ELF) Program in a prior year;

(9) unethical practices in return preparation;

(10) stockpiling returns prior to official acceptance into the Form 1040 On-Line Filing Program (see section 5.21 of this revenue procedure);

(11) knowingly and directly or indirectly employing or accepting assistance from any firm, organization, or individual that is prohibited from applying to participate in the Form 1040 On-Line Filing Program or the Form 1040 ELF Program, or that is suspended from participating in the Form 1040 On-Line Filing Program or the Form 1040 ELF Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Form 1040 On-Line Filing Program or the Form 1040 ELF Program; or

(12) knowingly and directly or indirectly accepting employment as an associate, correspondent, or as a subagent from, or sharing fees with, any firm, organization, or individual that is prohibited from applying to participate in the Form 1040 On-Line Filing Program or the Form 1040 ELF Program, or that is suspended from participating in the Form 1040 On-Line Filing Program or the Form 1040 ELF Program. This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Form 1040 On-Line Filing Program or the Form 1040 ELF Program.

SECTION 5. RESPONSIBILITIES OF AN ON-LINE FILER

.01 To ensure that complete returns are accurately and efficiently filed, an On-Line Filer must comply with all the publications and notices of the Service relating to electronic filing. Currently, these publications and notices include:

(1) Publication 1345, Handbook for Electronic Filers of Individual Income Tax Returns, and Publication 1345A, Handbook for Electronic Filers of Individual Income Tax Returns (Supplement);

(2) Publication 1346, Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns;

(3) Publication 1436, Test Package for Electronic Filing of Individual Income Tax Returns; and

(4) Postings to the Electronic Filing System Bulletin Board (EFS Bulletin Board).

.02 An On-Line Filer must maintain a high degree of integrity, compliance, and accuracy.

.03 An On-Line Filer may accept returns for on-line electronic filing only from taxpayers or from another On-Line Filer.

.04 If an On-Line Filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or any other amount from the tax return.

.05 An On-Line Filer must submit a revised Form 8633 (or a letter as provided in section 4.04 of this revenue procedure) to the Andover Service Center within 30 days of when any of the conditions or changes described in section 4.03 or 4.04 of this revenue procedure occur. See section 4.06 of this revenue procedure.

.06 An On-Line Filer must notify the Andover Service Center within 30 days of discontinuing its participation in the Form 1040 On-Line Filing Program. This does not preclude reapplication in the future.

.07 An On-Line Filer must ensure that it promptly processes returns submitted to it for electronic filing. See sections 5.09, 5.10, and 5.11 of this revenue procedure. However, an On-Line Filer that receives a return for electronic filing on or before the due date of the return must ensure that the on-line electronic return is filed on or before that due date (including extensions). An on-line electronic return is not considered filed until the electronic portion of the tax return has been acknowledged by the Service as accepted for processing and a completed and signed Form 8453–OL has been received by the Service. However, if the electronic portion of a return is successfully transmitted on or shortly before the due date and the taxpayer complies with section 7.01 of this revenue procedure, the return will be deemed timely filed. If the electronic portion of a return is transmitted on or shortly before the due date and is ultimately rejected, but the taxpayer complies with section 5.18 of this revenue procedure, the return will be deemed timely filed. For a balance due return, see section 10 of this revenue procedure for instructions on how to make a timely payment of tax.

.08 An On-Line Filer must ensure against the unauthorized use of its EFIN or ETIN. An On-Line Filer must not transfer its EFIN or ETIN by sale, loan, gift, or otherwise to another entity.

.09 An On-Line Filer that participates as an On-Line Service Provider must:

(1) provide assistance to a subscriber in transmitting the electronic portion of a tax return;

(2) ensure that no more than three tax returns are filed electronically by one subscriber;

(3) not provide to a subscriber software that has a Service-assigned production password built into the software;

(4) immediately send to a subscriber the information provided by a Transmitter under section 5.17 or 5.18 of this revenue procedure; and

(5) inform a subscriber upon request that information regarding a refund can be obtained by using the IRS TeleTax system.

.10 An On-Line Filer that participates as a Software Developer must:

(1) promptly correct any software error which causes the electronic portion of a return to be rejected;

Line Filing Program must submit a revised Form 8633 (designated for the Form 1040 On-Line Filing Program as described in section 4.02 of this revenue procedure), signed by all "Principals" and the "Responsible Official" (as described in section 4.11 of this revenue procedure) with completed fingerprint cards for the appropriate individuals if:

(1) the On-Line Filer functioned solely as a Software Developer during the most recent Form 1040 On-Line Filing Program and intends to function as an On-Line Service Provider or Transmitter during the Form 1040 On-Line Filing Program;

(2) there is an additional Principal, such as a partner or a corporate officer, that must be listed on Form 8633, line 8, "Principals of Your Firm or Organization";

(3) there is a Principal listed on Form 8633, line 8, that should be deleted; or

(4) the Responsible Official on Form 8633, line 9 changes.

.04 Except as provided in section 4.03 of this revenue procedure, to participate in the Form 1040 On-Line Filing Program, an On-Line Filer in the most recent Form 1040 On-Line Filing Program must submit either a revised Form 8633, or a letter containing the same information contained in a revised Form 8633, if any information on the On-Line Filer's Form 8633 has changed. A revised Form 8633 or letter submitted under this section should include only the information requested on lines 1a through 1i of Form 8633 and the information being revised. A Principal or a Responsible Official must sign the revised Form 8633 or the letter.

.05 For applicants described in section 4.02 of this revenue procedure, the application period runs from September 2, 1997, through December 1, 1997.

.06 Revised applications described in sections 4.03 and 4.04 of this revenue procedure must be submitted within 30 days of the change(s) reflected on the revised Form 8633 or in the letter.

.07 Applicants and On-Line Filers described in sections 4.02 through 4.04 of this revenue procedure must file Form 8633 (or a letter as provided in section 4.04 of this revenue procedure) with the Andover Service Center.

.08 Applicants described in section 4.02 must submit the following information (or the name and phone number of an individual who can provide the information) to the IRS Headquarters Form 1040 On-Line Filing Program Analyst (see section 17 of this revenue procedure) by December 31, 1997:

(1) the brand name of the software the applicant will be using, has developed, or will be transmitting, and the following information regarding the software:

(a) the name of the Software Developer for the software;

(b) the name of the Transmitter for the software;

(c) the retail cost of the software and any additional costs for transmitting the electronic portion of the taxpayer's return;

(d) whether the software can be used to file Federal/State returns;

(e) whether the software is available on the Internet and, if so, the Internet address;

(f) the Professional Package name of the software submitted for Participants Acceptance Testing (PATS) and whether the software has successfully completed PATS;

(2) the applicant's point of contact for matters relating to the Form 1040 On-Line Filing Program and the telephone number for the point of contact; and

(3) the applicant's customer service telephone number.

.09 On-Line Filers that participated in the most recent Form 1040 On-Line Filing Program must submit any changes to the information contained in sections 4.08(1) through (3) of this revenue procedure to the IRS Headquarters Form 1040 On-Line Filing Program Analyst by December 31, 1997.

.10 Applicants and On-Line Filers described in sections 4.01 through 4.04 of this revenue procedure that intend to participate as a Transmitter or a Software Developer in the Form 1040 On-Line Filing Program must first successfully complete the necessary testing at the appropriate service center(s).

.11 Each individual listed as a Principal or a Responsible Official must:

(1) be a United States citizen or an alien lawfully admitted for permanent residence as described in 8 U.S.C. § 1101(a)-(20) (1994);

(2) have attained the age of 21 as of the date of application;

(3) submit with Form 8633 one standard fingerprint card with a full set of fingerprints taken by a law enforcement agency, except as provided in section 4.12 of this revenue procedure; and

(4) pass a suitability check that includes a credit check, a tax compliance check, and a fingerprint check.

.12 An individual may choose to submit evidence of the individual's professional status in lieu of a standard fingerprint card if the individual is:

(1) an attorney in good standing of the bar of the highest court of any State, Commonwealth, possession, territory, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service or the bar of the highest court of any State, Commonwealth, possession, territory, or the District of Columbia;

(2) a certified public accountant who is duly qualified to practice as a certified public accountant in any State, Commonwealth, possession, territory, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service or whose license to practice is not currently suspended or revoked by any State, Commonwealth, possession, territory, or the District of Columbia;

(3) an enrolled agent pursuant to part 10 of 31 C.F.R. Subtitle A;

(4) an officer of a publicly held corporation; or

(5) a banking official who is bonded and has been fingerprinted within the last two years.

.13 The Service will issue credentials to eligible applicants for the Form 1040 On-Line Filing Program, as well as On-Line Filers that do not have to reapply pursuant to section 4.01, 4.03, or 4.04 of this revenue procedure (provided they have first satisfactorily completed the testing described in section 4.10 of this revenue procedure if they intend to participate as a Transmitter or Software Developer). No one may participate in the Form 1040 On-Line Filing Program without the following credentials:

(1) a letter of acceptance into the Form 1040 On-Line Filing Program;

(2) an Electronic Filing Identification Number (EFIN) for each applicable service center; and

(3) if appropriate, an Electronic Transmitter Identification Number (ETIN) for each applicable service center.

C.B. 412. The updates include changes in the Form 1040 On-Line Filing Program, clarification of prior Form 1040 On-Line Filing Program statements, and additional guidance derived from other Service documents that relate to the Form 1040 On-Line Filing Program. Some of the updates are:

(1) Unless certain changes listed in sections 4.03 and 4.04 of this revenue procedure have occurred, an On-Line Filer that actively participated in the most recent Form 1040 On-Line Filing Program does not have to reapply to participate in the Form 1040 On-Line Filing Program (section 4.01);

(2) the application period for the Form 1040 On-Line Filing Program runs from September 2, 1997, through December 1, 1997 (section 4.05);

(3) all applications for the Form 1040 On-Line Filing Program must be sent to the Andover Service Center (sections 4.07 and 5.05);

(4) Applicants and certain On-Line Filers must submit information to the IRS Headquarters Form 1040 On-Line Filing Program Analyst by December 31, 1997 (sections 4.08 and 4.09);

(5) an individual who is an attorney may submit evidence of professional status in lieu of a fingerprint card provided the individual is not currently under suspension or disbarment from practice before the Service or the bar of the highest court of any State, Commonwealth, possession, territory, or the District of Columbia (section 4.12(1));

(6) an individual who is a certified public accountant may submit evidence of professional status in lieu of a fingerprint card provided the individual is not currently under suspension or disbarment from practice before the Service, or whose license to practice is not currently suspended or revoked by any State, Commonwealth, possession, territory, or the District of Columbia (section 4.12(2);

(7) timely notification that an On-Line Filer has discontinued participation in the Form 1040 On-Line Filing Program must be sent to the Andover Service Center (section 5.06);

(8) a Transmitter must ensure that it does not use an EFIN or ETIN obtained through the Form 1040 Electronic Filing (ELF) Program in a transmission of the electronic portion of a taxpayer's return as part of the Form 1040 On-Line Filing Program (section 5.15); and

(9) the Andover Service Center is the office responsible for accepting or rejecting an application to participate in the Form 1040 On-Line Filing Program (sections 13.02 through 13.07).

SECTION 3. ON-LINE FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the Form 1040 On-Line Filing Program, as described in section 4 of this revenue procedure, a participant is referred to as an "On-Line Filer."

.02 The On-Line Filer categories are:

(1) ON-LINE SERVICE PROVIDER. An "On-Line Service Provider" is an on-line information service organization that provides paying subscribers (individuals who use the various services offered by an On-Line Service Provider) dial-up access to a variety of data bases. For purposes of the Form 1040 On-Line Filing Program, an On-Line Service Provider must also have:

(a) an established subscriber or client base to whom the On-Line Service Provider offers services on a continuing basis and about which the On-Line Service Provider maintains certain minimum information identifying the subscriber. Such information could include the subscriber's name, account number, or credit card or demand deposit account number;

(b) a port capacity of at least 1,000 lines or the ability to simultaneously service 1,000 customers;

(c) a network of personal computers that are linked by modems;

(d) access to a broad spectrum of information and/or entertainment services; and

(e) a client base that has the ability to communicate using electronic mail.

(2) SOFTWARE DEVELOPER. A "Software Developer" develops software for the purposes of (a) formatting returns according to the Service's electronic return specifications; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

(3) TRANSMITTER. A "Transmitter" transmits the electronic portion of a return directly to the Service. An entity that provides a "bump-up" service is a Transmitter. A "bump-up" service provider increases the transmission rate or line speed of formatted or reformatted information that is being sent to the Service via a public switched telephone network. The Service accepts both asynchronous and bisynchronous communications protocols.

.03 The On-Line Filer categories are not mutually exclusive. For example, a Software Developer can, at the same time, be considered a Transmitter or an On-Line Service Provider depending on the function(s) performed.

SECTION 4. ACCEPTANCE IN THE FORM 1040 ON-LINE FILING PROGRAM

.01 Except as provided in sections 4.02 through 4.04 of this revenue procedure, an On-Line Filer that has actively participated in the most recent Form 1040 On-Line Filing Program does not have to reapply to participate in the Form 1040 On-Line Filing Program. However, an On-Line Filer that intends to participate as a Transmitter or a Software Developer in the Form 1040 On-Line Filing Program must first successfully complete the testing referred to in section 4.10 of this revenue procedure. In addition, section 4.13 of this revenue procedure provides for the Service's issuance of credentials necessary for participation in the Form 1040 On-Line Filing Program.

.02 Applicants must file a new Form 8633, Application to Participate in the Electronic Filing Program, (hereinafter "Form 8633"), with completed fingerprint cards for the appropriate individuals, if:

(1) the applicant has never participated in the Form 1040 On-Line Filing Program;

(2) the applicant has previously been denied participation in the Form 1040 On-Line Filing Program; or

(3) the applicant has been suspended from the Form 1040 On-Line Filing Program.

Applicants must designate that the Form 8633 is for the Form 1040 On-Line Filing Program by putting the words "ON-LINE FILING PROGRAM" across the top of the form and the letters "OLF" in the box in the upper left hand corner of the form that indicates whether the form is new or revised.

.03 To participate in the Form 1040 On-Line Filing Program, an On-Line Filer in the most recent Form 1040 On-

that taxpayers receive accurate and essential information regarding the filing of their electronic returns and to identify the persons involved in the filing of electronic returns. The collections of information are required to retain the benefit of participating in the Form 1040 ELF Program. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and recordkeeping burden is 1,146,272 hours.

The estimated annual burden per respondent/recordkeeper varies from six (6) minutes to 15.5 hours, depending on individual circumstances, with an estimated average of 15.28 hours (or approximately six (6) minutes per electronically filed return). The estimated number of respondents and recordkeepers is 75,000.

The estimated annual frequency of responses is on occasion.

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.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, sections 6012, 6061; 1.6012-5, 1.6061–1)

Rev. Proc. 97–61

CONTENTS

SECTION 1. PURPOSE

This revenue procedure informs those who participate in the Form 1040 On-Line Filing Program of their obligations to the Internal Revenue Service, taxpayers, and other participants. The following returns can be filed under the Form 1040 On-Line Filing Program: (1) 1997 Form 1040 and 1997 Form 1040A, U.S. Individual Income Tax Return; and (2) 1997 Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents. This revenue procedure updates and supersedes Rev. Proc. 96–62, 1996-2 C.B. 412.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 1.6012–5 of the Income Tax Regulations provides that the Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in 26 C.F.R. Part 1 (Income Tax), subject to the conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.02 For purposes of this revenue procedure, an on-line electronically filed Form 1040, Form 1040A, or Form 1040EZ is a composite return consisting of electronically transmitted data and certain paper documents. The paper portion of the return consists of Form 8453–OL, U.S. Individual Income Tax Declaration for On-Line Filing, and other paper documents that cannot be electronically transmitted. Form 8453–OL must be received by the Service before the composite return is considered filed (see section 5.07 of this revenue procedure). The composite return must contain the same information that a return filed completely on paper contains. See section 7 of this revenue procedure for procedures for completing Form 8453–OL.

.03 The Service will periodically issue Publication 1345, Handbook for Electronic Filers of Individual Income Tax Returns, that lists the forms and schedules associated with the Form 1040 series that can be electronically transmitted.

.04 For the purposes of the Form 1040 On-Line Filing Program, a 1997 Form 1040, Form 1040A, or Form 1040EZ cannot be electronically filed after October 15, 1998, notwithstanding the fact that the taxpayer has been granted an extension to file a return beyond that date.

.05 An amended tax return cannot be electronically filed under the Form 1040 On-Line Filing Program. A taxpayer must file an amended tax return on paper in accordance with the instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

.06 A tax return that has a foreign address for the taxpayer cannot be electronically filed under the Form 1040 On-Line Filing Program. Army/Air Force (APO) and Fleet (FPO) post offices are not considered foreign addresses.

.07 A tax return for a decedent cannot be electronically filed under the Form 1040 On-Line Filing Program. The decedent's spouse or personal representative must file a paper tax return for the decedent.

.08 This revenue procedure updates and supersedes Rev. Proc. 96–62, 1996–2

.03 To be accepted in, or to continue participation in, the Form 1040 ELF Program, a VITA or TCE sponsor must:

(1) have obtained the District Director's permission (and, in the case of a TCE sponsor, the permission of the Service office that is funding the TCE program) to provide electronic filing; and

(2) have a manual or electronic quality review system for each return to be electronically filed.

.04 The District Director will advise the VITA and TCE sponsor how to submit or transmit returns. Some of the options available to the District Director are:

(1) having the VITA or TCE sponsor submit returns on paper, magnetic disk, or in an electronic transmission to the DOEFC or other locally designated office;

(2) having the VITA or TCE sponsor directly transmit returns to the appropriate service center; or

(3) having the VITA or TCE sponsor use a third party Transmitter.

.05 A VITA or TCE sponsor is not required to sign Form 8453 as ERO. However, if the VITA or TCE sponsor chooses not to sign Form 8453, the VITA or TCE sponsor must otherwise furnish on Form 8453 its VITA or TCE acronym and, if operating from multiple sites, a site designation number.

.06 A VITA or TCE sponsor can only accept a return for electronic filing that is (1) prepared at the VITA or TCE site by a VITA or TCE volunteer, (2) prepared by a taxpayer that meets the criteria for VITA or TCE assistance, or (3) prepared by a paid preparer that meets the criteria for VITA or TCE assistance.

.07 Only returns and accompanying forms and schedules included in a district, VITA, or TCE training course may be accepted for electronic filing by a VITA or TCE sponsor.

.08 A VITA or TCE sponsor and a District Director may enter into an agreement that provides for the retention of copies of tax returns and Forms 8453 by a District Director. This information must be retained by either the VITA or TCE sponsor or a District Director. This information must not be given to a third party, including a third party Transmitter.

.09 A District Director is responsible for ensuring that Form 8453 is sent to the appropriate district office or service center. However, a District Director may delegate to the VITA or TCE sponsor the responsibility for mailing Form 8453 to the appropriate district office or service center.

.10 A VITA or TCE sponsor may collect a fee only if it is directly related to defraying the actual cost of electronically transmitting a tax return. A VITA or TCE sponsor may also collect this fee on behalf of a third party Transmitter who electronically transmitted a VITA or TCE return.

.11 Before a VITA or TCE sponsor may collect a fee for electronically filing a tax return, the VITA or TCE sponsor must ensure that the taxpayer understands that:

(1) the fee is not for the preparation of the return; and

(2) the VITA or TCE service is offered without regard to either the electronic filing of a return or the collection of a fee.

SECTION 17. EMPLOYER SPONSORED ELECTRONIC FILING

.01 This revenue procedure applies to an employer who chooses to offer electronic filing as an employee benefit to (1) business owners and spouses, (2) employees and spouses, and/or (3) dependents of business owners and employees, subject to the exceptions and restrictions described in this section.

.02 For purposes of this section, the District Director may be represented by an individual designated by the District Director.

.03 An employer may choose to electronically transmit returns or may arrange to have tax returns electronically transmitted through a third party. If an employer chooses to transmit returns from more than one location, the employer must submit a properly completed Form 8633 for each location.

.04 An employer may offer electronic filing as an employee benefit whether the employer chooses to transmit tax returns or contracts with a third party to transmit the tax returns.

.05 If an employer contracts with a third party to transmit tax returns, the employer may collect from participating employees a fee that is directly related to defraying the actual cost of electronically transmitting a tax return.

.06 An employer is not required to sign Form 8453 as ERO. However, if the employer chooses not to sign Form 8453, the employer must otherwise furnish on Form 8453 its name, address, and the designation "Employee Benefit," and if operating from multiple sites, a site designation number.

.07 An employer and a District Director may enter into an agreement that provides for the retention of copies of tax returns including Forms 8453. In the absence of such an agreement, this information must be retained by the employer. This information is not to be given to a third party, including a third party Transmitter.

SECTION 18. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96–61, 1996–2 C.B. 401, is superseded.

SECTION 19. EFFECTIVE DATE

This revenue procedure is effective December 29, 1997.

SECTION 20. INTERNAL REVENUE SERVICE OFFICE CONTACT

All questions regarding this revenue procedure should be directed to the Internal Revenue Service. The telephone number for this purpose is (202) 283-0531 (not a toll-free number).

SECTION 21. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1512.

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

The collections of information in this revenue procedure are in sections 5, 8, 9, and 12. This information is required to implement the Form 1040 ELF Program and to enable taxpayers to file their individual income tax returns electronically. The information will be used to ensure

(21) failure to timely submit a revised Form 8633 (or a letter containing the same information contained in a revised Form 8633) notifying the Service of changes described in section 4.03 or 4.04 of this revenue procedure.

.08 The Service may list in the Internal Revenue Bulletin, district office listings, district office newsletters, and the EFS Bulletin Board the name and owner(s) of any entity suspended from the Form 1040 ELF Program and the effective date of the suspension.

.09 A district director may warn Electronic Filers who are using the services of a rejected or a suspended Electronic Filer that sections 4.19(11) and (12) of this revenue procedure prohibit a business relationship with a rejected or a suspended Electronic Filer. However, in appropriate circumstances, the Service may immediately suspend the Electronic Filer.

.10 If an Electronic Filer is suspended from participating in the Form 1040 ELF Program, the period of suspension includes the remainder of the calendar year in which the suspension occurs plus the next two calendar years. A suspended participant may submit a new application for the application period immediately preceding the end of the suspension.

SECTION 14. ADMINISTRATIVE REVIEW PROCESS FOR DENIAL OF PARTICIPATION IN THE FORM 1040 ELECTRONIC FILING PROGRAM

.01 An applicant that has been denied participation in the Form 1040 ELF Program has the right to an administrative review. During the administrative review process, the denial of participation remains in effect.

.02 In response to the submission of a Form 8633, the Andover Service Center will either (1) accept an applicant into the Form 1040 ELF Program, or (2) issue a proposed letter of denial that explains to the applicant why the service center proposes to reject the application to participate in the Form 1040 ELF Program.

.03 An applicant that receives a proposed letter of denial may mail or deliver, within 30 calendar days of the date of the proposed letter of denial, a written response to the Andover Service Center. The applicant's response must address the service center's reason(s) for proposing the denial to participate.

.04 Upon receipt of an applicant's written response, the Andover Service Center will reconsider its proposed letter of denial. The service center may either (1) withdraw its proposed letter of denial and admit the applicant into the Form 1040 ELF Program, or (2) finalize the proposed denial letter.

.05 If an applicant receives a final denial letter from the Andover Service Center, the applicant is entitled to an appeal, in writing, to the Director of Practice.

.06 The appeal must be mailed or delivered to the Andover Service Center within 30 calendar days of the date of the final denial letter. An applicant's written appeal must contain a detailed explanation, with supporting documentation, of why the denial should be reversed.

.07 The Andover Service Center will, upon receipt of a written appeal to the Director of Practice, forward to the Director of Practice its file on the applicant and the material described in section 14.06 of this revenue procedure. The service center will forward these materials to the Director of Practice within 15 calendar days of receipt of the applicant's written appeal.

.08 Failure to respond within either of the 30-day periods described in sections 14.03 and 14.06 of this revenue procedure irrevocably terminates an applicant's right to an administrative review or appeal.

.09 If an application for participation in the Form 1040 ELF Program is denied, the applicant is ineligible to submit a new application for two years from the application date of the denied application.

SECTION 15. ADMINISTRATIVE REVIEW PROCESS FOR SUSPENSION FROM THE FORM 1040 ELECTRONIC FILING PROGRAM

.01 An Electronic Filer that has been suspended from participation in the Form 1040 ELF Program has the right to an administrative review. During the administrative review process, the suspension remains in effect.

.02 If an Electronic Filer receives a suspension letter, the Electronic Filer may mail or deliver, within 30 calendar days of the date of the suspension letter, a detailed written explanation, with supporting documentation, of why the suspension letter should be withdrawn. This written response should be sent to the district office or service center that issued the suspension letter.

.03 Upon receipt of the Electronic Filer's written response, the district office or service center will reconsider its suspension of the Electronic Filer. The district office or service center may either (1) withdraw its suspension letter, or (2) affirm the suspension.

.04 If an Electronic Filer receives a letter affirming the suspension, the Electronic Filer is entitled to an appeal, in writing, to the Director of Practice.

.05 The appeal must be mailed or delivered to the district office or service center that issued the suspension letter within 30 calendar days of the date of the letter affirming the suspension. The Electronic Filer's written appeal must contain detailed reasons, with supporting documentation, for reversal of the suspension.

.06 The district office or service center whose decision to suspend is being appealed will, upon receipt of a written appeal to the Director of Practice, forward its file on the Electronic Filer to the Director of Practice. The district office or service center will also forward to the Director of Practice the material described in section 15.05 of this revenue procedure. The district office or the service center will forward these materials within 15 calendar days of the receipt of the Electronic Filer's written request for appeal.

.07 Failure to appeal within either of the 30-day periods described in sections 15.02 and 15.05 of this revenue procedure irrevocably terminates an Electronic Filer's right to an appeal.

SECTION 16. VITA AND TCE SPONSORED ELECTRONIC FILING

.01 This revenue procedure applies to VITA (Volunteer Income Tax Assistance) and TCE (Tax Counseling for the Elderly) sponsors subject to the exceptions and restrictions described in this section.

.02 For purposes of this section, the District Director may be represented by an individual designated by the District Director such as a District Office Electronic Filing Coordinator (DOEFC) or a Taxpayer Education Coordinator.

.07 Advertising materials shall not carry the FMS, IRS, or other Treasury Seals.

.08 Advertising for a cooperative electronic return filing project (public/private sector) must clearly state the names of all cooperating parties.

.09 In advertising the availability of a RAL, an Electronic Filer and a financial institution must clearly (and, if applicable, in easily readable print) refer to or describe the funds being advanced as a loan, not a refund; that is, it must be made clear in the advertising that the taxpayer is borrowing against the anticipated refund and not obtaining the refund itself from the financial institution.

.10 If an Electronic Filer uses radio or television broadcasting to advertise, the broadcast must be pre-recorded. The Electronic Filer must keep a copy of the pre-recorded advertisement for a period of at least 36 months from the date of the last transmission or use.

.11 If an Electronic Filer uses direct mail or fax communications to advertise, the Electronic Filer must retain a copy of the actual mailing or fax, along with a list or other description of the firms, organizations, or individuals to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.12 Acceptance to participate in the Form 1040 ELF Program does not imply endorsement by the Service, FMS, or the Treasury Department of the software or quality of services provided.

SECTION 13. MONITORING AND SUSPENSION OF AN ELECTRONIC FILER

.01 The Service will monitor an Electronic Filer for conformity with this revenue procedure. Before suspending an Electronic Filer, the Service may issue a warning letter that describes specific corrective action for deviations from this revenue procedure. However, the Service can immediately suspend, without notice, an Electronic Filer from the Form 1040 ELF Program. In most circumstances, a suspension from participation in the Form 1040 ELF Program is effective as of the date of the letter informing the Electronic Filer of the suspension.

.02 If a Principal or Responsible Official is suspended from the Form 1040 ELF Program, every entity that listed the suspended Principal or Responsible Official on its Form 8633 may also be suspended.

.03 The Service will monitor the timely receipt of Forms 8453, as well as their overall legibility.

.04 The Service will monitor the quality of an Electronic Filer's transmissions throughout the filing season. The Service will also monitor the electronic portion of returns and tabulate rejections, errors, and other defects. If quality deteriorates, the Electronic Filer will receive a warning from the Service.

.05 The Service will monitor Drop-Off Collection Points and advise a parent of any Form 1040 ELF Program violations the Service has encountered with a parent's Drop-Off Collection Point. If a parent fails to correct a Drop-Off Collection Point problem, the parent will be required to eliminate that Drop-Off Collection Point. Failure to take corrective action or eliminate a Drop-Off Collection Point may cause the Service to suspend the parent from participating in the Form 1040 ELF Program.

.06 The Service will monitor complaints about an Electronic Filer and issue a warning or suspension letter as appropriate.

.07 The Service reserves the right to suspend an Electronic Filer from participation in the Form 1040 ELF Program for violating any provision of this revenue procedure. Generally, the Service will advise a suspended Electronic Filer concerning the requirements for reacceptance into the Form 1040 ELF Program. The following reasons may lead to a warning letter and/or suspension of an Electronic Filer from the Form 1040 ELF Program (this list is not all-inclusive):

(1) the reasons listed in section 4.19 of this revenue procedure;

(2) deterioration in the format of individual transmissions;

(3) unacceptable cumulative error or rejection rate;

(4) untimely received, illegible, incomplete, missing, or unapproved substitute Forms 8453;

(5) stockpiling returns at any time while participating in the Form 1040 ELF Program;

(6) failure on the part of a Transmitter to retrieve acknowledgement files within two work days of transmission by the Service;

(7) failure on the part of a Transmitter to provide an ERO or Service Bureau with acknowledgement files within two work days after receipt from the Service;

(8) significant complaints about an Electronic Filer's performance in the Form 1040 ELF Program;

(9) failure on the part of an Electronic Filer to ensure against the unauthorized use of its EFIN and/or ETIN;

(10) having more than one EFIN for the same business entity at the same location (the business entity is generally the entity that reports on its return the income derived from electronic filing), unless the Service has issued more than one EFIN to a business entity at the same location. For example, the Service may issue more than one EFIN to accommodate high volumes of returns;

(11) failure on the part of a Transmitter to include a Service Bureau's SBIN in the transmission of a return submitted by a Service Bureau;

(12) failure on the part of an ERO to include a Drop-Off Collection Point's CPIN as part of a return collected from a Drop-Off Collection Point;

(13) failure on the part of an Electronic Filer to cooperate with the Service's efforts to monitor Electronic Filers and investigate electronic filing abuse;

(14) failure on the part of an Electronic Filer to properly use the standard/nonstandard W–2 indicator;

(15) failure on the part of an Electronic Filer to properly use the refund anticipation loan (RAL) indicator;

(16) failure on the part of a Service Bureau or a Transmitter to include the ERO's EFIN as part of a return that the ERO submits to the Service Bureau or the Transmitter;

(17) violation of the advertising standards described in section 12 of this revenue procedure;

(18) failure to maintain and make available records as described in section 5.09(4) of this revenue procedure;

(19) accepting a tax return for electronic filing either directly or indirectly from a firm, organization, or individual (other than the taxpayer who is submitting his or her return) that is not in the Form 1040 ELF Program;

(20) submitting the electronic portion of a return with information that is not identical to the information on Form 8453; or

on Part II of Form 8453 correctly and that the information entered is the information transmitted with the electronic portion of the return;

(6) caution the taxpayer that once an electronic

return has been accepted for processing by the Service:

(a) the Direct Deposit election cannot be rescinded;

(b) the Routing Transit Number (RTN) of the financial institution cannot be changed; and

(c) the taxpayer's account number cannot be changed; and

(7) advise the taxpayer that refund information is available by calling the local IRS TeleTax number. See section 8.05 of this revenue procedure.

SECTION 10. REFUND ANTICIPATION LOANS

.01 A Refund Anticipation Loan (RAL) is money borrowed by a taxpayer that is based on a taxpayer's anticipated income tax refund. The Service has no involvement in RALs. A RAL is a contract between the taxpayer and the lender.

.02 Any entity that is involved in the Form 1040 ELF Program, including a financial institution that accepts direct deposits of income tax refunds, has an obligation to every taxpayer who applies for a RAL to clearly explain to the taxpayer that a RAL is in fact a loan, and not a substitute for or a quicker way of receiving an income tax refund. An Electronic Filer must advise the taxpayer that if a Direct Deposit is not timely, the taxpayer may be liable to the lender for additional interest on the RAL.

.03 An Electronic Filer may assist a taxpayer in applying for a RAL.

.04 An Electronic Filer may charge a flat fee to assist a taxpayer in applying for a RAL. The fee must be identical for all of the Electronic Filer's customers and must not be related to the amount of the refund or a RAL. The Electronic Filer must not accept a fee from a financial institution for any service connected with a RAL that is contingent upon the amount of the refund or a RAL.

.05 The Service has no responsibility for the payment of any fees associated with the preparation of a return, the electronic transmission of a return, or a RAL.

.06 An Electronic Filer may disclose tax information to the lending financial institution in connection with an application for a RAL only with the taxpayer's written consent as specified in § 301.7216–3(b).

.07 An Electronic Filer that is also the return preparer, and the financial institution or other lender that makes an RAL, may not be related taxpayers within the meaning of § 267 or § 707.

.08 Section 6695(f) imposes a $500 penalty on a return preparer who endorses or negotiates a refund check issued to any taxpayer other than the return preparer. However, a bank, as defined in § 581, may accept the full amount of a refund check as a deposit in the taxpayer's account for the benefit of the taxpayer. Section 1.6695–1(f) clarifies § 6695(f) by explaining that the prohibition on a return preparer negotiating a refund check is limited to a refund check for a return that the return preparer prepared. A preparer that is also a financial institution, but has not made a loan to the taxpayer on the basis of the taxpayer's anticipated refund, may (1) cash a refund check and remit all of the cash to the taxpayer or accept a refund check for deposit in full to a taxpayer's account, provided the bank does not initially endorse or negotiate the check; or (2) endorse a refund check for deposit in full to a taxpayer's account pursuant to a written authorization of the taxpayer. A preparer bank may also subsequently endorse or negotiate a refund check as part of the check-clearing process through the financial system after initial endorsement. Any income tax return preparer that violates this provision may be suspended from the Form 1040 ELF Program.

SECTION 11. BALANCE DUE RETURNS

.01 All service centers that accept electronically filed

returns will accept electronically filed balance due returns.

.02 The Electronic Filer must furnish Form 1040-V, Payment Voucher, to a taxpayer who electronically files a balance due return.

.03 To expedite the crediting of a tax payment, a taxpayer who electronically files a balance due return should mail his or her tax payment with either Form 1040-V or the scannable payment voucher that is included in some tax packages. Each of these options has specific mailing instructions.

.04 A taxpayer who electronically files a balance due return must make a full and timely payment of any tax that is due. Failure to make full payment of any tax that is due on or before April 15, 1998, will result in the imposition of interest and may result in the imposition of penalties.

SECTION 12. ADVERTISING STANDARDS FOR ELECTRONIC FILERS AND FINANCIAL INSTITUTIONS

.01 An Electronic Filer shall comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. Any claims concerning faster refunds by virtue of electronic filing must be consistent with the language in official Service publications.

.02 An Electronic Filer must adhere to all relevant federal, state, and local consumer protection laws that relate to advertising and soliciting.

.03 An Electronic Filer must not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name.

.04 An Electronic Filer must not use improper or misleading advertising in relation to the Form 1040 ELF Program (including the time frames for refunds and RALs).

.05 An Electronic Filer using electronic filing promotional materials or logos provided by the Service must comply with all Service instructions pertaining to the promotional materials or logos.

.06 Use of Direct Deposit name and logo.

(1) The name "Direct Deposit" will be used with initial capital letters or all capital letters.

(2) The logo/graphic for Direct Deposit will be used whenever feasible in advertising copy.

(3) The color or size of the Direct Deposit logo/graphic may be changed when used in advertising pieces.

the information on the electronic portion of the return by viewing this information on a computer display terminal. A taxpayer need not verify the electronic portion of the return prior to its transmission if the taxpayer provided a completed paper return for filing and the information on the electronic portion is identical to the information provided by the taxpayer.

(5) An Electronic Filer must submit the taxpayer's Form 8453 to the appropriate service center within one work day after the Electronic Filer receives acknowledgment that the electronic portion of the taxpayer's return has been accepted for processing.

(6) If an Electronic Filer functions as an ERO, the Electronic Filer must sign the ERO's Declaration on Form 8453.

(7) If the ERO is also the paid preparer, the ERO must check the "Paid Preparer" box and sign the ERO Declaration on Form 8453.

.02 *Corrections to Form 8453.*

(1) A new Form 8453 is not required for a nonsubstantive change. A nonsubstantive change is limited to a correction that does not exceed the tolerances, described in section 7.02(2) of this revenue procedure for arithmetic errors, a transposition error, a misplaced entry, or a spelling error. The incorrect nonsubstantive information must be neatly lined through on the Form 8453 and the correct data entered next to the lined-through entry. Also, the individual making the correction must initial the correction.

(2) The tolerances for section 7.02(1) of this revenue procedure are:

(a) the amount of "Total income" does not differ from the amount on the electronic tax return by more than $25; or

(b) the amount of "Total tax", "Federal income tax withheld", "Refund", or "Amount you owe" does not differ from the amount on the electronic portion of the tax return by more than $7.

(3) If the ERO makes a substantive change to the electronic portion of the return after Form 8453 has been signed by the taxpayer, but before it is transmitted, the ERO must have all the necessary parties described above sign a new Form 8453 that reflects the corrections before the return is transmitted.

(4) Dropping cents or rounding to whole dollars does not constitute a substantive change or alteration to the return unless the amount differs by more than the above tolerances. All rounding should be accomplished in accordance with the instructions in the Form 1040 tax package.

.03 *Missing Form 8453.* If the Service determines that a Form 8453 is missing, the ERO must provide the Service with a replacement. The ERO must also provide a copy of the Form(s) W–2, W–2G, 1099R, and all other attachments to Form 8453.

.04 *Substitute Form 8453.* If a substitute Form 8453 is used, it must be approved by the Service prior to use. See Rev. Proc. 96–48, 1996–2 C.B. 339.

SECTION 8. INFORMATION AN ELECTRONIC FILER MUST PROVIDE TO THE TAXPAYER

.01 The ERO must furnish the taxpayer with a complete paper copy of the taxpayer's return. However, the copy need not contain the social security number of the paid preparer. See Rev. Rul. 78–317, 1978–2 C.B. 335. A complete copy of a taxpayer's return includes:

(1) Form 8453 and other paper documents that cannot be electronically transmitted; and

(2) a printout of the electronic portion of the return. See section 2.02 of this revenue procedure. The electronic portion of the return can be contained on a replica of an official form or on an unofficial form. However, on an unofficial form, data entries must be referenced to the line numbers on an official form. Also, a printout of the electronic portion of the return does not have to be provided to the taxpayer if the taxpayer provided a completed paper return for electronic filing and the information on the electronic portion of the return is identical to the information provided by the taxpayer.

.02 The ERO must advise the taxpayer to retain a complete copy of the return and any supporting material.

.03 The ERO must advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center that would handle the taxpayer's paper return.

.04 The ERO must, upon request, provide the taxpayer with the Declaration Control Number and the date the Service gave notification that the electronic portion of the taxpayer's return was accepted for processing.

.05 The ERO must advise taxpayers that they can call the local IRS TeleTax number to inquire about the status of their tax refund. The ERO should also advise taxpayers to wait at least three weeks from the date the Service accepted the electronic portion of the taxpayer's return for processing before calling the TeleTax number.

.06 If a taxpayer chooses to use an address other than his or her home address on the return, the Electronic Filer must inform the taxpayer that the address on the electronic portion of the return, once processed by the Service, will be used to update the taxpayer's address of record. The Internal Revenue Service uses the taxpayer's address of record for various notices that are required to be sent to a taxpayer's "last known address" under the Internal Revenue Code, and for refunds of overpayments of tax (unless otherwise specifically directed by the taxpayer, such as by Direct Deposit).

SECTION 9. DIRECT DEPOSIT OF REFUNDS

.01 The Service will ordinarily process a request for Direct Deposit but reserves the right to issue a paper refund check.

.02 The Service does not guarantee a specific date by which a refund will be directly deposited into the taxpayer's financial institution account.

.03 Neither the Service nor Financial Management Service (FMS) is responsible for the misapplication of a Direct Deposit that is caused by error, negligence, or malfeasance on the part of the taxpayer, Electronic Filer, financial institution, or any of their agents.

.04 An ERO must:

(1) advise taxpayers of the option to receive their refund by paper check or direct deposit;

(2) not charge a separate fee for a Direct Deposit;

(3) accept any Direct Deposit election to any eligible

financial institution designated by the taxpayer;

(4) ensure that the taxpayer is eligible to choose Direct Deposit;

(5) verify that the taxpayer has entered the Direct Deposit information requested

which causes the electronic portion of a return to be rejected;

(2) promptly distribute any software correction;

(3) ensure that any software package that will be used to transmit electronic returns from multiple Electronic Filers has the capability of combining returns from these Electronic Filers into one Service transmission file taking into account the sorting requirements of the Declaration Control Number (DCN);

(4) ensure that no other entity uses the Software Developer's EFIN or ETIN. A Software Developer must not transfer by sale, merger, loan, gift, or otherwise its EFIN or ETIN to another entity; and

(5) not incorporate into its software a Service assigned production password.

.19 An Electronic Filer with a Drop-Off Collection Point is the ERO for that Drop-Off Collection Point. The ERO must clearly display its name at each Drop-Off Collection Point. The Service will hold the ERO responsible for any violation of the advertising standards described in section 12 or any other violation of this revenue procedure that occurs at a Drop-Off Collection Point listed on the ERO's Form 8633. The ERO must also serve as the contact point between the Service and the Drop-Off Collection Point for all correspondence including problem resolution and report evaluation.

.20 In addition to the specific responsibilities described in this section, an Electronic Filer must meet all the requirements in this revenue procedure to retain the privilege of participating in the Form 1040 ELF Program.

SECTION 6. PENALTIES

.01 *Penalties for Disclosure or Use of Information.*

(1) An Electronic Filer, except a Software Developer, is a tax return preparer (Preparer) under the definition of § 301.7216–1(b) of the Regulations on Procedure and Administration. A Preparer is subject to a criminal penalty for unauthorized disclosure or use of tax return information. See § 7216 of the Internal Revenue Code and § 301.7216–1(a). In addition, § 6713 establishes civil penalties for unauthorized disclosure or use of tax return information.

(2) Under § 301.7216–2(h), disclosure of tax return information among accepted Electronic Filers for the purpose of preparing a return is permissible. For example, an ERO may pass on tax return information to a Service Bureau and/or a Transmitter for the purpose of having an electronic return formatted and transmitted to the Service. However, if the tax return information is disclosed or used in any other way, a Service Bureau and/or a Transmitter may be subject to the penalties described in section 6.01(1) of this revenue procedure.

.02 *Other Preparer Penalties.*

(1) Preparer penalties may be asserted against an individual or firm meeting the definition of an income tax return preparer under § 7701(a)(36) and § 301.7701–15. Preparer penalties that may be asserted under appropriate circumstances include, but are not limited to, those set forth in §§ 6694, 6695, and 6713.

(2) Under § 301.7701–15(d), Electronic Return Collectors, Service Bureaus, Transmitters, and Software Developers are not income tax return preparers for the purpose of assessing most preparer penalties as long as their services are limited to "typing, reproduction, or other mechanical assistance in the preparation of a return or claim for refund."

(3) If an Electronic Return Collector, Service Bureau, Transmitter, or the product of a Software Developer alters the return information in a nonsubstantive way, this alteration will be considered to come under the "mechanical assistance" exception described in § 301.7701–15(d)(1). A nonsubstantive change is a correction or change limited to a transposition error, misplaced entry, spelling error, or arithmetic correction that falls within the following tolerances:

(a) the amount of "Total tax", "Federal income tax withheld", "Refund", or "Amount you owe" on Form 8453 differs from the corresponding amount on the electronic portion of the tax return by no more than $7;

(b) the amount of "Total income" on Form 8453 differs from the corresponding amount on the electronic portion of the tax return by no more than $25; or

(c) dropping cents and rounding to whole dollars.

(4) If an Electronic Return Collector, Service Bureau, or Transmitter alters the return information in a substantive way, rather than having the taxpayer alter the return, the Electronic Return Collector, Service Bureau, or Transmitter will be considered to be an income tax return preparer for purposes of § 7701(a)(36).

(5) If an Electronic Return Collector, Service Bureau, or Transmitter, or the product of a Software Developer, goes beyond mechanical assistance, any of these parties may be held liable for income tax return preparer penalties. See Rev. Rul. 85–189, 1985–2 C.B. 341 (which describes a situation where a Software Developer was determined to be an income tax return preparer and subject to certain preparer penalties).

.03 *Other Penalties.* In addition to the above specified provisions, the Service reserves the right to assert all appropriate preparer, nonpreparer, and disclosure penalties against an Electronic Filer as warranted under the circumstances.

SECTION 7. FORM 8453, U.S. INDIVIDUAL INCOME TAX DECLARATION FOR ELECTRONIC FILING

.01 *Procedures for Completing Form 8453.*

(1) Form 8453 must be completed in accordance with the instructions for that form.

(2) The taxpayer(s)'s name, address, social security number(s), tax return information, and direct deposit of refund information in the electronic transmission must be identical to the information on the Form 8453 that the taxpayer(s) signed and provided for submission to the Service.

(3) An Electronic Filer, a financial institution, or any other entity associated with the electronic filing of a taxpayer's return must not put its address in the section reserved for the taxpayer's address on Form 8453 or anywhere in the electronic portion of a return.

(4) Before the electronic portion of the return is transmitted, the taxpayer must verify the information on the electronic portion of the return and on Form 8453, and must sign Form 8453. Both spouses' signatures are required on the Form 8453 prior to the electronic transmission of a joint tax return. The taxpayer may verify

from the Service or from a third party Transmitter; and

(4) retain until the end of the calendar year in which a return was filed, and make available to the Service upon request the materials described in section 5.09(3) of this revenue procedure at either the business address from which a return was electronically filed or from the contact representative named on Form 8633.

.10 An ERO who is the paid preparer of an electronic tax return must also retain for the prescribed amount of time the materials described in § 1.6107–1(b) that are required to be kept by an income tax return preparer.

.11 An ERO must identify the paid preparer (if any) in the appropriate field of the electronic return and ensure that the paid preparer signed Form 8453. If Form 8453 is not signed by the paid preparer, the ERO must attach to Form 8453 a copy of pages 1 and 2 of the Form 1040EZ, Form 1040A, or Form 1040 signed by the paid preparer. These copies must be marked "COPY-DO NOT PROCESS" to prevent duplicate filings.

.12 An ERO must ensure against the unauthorized use of its EFIN and, if applicable, the CPIN(s) issued to its Drop-Off Collection Point(s). An ERO must not transfer its EFIN or the CPIN(s) of its Drop-Off Collection Point(s) by sale, merger, loan, gift, or otherwise to another entity.

.13 If the Service rejects the electronic portion of a taxpayer's return (the Service states whether it accepts or rejects the electronic portion of a taxpayer's return in an "acknowledgment file"), and the reason for the rejection cannot be rectified by the actions described in section 6.02(3) of this revenue procedure, the ERO, within 24 hours of receiving the rejection, must take reasonable steps to inform the taxpayer that the taxpayer's return has not been filed. When the ERO advises the taxpayer that the taxpayer's return has not been filed, the ERO must provide the taxpayer with the reject code(s), an explanation of the reject code(s), and the sequence number of each reject code(s). If the taxpayer chooses not to have the electronic portion of the return corrected and transmitted to the Service, or if the electronic portion of the return cannot be accepted for processing by the Service, the taxpayer must file a paper return by the later of:

(1) the due date of the return; or

(2) ten calendar days after the date the Service gives notification that the electronic portion of the return is rejected or that the electronic portion of the return cannot be accepted for processing.

The paper return should include an explanation of why the return is being filed after the due date.

.14 An ERO is responsible for ensuring that stockpiling does not occur at its office(s) or Drop-Off Collection Point(s). Stockpiling means collecting returns from taxpayers or from another Electronic Filer prior to official acceptance into the Form 1040 ELF Program, or, after official acceptance into the Form 1040 ELF Program, waiting more than three calendar days to transmit a return to the Service after receiving the information necessary for an electronic transmission of a tax return.

.15 An Electronic Filer who participates as a Service Bureau must:

(1) deliver all electronic returns to a Transmitter or to the ERO who gave the electronic returns to the Service Bureau within three calendar days of receipt;

(2) retrieve the acknowledgement file from the Transmitter within one calendar day of receipt by the Transmitter;

(3) send the acknowledgement file to the ERO (whether related or not) within one work day of retrieving the acknowledgement file;

(4) if the Service Bureau processes Forms 8453, send back to the ERO any return and Form 8453 that needs correction, unless the correction is described in section 6.02(3) of this revenue procedure;

(5) accept tax return information only from Electronic Filers;

(6) include its SBIN and the ERO's EFIN with all return information the Service Bureau forwards to a Transmitter or sends back to an ERO;

(7) retain each acknowledgement file received from a Transmitter until the end of the calendar year in which the electronic return was filed;

(8) if requested, serve as a contact point between its client EROs and the Service;

(9) if requested, provide the Service with a list of each client ERO; and

(10) ensure against the unauthorized use of its SBIN. A Service Bureau must not transfer its SBIN by sale, merger, loan, gift, or otherwise to another entity.

.16 An Electronic Filer who participates as a Transmitter must:

(1) transmit all electronic returns within three calendar days of receipt;

(2) retrieve the acknowledgement file within two work days of transmission;

(3) match the acknowledgement file to the original transmission file and send the acknowledgement file to the ERO or the Service Bureau (whether or not the ERO or the Service Bureau are related to the Transmitter) within two work days of retrieving the acknowledgement file;

(4) retain an acknowledgement file received from the Service until the end of the calendar year in which the electronic return was filed;

(5) immediately contact the appropriate service center's Electronic Filing Unit for further instructions if an acknowledgement of acceptance for processing has not been received by the Transmitter within two work days of transmission or if a Transmitter receives an acknowledgement for a return that was not transmitted on the designated transmission;

(6) promptly correct any transmission error that causes an electronic transmission to be rejected;

(7) contact the appropriate service center's Electronic Filing Unit for assistance if a return has been rejected after three transmission attempts;

(8) ensure the security of all transmitted data;

(9) ensure against the unauthorized use of its EFIN or ETIN. A Transmitter must not transfer its EFIN or ETIN by sale, merger, loan, gift, or otherwise to another entity; and

(10) not use software that has a Service assigned production password built into the software.

.17 A Transmitter who provides transmission services to other unrelated Electronic Filers must accept electronic returns for transmission to the Service only from accepted Electronic Filers. A Transmitter must include the ERO's EFIN and if applicable, the CPIN on each return that the Transmitter accepts from an ERO. In addition, a Transmitter must also include a Service Bureau's SBIN if a Service Bureau formats the return information.

.18 An Electronic Filer who participates as a Software Developer must:

(1) promptly correct any software error

(4) assessment of tax penalties;
(5) suspension/disbarment from practice before the Service;

(6) disreputable conduct or other facts that would reflect adversely on the Form 1040 ELF Program;

(7) misrepresentation on an application;

(8) suspension or rejection from the program in a prior year;

(9) unethical practices in return preparation;

(10) stockpiling returns prior to official acceptance into the Form 1040 ELF Program (see section 5.14 of this revenue procedure);

(11) knowingly and directly or indirectly employing or accepting assistance from any firm, organization, or individual that is prohibited from applying to participate in the Form 1040 ELF Program (see section 13.10 of this revenue procedure) or that is suspended from participating in the Form 1040 ELF Program (see section 13.11 of this revenue procedure). This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Form 1040 ELF Program; or

(12) knowingly and directly or indirectly accepting employment as an associate, correspondent, or as a subagent from, or sharing fees with, any firm, organization, or individual that is prohibited from applying to participate in the Form 1040 ELF Program (see section 13.10 of this revenue procedure) or that is suspended from participating in the Form 1040 ELF Program (see section 13.11 of this revenue procedure). This includes any individual whose actions resulted in the rejection or suspension of a corporation or a partnership from the Form 1040 ELF Program.

SECTION 5. RESPONSIBILITIES OF AN ELECTRONIC FILER

.01 To ensure that complete returns are accurately and efficiently filed, an Electronic Filer must comply with all publications and notices of the Service relating to electronic filing. Currently, these publications and notices include:

(1) Publication 1345, Handbook for Electronic Filers of Individual Income Tax Returns, and Publication 1345A, Handbook for Electronic Filers of Individual Income Tax Returns (Supplement);

(2) Publication 1346, Electronic Return File Specifications and Record Layouts for Individual Income Tax Returns;

(3) Publication 1436, Test Package for Electronic Filing of Individual Income Tax Returns; and

(4) Postings to the Electronic Filing System Bulletin Board (EFS Bulletin Board).

.02 An Electronic Filer must maintain a high degree of integrity, compliance, and accuracy.

.03 An Electronic Filer may accept returns for electronic filing only from taxpayers, from Drop-Off Collection Points as listed on the Electronic Filer's Form 8633 (see section 4.18 of this revenue procedure), or from another Electronic Filer.

.04 If the taxpayer's address on a Form W-2, Wage and Tax Statement, Form W-2G, Statement for Recipients of Certain Gambling Winnings, Form 1099–R, Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc., Form 1040, Schedule C, Profit or Loss From Business (Sole Proprietorship), or Form 1040, Schedule C-EZ, Profit or Loss From Business - Short Version, or any other tax form is different than the taxpayer's address in the entity section of the electronic portion of the taxpayer's Form 1040, the ERO or the Service Bureau must input for transmission to the Service those addresses that differ from the taxpayer's address on the electronic portion of the taxpayer's Form 1040.

.05 If an Electronic Filer charges a fee for the electronic transmission of a tax return, the fee may not be based on a percentage of the refund amount or any other amount from the tax return. An Electronic Filer may not charge a separate fee for Direct Deposit. See section 9 of this revenue procedure.

.06 An Electronic Filer must submit a revised Form 8633 (or a letter as provided in section 4.04 of this revenue procedure) to the Andover Service Center within 30 days of when any of the conditions or changes described in section 4.03 or 4.04 of this revenue procedure occur. See section 4.06 of this revenue procedure.

.07 An Electronic Filer must notify the Andover Service Center within 30 days of discontinuing its participation in the Form 1040 ELF Program. This does not preclude reapplication in the future.

.08 An Electronic Filer must ensure that it promptly processes returns submitted to it for electronic filing. See sections 5.14, 5.15, 5.16, and 7.01 of this revenue procedure. However, an Electronic Filer that receives a return for electronic filing on or before the due date of the return must ensure that the electronic return is filed on or before that due date (including extensions). An electronic return is not considered filed until the electronic portion of the tax return has been acknowledged by the Service as accepted for processing and a completed and signed Form 8453 has been received by the Service. However, if the electronic portion of a return is successfully transmitted on or shortly before the due date and the Electronic Filer complies with section 7.01 of this revenue procedure, the return will be deemed timely filed. If the electronic portion of a return is transmitted on or shortly before the due date and is ultimately rejected, but the Electronic Filer and the taxpayer comply with section 5.13 of this revenue procedure, the return will be deemed timely filed. For a balance due return, see section 11 of this revenue procedure for instructions on how to make a timely payment of tax.

.09 An Electronic Filer that functions as an ERO must:

(1) comply with the procedures for completing and securing Forms 8453 described in section 7 of this revenue procedure;

(2) comply with the procedures described in section 11 of this revenue procedure for handling a balance due return;

(3) while returns are being filed by the ERO, retain and make available to the Service upon request the following material at the business address from which a return was accepted for electronic filing:

(a) a copy of the signed Form 8453 and paper copies of Forms W–2, W–2G, and 1099–R;

(b) a complete copy of the electronic portion of the return (may be retained on magnetic media) that can be readily and accurately converted into an electronic transmission that the Service can process; and

(c) the acknowledgement file received

connection with the preparation of tax returns and the collection of prepared returns that taxpayers intend to have electronically filed. However, if the state and local licensing and/or bonding requirements apply to a business entity, the individual(s) must demonstrate that the business entity meets the requirements.

.10 A Principal for a firm or organization includes the following:

(1) Sole Proprietorship. The sole proprietor is the Principal for a sole proprietorship.

(2) Partnership. Each partner who has a 5 percent or more interest in the partnership is a Principal of the partnership. If no partner has at least a 5 percent or more interest in the partnership, the Principal is an individual authorized to act for the partnership in legal and/or tax matters (at least one such individual must be listed on Form 8633).

(3) Corporation. The President, Vice-President, Secretary, and Treasurer of the corporation are each a Principal of the corporation.

(4) Other. The Principal for a for-profit entity that is not a sole proprietorship, partnership, or corporation, is an individual authorized to act for the entity in legal and/or tax matters (at least one such individual must be listed on Form 8633).

.11 A Responsible Official is the individual who oversees the daily operations of an Electronic Filer's office. A Responsible Official may also be a Principal. As set forth in section 4.12 of this revenue procedure, a Responsible Official may be responsible for more than one office.

.12 The Responsible Official categories are:

(1) TIER I RESPONSIBLE OFFICIAL. A "Tier I Responsible Official" is a Responsible Official who does not meet the definition of a "Tier II Responsible Official." A Tier I Responsible Official should be able to visit on a daily basis each office for which he or she is listed as a Responsible Official. A Tier I Responsible Official may be listed on a maximum of ten applications (Forms 8633).

(2) TIER II RESPONSIBLE OFFICIAL. A "Tier II Responsible Official" is an individual who has participated in the Form 1040 ELF Program as a Responsible Official during at least the two most recent filing seasons and who has never been suspended from participation in the Form 1040 ELF Program. A Tier II Responsible Official should be able to visit on a daily basis any office for which he or she is listed as a Responsible Official. A Tier II Responsible Official may be listed on a maximum of twenty applications (Forms 8633).

.13 An individual may choose to submit evidence of the individual's professional status in lieu of a standard fingerprint card if the individual is:

(1) an attorney in good standing of the bar of the highest court of any State, Commonwealth, possession, territory, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service or the bar of the highest court of any State, Commonwealth, possession, territory, or the District of Columbia;

(2) a certified public accountant who is duly qualified to practice as a certified public accountant in any State, Commonwealth, possession, territory, or the District of Columbia, and is not currently under suspension or disbarment from practice before the Service or whose license to practice is not currently suspended or revoked by any State, Commonwealth, possession, territory, or the District of Columbia;

(3) an enrolled agent pursuant to part 10 of 31 C.F.R. Subtitle A;

(4) an officer of a publicly held corporation; or

(5) a banking official who is bonded and has been fingerprinted within the last two years.

.14 If an Electronic Filer has a foreign location, the stateside contact representative will receive all Service correspondence for the foreign location relating to the Form 1040 ELF Program.

.15 The Service will issue credentials to eligible applicants for the Form 1040 ELF Program, as well as Electronic Filers that do not have to reapply pursuant to section 4.01, 4.03, or 4.04 of this revenue procedure (provided they have first satisfactorily completed the testing described in section 4.08 of this revenue procedure if they intend to participate as a Transmitter or Software Developer). No one may participate in the Form 1040 ELF Program without the following credentials:

(1) a letter of acceptance into the Form 1040 ELF Program;

(2) an Electronic Filing Identification Number (EFIN) or a Service Bureau Identification Number (SBIN);

(3) if appropriate, an Electronic Transmitter Identification Number (ETIN); and

(4) if appropriate, a Collection Point Identification Number (CPIN).

.16 The Service will not issue a letter of acceptance to participate in the Form 1040 ELF Program to an ERO if the Service did not receive and accept during the most recent Form 1040 ELF Program any electronically filed returns containing the ERO's EFIN. In addition, an ERO may be dropped from the Form 1040 ELF Program if the Service does not receive and accept prior to April 15, 1998, any electronically filed returns containing the ERO's EFIN. In either case, the Service will notify the ERO that it has been dropped from the Form 1040 ELF Program and explain what steps the ERO needs to take for future participation in the program.

.17 If an Electronic Filer is a Software Developer that performs no other function in the Form 1040 ELF Program but software development, no Principal or Responsible Official needs to pass a suitability check.

.18 If an Electronic Filer will have a Drop-Off Collection Point(s) (as defined in section 3.04 of this revenue procedure), an Electronic Filer must submit a Form 8633 that lists each Drop-Off Collection Point. By listing a Drop-Off Collection Point on Form 8633, an Electronic Filer becomes a "parent" in relation to a listed Drop-Off Collection Point.

.19 The Service may reject an application to participate in the Form 1040 ELF Program for the following reasons (this list is not all-inclusive). These reasons apply to any firm, organization, Principal, or Responsible Official listed on Form 8633:

(1) conviction of any criminal offense under the revenue laws of the United States, or of any offense involving dishonesty or breach of trust;

(2) failure to file timely and accurate tax returns, including returns indicating that no tax is due;

(3) failure to timely pay any tax liabilities;

turn specifications; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

(4) TRANSMITTER. A "Transmitter" transmits the electronic portion of a return directly to the Service. An entity that provides a "bump-up" service is a Transmitter. A bump-up service provider increases the transmission rate or line speed of formatted or reformatted information that is being sent to the Service via a public switched telephone network. The Service accepts both asynchronous and bisynchronous communications protocols.

.03 The Electronic Filer categories are not mutually exclusive. For example, an ERO can, at the same time, be considered a Transmitter, Software Developer, or Service Bureau depending on the function(s) performed.

.04 An Electronic Filer may have a "Drop-Off Collection Point(s)." The activity at a Drop-Off Collection Point is limited solely to receiving a return or return information that a taxpayer wants to have electronically filed and collecting a fee for electronically filing that return. Return preparation activity may not be conducted at a Drop-Off Collection Point. Return preparation activity includes, but is not limited to, comparing amounts listed on Form 8453 with those on the paper return or return information provided by a taxpayer and verifying routing numbers and account numbers used for direct deposit of refunds. Return preparation activity does not include collecting a fee for electronic filing or ensuring that the taxpayer has signed Form 8453. An Electronic Filer need not have an ownership interest in the Drop-Off Collection Point.

SECTION 4. ACCEPTANCE IN THE FORM 1040 ELECTRONIC FILING PROGRAM

.01 Except as provided in sections 4.02 through 4.04 of this revenue procedure, an Electronic Filer that actively participated in the most recent Form 1040 ELF Program does not have to reapply to participate in the Form 1040 ELF Program. However, an Electronic Filer that intends to participate as a Transmitter or a Software Developer in the Form 1040 ELF Program must first successfully complete the testing referred to in section 4.08 of this revenue procedure. In addition, section 4.15 of this revenue procedure provides for the Service's issuance of credentials necessary for participation in the Form 1040 ELF Program.

.02 Applicants and Electronic Filers must file a new Form 8633, Application to Participate in the Electronic Filing Program, with completed fingerprint cards for the appropriate individuals, if:

(1) the applicant has never participated in the Form 1040 ELF Program;

(2) the applicant has previously been denied participation in the Form 1040 ELF Program;

(3) the applicant has been suspended from the Form 1040 ELF Program; or

(4) the Electronic Filer is participating in the Form 1040 ELF Program and wants to operate an electronic filing business at an additional location (except that an individual listed on the Electronic Filer's application who has previously submitted a fingerprint card does not need to submit an additional fingerprint card).

.03 To participate in the Form 1040 ELF Program, an Electronic Filer in the most recent Form 1040 ELF Program must submit a revised Form 8633, signed by all "Principals" and the "Responsible Official" (as described in sections 4.09 through 4.12 of this revenue procedure), with completed fingerprint cards for the appropriate individuals, if:

(1) the Electronic Filer functioned solely as a Software Developer during the most recent Form 1040 ELF Program and intends to function as an ERO, Service Bureau, or Transmitter during the Form 1040 ELF Program;

(2) there is an additional Principal, such as a partner or a corporate officer, that must be listed on Form 8633, line 8, "Principals of Your Firm or Organization";

(3) there is a Principal listed on Form 8633, line 8, that should be deleted; or

(4) the Responsible Official on Form 8633, line 9 changes.

.04 Except as provided in section 4.03 of this revenue procedure, to participate in the Form 1040 ELF Program, an Electronic Filer in the most recent Form 1040 ELF Program must submit either a revised Form 8633, or a letter containing the same information contained in a revised Form 8633, if any information on the Electronic Filer's Form 8633 has changed. A revised Form 8633 or letter submitted under this section should include only the information requested on lines 1a through 1i of Form 8633 and the information being revised. A Principal or a Responsible Official must sign the revised Form 8633 or the letter.

.05 Applicants and Electronic Filers described in section 4.02 of this revenue procedure must submit new applications within the following time periods:

(1) except as provided in section 4.05(2) of this revenue procedure, the application period runs from September 2, 1997, through December 1, 1997; and

(2) if an applicant purchases an existing Electronic Filer's business on or after November 1, 1997, a new application with proof of sale attached must be submitted within 30 days after the date of the purchase.

.06 Revised applications described in sections 4.03 and 4.04 of this revenue procedure must be submitted within 30 days of the change(s) reflected on the revised Form 8633 or in the letter.

.07 Applicants and Electronic Filers described in sections 4.02 through 4.04 of this revenue procedure must file Form 8633 (or a letter as provided in section 4.04 of this revenue procedure) with the Andover Service Center.

.08 Applicants and Electronic Filers described in sections 4.01 through 4.04 of this revenue procedure that intend to participate as a Transmitter or a Software Developer in the Form 1040 ELF Program must first successfully complete the necessary testing at the appropriate service center(s).

.09 Each individual listed as a Principal or a Responsible Official must:

(1) be a United States citizen or an alien lawfully admitted for permanent residence as described in 8 U.S.C. § 1101(a)-(20) (1994);

(2) have attained the age of 21 as of the date of application;

(3) submit with Form 8633 one standard fingerprint card with a full set of fingerprints taken by a law enforcement agency, except as provided in section 4.13 of this revenue procedure;

(4) pass a suitability check that includes a credit check, a tax compliance check, and a fingerprint check; and

(5) meet any applicable state and local licensing and/or bonding requirements in

Form 1040 and 1997 Form 1040A, U.S. Individual Income Tax Return; and (2) 1997 Form 1040EZ, Income Tax Return for Single and Joint Filers With No Dependents. This revenue procedure updates and supersedes Rev. Proc. 96-61, 1996–2 C.B. 401.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 1.6012–5 of the Income Tax Regulations provides that the Commissioner may authorize the use, at the option of a person required to make a return, of a composite return in lieu of any form specified in 26 CFR Part 1 (Income Tax), subject to the conditions, limitations, and special rules governing the preparation, execution, filing, and correction thereof as the Commissioner may deem appropriate.

.02 For purposes of this revenue procedure, an electronically filed Form 1040, Form 1040A, or Form 1040EZ is a composite return consisting of electronically transmitted data and certain paper documents. The paper portion of the return consists of Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing, and other paper documents that cannot be electronically transmitted. Form 8453 must be received by the Service before the composite return is considered filed (see section 5.08 of this revenue procedure). The composite return must contain the same information that a return filed completely on paper contains. See section 7 of this revenue procedure for procedures for completing Form 8453.

.03 The Service will periodically issue Publication 1345, Handbook for Electronic Filers of Individual Income Tax Returns, that lists the forms and schedules associated with the Form 1040 series that can be electronically transmitted.

.04 For the purposes of the Form 1040 ELF Program, a 1997 Form 1040, Form 1040A, or Form 1040EZ cannot be electronically filed after October 15, 1998, notwithstanding the fact that the taxpayer has been granted an extension to file a return beyond that date.

.05 An amended tax return cannot be electronically filed under the Form 1040 ELF Program. A taxpayer must file an amended tax return on paper in accordance with the instructions for Form 1040X, Amended U.S. Individual Income Tax Return.

.06 A tax return that has a foreign address for the taxpayer cannot be electronically filed under the Form 1040 ELF Program. Army/Air Force (APO) and Fleet (FPO) post offices are not considered foreign addresses.

.07 A tax return for a decedent cannot be electronically filed under the Form 1040 ELF Program. The decedent's spouse or personal representative must file a paper tax return for the decedent.

.08 This revenue procedure updates and supersedes Rev. Proc. 96–61, 1996–2 C.B. 401. The updates include changes in the Form 1040 ELF Program, clarification of prior Form 1040 ELF Program statements, and additional guidance derived from other Service documents that relate to the Form 1040 ELF Program. Some of the updates are:

(1) additional fingerprint cards are not required for an application to operate an electronic filing business at a new location (section 4.02(4));

(2) the application period for the Form 1040 ELF Program runs from September 2, 1997, through December 1, 1997 (section 4.05(1));

(3) a proof of sale must be attached to an application from the purchaser of an existing Electronic Filer (section 4.05(2));

(4) all applications for the Form 1040 ELF Program must be sent to the Andover Service Center (sections 4.07 and 5.07);

(5) the definition of Responsible Official is clarified to reflect that a Responsible Official may also be a Principal (section 4.11));

(6) an individual who is an attorney may submit evidence of professional status in lieu of a fingerprint card provided the individual is not currently under suspension or disbarment from practice before the Service or the bar of the highest court of any State, Commonwealth, possession, territory, or the District of Columbia (section 4.13(1));

(7) an individual who is a certified public accountant may submit evidence of professional status in lieu of a fingerprint card provided the individual is not currently under suspension or disbarment from practice before the Service, or whose license to practice is not currently suspended or revoked by any State, Commonwealth, possession, territory, or the District of Columbia (section 4.13(2));

(8) timely notification that an Electronic Filer has discontinued participation in the Form 1040 ELF Program must be sent to the Andover Service Center (section 5.07);

(9) the complete paper copy of the return furnished to the taxpayer need not include the social security number of the paid preparer (section 8.01);

(10) a printout of the electronic portion of the return does not have to be provided to the taxpayer if the taxpayer provided a completed tax return for electronic filing and the information on the electronic portion of the return is identical to the information on the completed tax return (section 8.01); and

(11) the Andover Service Center is the office responsible for accepting or rejecting an application to participate in the Form 1040 ELF Program (sections 14.02 through 14.07).

SECTION 3. ELECTRONIC FILING PARTICIPANTS—DEFINITIONS

.01 After acceptance into the Form 1040 ELF Program, as described in section 4 of this revenue procedure, a participant is referred to as an "Electronic Filer."

.02 The Electronic Filer categories are:

(1) ELECTRONIC RETURN ORIGINATOR. An "Electronic Return Originator" (ERO) is: (a) an "Electronic Return Preparer" who prepares tax returns, including Forms 8453, for taxpayers who intend to have their returns electronically filed; and/or (b) an "Electronic Return Collector" who accepts completed tax returns, including Forms 8453, from taxpayers who intend to have their returns electronically filed.

(2) SERVICE BUREAU. A "Service Bureau" receives tax return information on any media from an ERO, formats the return information, and either forwards the return information to a Transmitter or sends back the return information to the ERO. A Service Bureau may send Forms 8453 to the appropriate service center.

(3) SOFTWARE DEVELOPER. A "Software Developer" develops software for the purposes of (a) formatting returns according to the Service's electronic re-

for those days under section 4.01, 4.02, or 5 of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

.02 In the case of a per diem allowance paid as a reimbursement, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the days of travel substantiated. See § 1.62–2(h)(2)(i)(B)(*2*).

.03 In the case of a per diem allowance paid as an advance, the excess described in section 8.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the days of travel with respect to which the advance was paid are substantiated. See § 1.62–2(h)(2)(i)-(B)(*3*). If some or all of the days of travel with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those days within a reasonable period of time, the portion of the allowance that relates to those days is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

.04 In the case of a per diem allowance only for meal and incidental expenses for travel away from home paid to an employee in the transportation industry by a payor that uses the rule in section 4.04(3) of this revenue procedure, the excess of the per diem allowance paid for the period over the amount deemed substantiated for the period under section 4.02 of this revenue procedure (after applying section 4.04(3) of this revenue procedure), is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62-2(h)(2)(i)(B)(4).

.05 For example, assume that an employer pays an employee a per diem allowance to cover business expenses for meals and lodging for travel away from home at a rate of 120 percent of the Federal per diem rate for the localities to which the employee travels. The employer does not require the employee to return the 20 percent by which the reimbursement for those expenses exceeds the Federal per diem rate. The employee substantiates 6 days of travel away from home: 2 days in a locality in which the Federal per diem rate is $100 and 4 days in a locality in which the Federal per diem rate is $125. The employer reimburses the employee $840 for the 6 days of travel away from home (2 × (120% × $100) +4 × (120% × $125)), and does not require the employee to return the excess payment of $140 ((2 days × $20 ($120–$100) + 4 days x $25 ($150–$125)). For the payroll period in which the employer reimburses the expenses, the employer must withhold and pay employment taxes on $140. See section 8.02 of this revenue procedure.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96–64 is hereby superseded for per diem allowances paid to an employee on or after January 1, 1998, with respect to lodging, meal, and incidental expenses or with respect to meal and incidental expenses paid or incurred for travel while away from home on or after January 1, 1998, and, for purposes of computing the amount allowable as a deduction, for meal and incidental expenses paid or incurred by an employee or self-employed individual for travel while away from home on or after January 1, 1998.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, sections 6012, 6061; 1.6012–5, 1.6061–1)

Rev. Proc. 97–60

CONTENTS

SECTION 1. PURPOSE

This revenue procedure informs those who participate in the Form 1040 Electronic Filing (ELF) Program of their obligations to the Internal Revenue Service, taxpayers, and other participants. The following returns can be filed under the Form 1040 ELF Program: (1) 1997

SECTION 7. APPLICATION

.01 If the amount of travel expenses is deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place, and business purpose of the travel expenses in accordance with paragraphs (b)(2) (travel away from home) and (c) (other than subparagraph (2)(iii)(A) thereof) of § 1.274–5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5T(f) as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5T(c). See § 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.02 An arrangement providing per diem allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) with respect to returning amounts in excess of expenses if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of such an allowance that relates to days of travel not substantiated, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance per diem allowance for meal and incidental expenses of $200, based on an anticipated 5 days of business travel at $40 per day to a locality for which the Federal M&IE rate is $34, and the employee substantiates 3 full days of business travel. The requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) the portion of the allowance that is attributable to the 2 unsubstantiated days of travel ($80), even though the employee is not required to return the portion of the allowance ($18) that exceeds the amount of the employee's expenses deemed substantiated under section 4.02 of this revenue procedure ($102) for the 3 substantiated days of travel. However, the $18 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 7.04 of this revenue procedure.

.03 An employee is not required to include in gross income the portion of a per diem allowance received from a payor that is less than or equal to the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01 of this revenue procedure. See § 1.274–5T(f)(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W–2, and is exempt from the withholding and payment of employment taxes. See § 1.62–2(c)(2) and (c)(4).

.04 An employee is required to include in gross income only the portion of the per diem allowance received from a payor that exceeds the amount deemed substantiated under the rules provided in section 4 or 5 of this revenue procedure if the employee substantiates the business travel expenses covered by the per diem allowance in accordance with section 7.01 of this revenue procedure. See § 1.274–5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See § 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.05 If the amount of the expenses that is deemed substantiated under the rules provided in section 4.01, 4.02, or 5 of this revenue procedure is less than the amount of the employee's business expenses for travel away from home, the employee may claim an itemized deduction for the amount by which the business travel expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business travel expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the per diem allowance received from the payor, and includes in gross income the portion (if any) of the per diem allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274–5T(f)(2)(iii). However, for purposes of claiming this itemized deduction with respect to meal and incidental expenses, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the amount computed under section 4.03 of this revenue procedure minus the amount deemed substantiated under sections 4.02 and 7.01 of this revenue procedure. The itemized deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.06 An employee who does not receive a per diem allowance for meal and incidental expenses may deduct an amount computed pursuant to section 4.03 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n) and the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.07 A self-employed individual may deduct an amount computed pursuant to section 4.03 of this revenue procedure in determining adjusted gross income under § 62(a)(1). This deduction is subject to the appropriate limitation (see section 2.02 of this revenue procedure) on meal and entertainment expenses provided in § 274(n).

.08 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. See § 1.62–2(c)(3), (c)(5), and (h)(2).

SECTION 8. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES.

.01 The portion of a per diem allowance, if any, that relates to the days of business travel substantiated and that exceeds the amount deemed substantiated

method for all amounts paid to that employee for travel away from home within CONUS during the calendar year. However, with respect to that employee, the payor may still reimburse actual expenses or use the meals only per diem method described in section 4.02 of this revenue procedure for any travel away from home, and may use the per diem substantiation method described in section 4.01 of this revenue procedure for any OCONUS travel away from home.

SECTION 6. LIMITATIONS AND SPECIAL RULES

.01 *In general.* The Federal per diem rate and the Federal M&IE rate described in section 3.02 of this revenue procedure for the locality of travel will be applied in the same manner as applied under the Federal Travel Regulations, 41 C.F.R. Part 301–7 (1996), except as provided in sections 6.02 through 6.04 of this revenue procedure.

.02 *Federal per diem rate.* A receipt for lodging expenses is not required in determining the amount of expenses deemed substantiated under section 4.01 or 5.01 of this revenue procedure. See section 7.01 of this revenue procedure for the requirement that the employee substantiate the time, place, and business purpose of the expense.

.03 *Federal per diem or M&IE rate.* A payor is not required to reduce the Federal per diem rate or the Federal M&IE rate for the locality of travel for meals provided in kind, provided the payor has a reasonable belief that meal and incidental expenses were or will be incurred by the employee.

.04 *Proration of the Federal per diem or M&IE rate.* Pursuant to the Federal Travel Regulations, in determining the Federal per diem rate or the Federal M&IE rate for the locality of travel, the full applicable Federal M&IE rate is available for a full day of travel from 12:01 a.m. to 12:00 midnight. For purposes of determining the amount deemed substantiated under section 4 or 5 of this revenue procedure with respect to partial days of travel away from home, either of the following methods may be used to prorate the Federal M&IE rate to determine the Federal per diem rate or the Federal M&IE rate for the partial days of travel:

(1) Such rate may be prorated using the method prescribed by the Federal Travel Regulations. Currently the Federal Travel Regulations allow three-fourths of the applicable Federal M&IE rate for each partial day during which the employee or self-employed individual is traveling away from home in connection with the performance of services as an employee or self-employed individual; or

(2) Such rate may be prorated using any method that is consistently applied and in accordance with reasonable business practice. For example, if an employee travels away from home from 9 a.m. one day to 5 p.m. the next day, a method of proration that results in an amount equal to 2 times the Federal M&IE rate will be treated as being in accordance with reasonable business practice (even though only 1 1/2 times the Federal M&IE rate would be allowed under the Federal Travel Regulations).

.05 *Application of the appropriate § 274(n) limitation on meal expenses.* All or part of the amount of an expense deemed substantiated under this revenue procedure is subject to the appropriate limitation under § 274(n) (see section 2.02 of this revenue procedure) on the deductibility of food and beverage expenses.

(1) When an amount for meal and incidental expenses is computed pursuant to section 4.03 of this revenue procedure, the taxpayer must treat such amount as an expense for food and beverages.

(2) When a per diem allowance is paid only for meal and incidental expenses, the payor must treat an amount equal to the lesser of the allowance or the Federal M&IE rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure) as an expense for food and beverages.

(3) When a per diem allowance is paid for lodging, meal, and incidental expenses, the payor must treat an amount equal to the Federal M&IE rate for the locality of travel for each calendar day (or partial day, see section 6.04 of this revenue procedure) the employee is away from home as an expense for food and beverages. For purposes of the preceding sentence, when a per diem allowance for lodging, meal, and incidental expenses is paid at a rate that is less than the Federal per diem rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure), the payor may treat an amount equal to 40 percent of such allowance as the Federal M&IE rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure).

.06 *No double reimbursement or deduction.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses or for meal and incidental expenses in accordance with section 4 or 5 of this revenue procedure, any additional payment with respect to such expenses is treated as paid under a nonaccountable plan, is included in the employee's gross income, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. Similarly, if an employee or self-employed individual computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 or 4.04 of this revenue procedure, no other deduction is allowed to the employee or self-employed individual with respect to such expenses. For example, assume an employee receives a per diem allowance from a payor for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home. During that trip, the employee pays for dinner for the employee and two business associates. The payor reimburses as a business entertainment meal expense the meal expense for the employee and the two business associates. Because the payor also pays a per diem allowance to cover the cost of the employee's meals, the amount paid by the payor for the employee's portion of the business entertainment meal expense is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes.

.07 *Related parties.* Sections 4.01, 4.02, 4.04 (to the extent it relates to section 4.02), and 5 of this revenue procedure will not apply in any case in which a payor and an employee are related within the meaning of § 267(b), but for this purpose the percentage of ownership interest referred to in § 267(b)(2) shall be 10 percent.

Key city	County and other defined location
New Hampshire	
Hanover (June 1-October 31)	Grafton and Sullivan
New Jersey	
Ocean City/Cape May (May 15-September 30)	Cape May
Parsippany/Dover	Morris; Picatinny Arsenal
New Mexico	
Santa Fe (May 1-October 31)	Santa Fe
New York	
New York City	The boroughs of Bronx, Brooklyn, Manhattan, Queens, and Staten Island; Nassau and Suffolk Counties
Tarrytown/White Plains	Westchester
North Carolina	
Kill Devil/Duck/ Outer Banks (May 1-September 30)	Dare
Pennsylvania	
Philadelphia	Philadelphia; city of Bala Cynwyd in Montgomery County
Rhode Island	
Newport/Block Island (May 1-October 14)	Newport and Washington
South Carolina	
Hilton Head (March 1-September 30)	Beaufort
Myrtle Beach (May 1-September 30)	Horry; Myrtle Beach Air Force Base
Utah	
Park City (December 1-March 31)	Summit
Virginia	
(For the cities of Alexandria, Fairfax, and Falls Church, and the counties of Arlington, Fairfax, and Loudoun, see District of Columbia)	
Washington	
Friday Harbor (June 1-October 31)	San Juan
Seattle	King
Wyoming	
Jackson (June 1-October 14)	Teton

.04 *Changes in high-cost localities.* The list of high-cost localities in section 5.03 of this revenue procedure differs from the list of high-cost localities in section 5.03 of Rev. Proc. 96-64. The following localities have been added to the list of high-cost localities: Napa, California; Lewes, Delaware; Naples, Florida; Baltimore, Maryland; Hanover, New Hampshire; Parsippany/Dover, New Jersey; Tarrytown, New York; Kill Devil, North Carolina; Hilton Head, South Carolina; Myrtle Beach, South Carolina; Friday Harbor, Washington; and Seattle, Washington. The portion of the year for which the following are high-cost localities has been changed: Aspen, Colorado; Key West, Florida; Saint Michaels, Maryland; Martha's Vineyard, Massachusetts; Nantucket, Massachusetts; and Incline Village, Nevada. The following localities have been removed from the list of high-cost localities: Phoenix/Scottsdale, Arizona; South Lake Tahoe, California; Yosemite National Park, California; Steamboat Springs, Colorado; Hyannis, Massachusetts; Leland, Michigan; Mackinac Island, Michigan; Stateline, Nevada; Atlantic City, New Jersey; Sandusky, Ohio; Chester/Radnor, Pennsylvania; Bullfrog, Utah; Virginia Beach, Virginia; Wintergreen, Virginia; and Wisconsin Dells, Wisconsin.

.05 *Specific limitation.* A payor that uses the high-low substantiation method with respect to an employee must use that

Key city	County and other defined location
Arizona	
Grand Canyon	All points in the Grand Canyon National Park and Kaibab National Forest within Coconino County
California	
Los Angeles	Los Angeles, Kern, Orange, and Ventura Counties; Edwards Air Force Base, Naval Weapons Center and Ordnance Test Station, China Lake
Napa (April 1-October 31)	Napa
Palo Alto/San Jose	Santa Clara
Point Arena/Gualala	Mendocino
San Francisco	San Francisco
Colorado	
Aspen	Pitkin
Keystone/Silverthorne	Summit
Telluride	San Miquel
Vail (November 1-March 31)	Eagle
Delaware	
Lewes (June 1-September 14)	Sussex
District of Columbia	
Washington, D.C.	Washington, D.C.; the cities of Alexandria, Falls Church, and Fairfax, and the counties of Arlington, Loudoun, and Fairfax in Virginia; and the counties of Montgomery and Prince George's in Maryland
Florida	
Key West (December 15-April 30)	Monroe
Naples December 15-April 30)	Collier
Illinois	
Chicago	Du Page, Cook, and Lake
Indiana	
Nashville (June 1-October 31)	Brown
Maine	
Bar Harbor (July 1-September 14)	Hancock
Maryland	
(For the counties of Montgomery and Prince George's, see District of Columbia)	
Baltimore	Baltimore and Harford
Ocean City (May 1-September 30)	Worcester
Saint Michaels (April 1-November 30)	Talbot
Maryland—Continued	
Massachusetts	
Boston	Suffolk
Cambridge/Lowell	Middlesex
Martha's Vineyard (June 1-October 31)	Dukes
Nantucket (June 1-October 31)	Nantucket
Nevada	
Incline Village (June 1-September 30)	All points in the Northern Lake Tahoe area within Washoe County

for travel away from home, may use an amount computed at the Federal M&IE rate for the locality of travel for each calendar day (or partial day, see section 6.04 of this revenue procedure) the employee or self-employed individual is away from home. Such amount will be deemed substantiated for purposes of paragraphs (b)(2) (travel away from home) and (c) of § 1.274–5T, provided the employee or self-employed individual substantiates the elements of time, place, and business purpose of the travel expenses in accordance with those regulations.

.04 *Special rules for transportation industry.*

(1) *In general.* This section 4.04 applies to (a) a payor that pays a per diem allowance only for meal and incidental expenses for travel away from home as described in section 4.02 of this revenue procedure to an employee in the transportation industry, or (b) an employee or self-employed individual in the transportation industry who computes the amount allowable as a deduction for meal and incidental expenses for travel away from home in accordance with section 4.03 of this revenue procedure.

(2) *Rates.* A taxpayer described in section 4.04(1) of this revenue procedure may treat $36 as the Federal M&IE rate for any locality of travel in CONUS, and/or $40 as the Federal M&IE rate for any locality of travel OCONUS. A payor that uses either (or both) of these special rates with respect to an employee must use the special rate(s) for all amounts subject to section 4.02 of this revenue procedure paid to that employee for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year. Similarly, an employee or self-employed individual that uses either (or both) of these special rates must use the special rate(s) for all amounts computed pursuant to section 4.03 of this revenue procedure for travel away from home within CONUS and/or OCONUS, as the case may be, during the calendar year.

(3) Periodic rule. A payor described in section 4.04(1) of this revenue procedure may compute the amount of the employee's expenses that is deemed substantiated under section 4.02 of this revenue procedure periodically (not less frequently than monthly), rather than daily, by comparing the total per diem allowance paid for the period to the sum of the amounts computed at the Federal M&IE rate(s) for the localities of travel for the days (or partial days, see section 6.04 of this revenue procedure) the employee is away from home during the period. For example, assume an employee in the transportation industry travels away from home within CONUS on 17 days (including partial days, see section 6.04 of this revenue procedure) during a calendar month and receives a per diem allowance only for meal and incidental expenses from a payor that uses the special rule under section 4.04(2) of this revenue procedure. The amount deemed substantiated under section 4.02 of this revenue procedure is equal to the lesser of the total per diem allowance paid for the month or $612 (17 days at $36 per day).

(4) *Transportation industry defined.* For purposes of this section 4.04 of this revenue procedure, an employee or self-employed individual is "in the transportation industry" only if the employee's or individual's work (a) is of the type that directly involves moving people or goods by airplane, barge, bus, ship, train, or truck, and (b) regularly requires travel away from home which, during any single trip away from home, usually involves travel to localities with differing Federal M&IE rates. For purposes of the preceding sentence, a payor must determine that an employee or a group of employees is "in the transportation industry" by using a method that is consistently applied and in accordance with reasonable business practice.

SECTION 5. HIGH-LOW SUBSTANTIATION METHOD

.01 *General rule.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home and the payor uses the high-low substantiation method described in this section 5 for travel within CONUS, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the rate set forth in section 5.02 of this revenue procedure for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure). This high-low substantiation method may be used in lieu of the per diem substantiation method provided in section 4.01 of this revenue procedure, but may not be used in lieu of the meals only substantiation method provided in section 4.02 or 4.03 of this revenue procedure.

.02 *Specific high-low rates.* The per diem rate set forth in this section 5.02 is $180 for travel to any "high-cost locality" specified in section 5.03 of this revenue procedure, or $113 for travel to any other locality within CONUS. Whichever per diem rate applies, it is applied as if it were the Federal per diem rate for the locality of travel. For purposes of applying the high-low substantiation method, the Federal M&IE rate shall be treated as $40 for a high-cost locality and $32 for any other locality within CONUS.

.03 *High-cost localities.* The following localities have a Federal per diem rate of $147 or more for all or part of the calendar year, and are high-cost localities for all of the calendar year or the portion of the calendar year specified in parenthesis under the key city name:

eral Travel Regulations by 61 Fed. Reg. 68,158 (1996) (to be codified at 41 C.F.R. § 301–7.8) (section 6.04); and

(3) modification of the limitation on the deduction of meal expenses to reflect an amendment to § 274(n) (as described in section 2.02 of this revenue procedure) (sections 6.05 and 7).

SECTION 3. DEFINITIONS

.01 *Per diem allowance.* The term "per diem allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62–2(c)(1) and that is

(1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and incidental expenses or for meal and incidental expenses for travel away from home in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at or below the applicable Federal per diem rate, a flat rate or stated schedule, or in accordance with any other Service-specified rate or schedule.

.02 *Federal per diem rate.*

(1) *General rule.* The Federal per diem rate is equal to the sum of the Federal lodging expense rate and the Federal meal and incidental expense (M&IE) rate for the locality of travel. Each of these rates for a particular locality in the continental United States ("CONUS") is set forth in Appendix A of 41 C.F.R., Chapter 301, as amended. See 41 C.F.R. Part 301–7 (1996), as amended, for specific rules regarding these Federal rates. Each of these rates is established by the Secretary of Defense for a particular nonforeign locality outside the continental United States ("OCONUS") (including Alaska, Hawaii, Puerto Rico, the Northern Mariana Islands, and the possessions of the United States), and by the Secretary of State for a particular foreign OCONUS locality. Each of these OCONUS rates is published in the Per Diem Supplement to the Standardized Regulations (Government Civilians, Foreign Areas). See, *e.g.*, Maximum Travel Per Diem Allowances for Foreign Areas, PD Supplement 382, issued March 1, 1996.

(2) *Locality of travel.* The term "locality of travel" means the locality where an employee traveling away from home in connection with the performance of services as an employee of the employer stops for sleep or rest.

(3) *Incidental expenses.* The term "incidental expenses" includes, but is not limited to, expenses for laundry, cleaning and pressing of clothing, and fees and tips for services, such as for porters and baggage carriers. The term "incidental expenses" does not include taxicab fares or the costs of telegrams or telephone calls.

.03 *Flat rate or stated schedule.*

(1) *In general.* Except as provided in section 3.03(2) of this revenue procedure, an allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 3.01 of this revenue procedure. Such allowance may be paid with respect to the number of days away from home in connection with the performance of services as an employee or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, an hourly payment to cover meal and incidental expenses paid to a pilot or flight attendant who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule. Likewise, a payment based on the number of miles traveled (*e.g.*, cents per mile) to cover meal and incidental expenses paid to an over-the-road truck driver who is traveling away from home in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

(2) *Limitation.* For purposes of this revenue procedure, an allowance that is computed on a basis similar to that used in computing the employee's wages or other compensation (*e.g.*, the number of hours worked, miles traveled, or pieces produced) does not meet the business connection requirement of § 1.62–2(d), is not a per diem allowance, and is not paid at a flat rate or stated schedule, unless, as of December 12, 1989, (a) the allowance was identified by the payor either by making a separate payment or by specifically identifying the amount of the allowance, or (b) an allowance computed on that basis was commonly used in the industry in which the employee is employed. See § 1.62–2(d)(3)(ii).

SECTION 4. PER DIEM SUBSTANTIATION METHOD

.01 *Per diem allowance.* If a payor pays a per diem allowance in lieu of reimbursing actual expenses for lodging, meal, and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal per diem rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure).

.02 *Meals only per diem allowance.* If a payor pays a per diem allowance only for meal and incidental expenses in lieu of reimbursing actual expenses for meal and incidental expenses incurred or to be incurred by an employee for travel away from home, the amount of the expenses that is deemed substantiated for each calendar day is equal to the lesser of the per diem allowance for such day or the amount computed at the Federal M&IE rate for the locality of travel for such day (or partial day, see section 6.04 of this revenue procedure). A per diem allowance is treated as paid only for meal and incidental expenses if (1) the payor pays the employee for actual expenses for lodging based on receipts submitted to the payor, (2) the payor provides the lodging in kind, (3) the payor pays the actual expenses for lodging directly to the provider of the lodging, (4) the payor does not have a reasonable belief that lodging expenses were or will be incurred by the employee, or (5) the allowance is computed on a basis similar to that used in computing the employee's wages or other compensation (*e.g.*, the number of hours worked, miles traveled, or pieces produced).

.03 *Optional method for meals only deduction.* In lieu of using actual expenses, employees and self-employed individuals, in computing the amount allowable as a deduction for ordinary and necessary meal and incidental expenses paid or incurred

which the amount of an employee's lodging expenses will be deemed substantiated when a payor provides an allowance to pay for those expenses but not meal and incidental expenses.

SECTION 2. BACKGROUND AND CHANGES

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct expenses paid or incurred while traveling away from home in pursuit of a trade or business. However, under § 262, no portion of such travel expenses that is attributable to personal, living, or family expenses is deductible.

.02 Section 274(n) generally limits the amount allowable as a deduction under § 162 for any expense for food, beverages, or entertainment to 50 percent of the amount of the expense that otherwise would be allowable as a deduction. In the case of any expenses for food or beverages consumed while away from home (within the meaning of § 162(a)(2)) by an individual during, or incident to, the period of duty subject to the hours of services limitations of the Department of Transportation, § 274(n)(3), as added by § 969 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788 (August 5, 1997), gradually increases the deductible percentage to 80 percent for taxable years beginning in 2008. For taxable years beginning in 1998, the deductible percentage for these expenses is 55 percent.

.03 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 for any traveling expense (including meals and lodging while away from home) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.04 Section 1.274(d)–1(a) of the regulations, in part, grants the Commissioner the authority to prescribe rules relating to reimbursement arrangements or per diem allowances for ordinary and necessary expenses paid or incurred while traveling away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such arrangements or allowances, if in accordance with reasonable business practice, will be regarded (1) as equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel expenses for purposes of § 1.274–5T(c), and (2) as satisfying the requirements of an adequate accounting to the employer of the amount of such travel expenses for purposes of § 1.274–5T(f).

.05 For purposes of determining adjusted gross income, § 62(a)(2)(A) allows an employee a deduction for expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.06 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.07 Under § 1.62–2(c)(1) a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62–2(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)–1(a) or 1.274–5T(j) will be treated as substantiation of the amount of such expenses for purposes of § 1.62–2. Under § 1.62–2(f)(2), the Commissioner may prescribe rules under which an arrangement providing per diem allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to days of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to days of travel not substantiated.

.08 Section 1.62–2(h)(2)(i)(B) provides that if a payor pays a per diem allowance that meets the requirements of § 1.62–2(c)(1), the portion, if any, of the allowance that relates to days of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under § 274(d) and § 1.274(d)–1(a) or § 1.274–5T(j), and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–1(a)(5), 31.3306(b)–2, and 31.3401(a)–4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this portion.

.09 Under § 1.62–2(h)(2)(i)(B)(*4*), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on per diem allowances.

.10 Section 1.274–5T(j) grants the Commissioner the authority to establish a method under which a taxpayer may elect to use a specified amount for meals paid or incurred while traveling away from home in lieu of substantiating the actual cost of meals.

.11 Significant changes to this revenue procedure include:

(1) revisions to the list of high-cost localities and high-low rates for purposes of the high-low substantiation method (section 5);

(2) modification of how to prorate the Federal M&IE rate for partial days of travel to reflect an amendment to the Fed-

treated as made under a nonaccountable plan. Thus, such payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes. See §§ 1.62–2(c)(3), (c)(5), and (h)(2).

SECTION 10. WITHHOLDING AND PAYMENT OF EMPLOYMENT TAXES

.01 The portion of a mileage allowance (other than a FAVR allowance), if any, that relates to the miles of business travel substantiated and that exceeds the amount deemed substantiated for those miles under section 9.01(1) of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62–2(h)(2)(i)(B).

(1) In the case of a mileage allowance paid as a reimbursement, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes in the payroll period in which the payor reimburses the expenses for the business miles substantiated. See § 1.62–2(h)(2)(i)(B)(*2*).

(2) In the case of a mileage allowance paid as an advance, the excess described in section 10.01 of this revenue procedure is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the business miles with respect to which the advance was paid are substantiated. See § 1.62–2(h)(2)-(i)(B)(*3*). If some or all of the business miles with respect to which the advance was paid are not substantiated within a reasonable period of time and the employee does not return the portion of the allowance that relates to those miles within a reasonable period of time, the portion of the allowance that relates to those miles is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)(2)(i)(A).

(3) In the case of a mileage allowance that is not computed on the basis of a fixed amount per mile of travel (e.g., a mileage allowance that combines periodic fixed and variable rate payments, but that does not satisfy the requirements of section 8 of this revenue procedure), the payor must compute periodically (no less frequently than quarterly) the amount, if any, that exceeds the amount deemed substantiated under section 9.01(1) of this revenue procedure by comparing the total mileage allowance paid for the period to the applicable standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee for the period. Any excess is subject to withholding and payment of employment taxes no later than the first payroll period following the payroll period in which the excess is computed. See § 1.62–2(h)(2)(i)(B)(*4*).

(4) For example, assume an employer pays its employees a mileage allowance at a rate of 35 cents per mile (when the business standard mileage rate is 32.5 cents per mile). The employer does not require the return of the portion of the allowance (2.5 cents) that exceeds the business standard mileage rate for the business miles substantiated. In June, the employer advances an employee $175 for 500 miles to be traveled during the month. In July, the employee substantiates to the employer 400 business miles traveled in June and returns $35 to the employer for the 100 business miles not traveled. The amount deemed substantiated for the 400 miles traveled is $130 and the employee is not required to return the remaining $10. No later than the first payroll period following the payroll period in which the 400 business miles traveled are substantiated, the employer must withhold and pay employment taxes on $10.

.02 The portion of a FAVR allowance, if any, that exceeds the amount deemed substantiated for those miles under section 9.01(2) of this revenue procedure is subject to withholding and payment of employment taxes. See § 1.62–2(h)-(2)(i)(B).

(1) Any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return within a reasonable period, or any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return within a reasonable period, is subject to withholding and payment of employment taxes no later than the first payroll period following the end of the reasonable period. See § 1.62–2(h)-(2)(i)(A).

(2) Any optional high mileage payment is subject to withholding and payment of employment taxes when paid.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 96-63, 1996–2 C.B. 420, is hereby superseded for mileage allowances paid to an employee on or after January 1, 1998, with respect to transportation expenses paid or incurred on or after January 1, 1998, and, for purposes of computing the amount allowable as a deduction, for transportation expenses paid or incurred on or after January 1, 1998.

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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 I, §§ 62, 162, 267, 274; 1.62–2, 1.162–17, 1.267(a)–1, 1.274–5T, 1.274(d)–1)

Rev. Proc. 97–59

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 96-64, 1996–2 C.B. 427, by providing rules under which the amount of ordinary and necessary business expenses of an employee for lodging, meal, and incidental expenses or for meal and incidental expenses incurred while traveling away from home will be deemed substantiated under § 1.274–5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a per diem allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. This revenue procedure also provides an optional method for employees and self-employed individuals to use in computing the deductible costs of business meal and incidental expenses paid or incurred while traveling away from home. Use of a method described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation. This revenue procedure does not provide rules under

rules provided in section 9.01 of this revenue procedure, and the employee actually substantiates to the payor the elements of time, place (or use), and business purpose of the transportation expenses in accordance with paragraphs (b)(2) (travel away from home), (b)(6) (listed property, which includes passenger automobiles and any other property used as a means of transportation), and (c) of § 1.274–5T, the employee is deemed to satisfy the adequate accounting requirements of § 1.274–5T(f), as well as the requirement to substantiate by adequate records or other sufficient evidence for purposes of § 1.274–5T(c). See § 1.62–2(e)(1) for the rule that an arrangement must require business expenses to be substantiated to the payor within a reasonable period of time.

.03 An arrangement providing mileage allowances will be treated as satisfying the requirement of § 1.62–2(f)(2) with respect to returning amounts in excess of expenses as follows:

(1) For a mileage allowance other than a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)) any portion of such an allowance that relates to miles of travel not substantiated by the employee, even though the arrangement does not require the employee to return the portion of such an allowance that relates to the miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated. For example, assume a payor provides an employee an advance mileage allowance of $70 based on an anticipated 200 business miles at 35 cents per mile (at a time when the applicable business standard mileage rate is 32.5 cents per mile), and the employee substantiates 120 business miles. The requirement to return excess amounts will be treated as satisfied if the employee is required to return the portion of the allowance that relates to the 80 unsubstantiated business miles ($28) even though the employee is not required to return the portion of the allowance ($3) that exceeds the amount of the employee's expenses deemed substantiated under section 9.01 of this revenue procedure ($39) for the 120 substantiated business miles. However, the $3 excess portion of the allowance is treated as paid under a nonaccountable plan as discussed in section 9.05.

(2) For a FAVR allowance, the requirement to return excess amounts will be treated as satisfied if the employee is required to return within a reasonable period of time (as defined in § 1.62–2(g)), (a) the portion (if any) of the periodic variable payment received that relates to miles in excess of the business miles substantiated by the employee, and (b) the portion (if any) of a periodic fixed payment that relates to a period during which the employee was not covered by the FAVR allowance.

.04 An employee is not required to include in gross income the portion of a mileage allowance received from a payor that is less than or equal to the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02. See § 1.274–5T(f)-(2)(i). In addition, such portion of the allowance is treated as paid under an accountable plan, is not reported as wages or other compensation on the employee's Form W-2, and is exempt from the withholding and payment of employment taxes. See §§ 1.62–2(c)(2) and (c)(4).

.05 An employee is required to include in gross income only the portion of a mileage allowance received from a payor that exceeds the amount deemed substantiated under section 9.01 of this revenue procedure, provided the employee substantiates in accordance with section 9.02 of this revenue procedure. See § 1.274–5T(f)(2)(ii). In addition, the excess portion of the allowance is treated as paid under a nonaccountable plan, is reported as wages or other compensation on the employee's Form W-2, and is subject to withholding and payment of employment taxes. See §§ 1.62–2(c)(3)(ii), (c)(5), and (h)(2)(i)(B).

.06

(1) Except as otherwise provided in section 9.06(2) of this revenue procedure with respect to leased automobiles, if the amount of the expenses deemed substantiated under the rules provided in section 9.01 of this revenue procedure is less than the amount of the employee's business transportation expenses, the employee may claim an itemized deduction for the amount by which the business transportation expenses exceed the amount that is deemed substantiated, provided the employee substantiates all the business transportation expenses, includes on Form 2106, Employee Business Expenses, the deemed substantiated portion of the mileage allowance received from the payor, and includes in gross income the portion (if any) of the mileage allowance received from the payor that exceeds the amount deemed substantiated. See § 1.274–5T(f)(2)(iii). However, for purposes of claiming this itemized deduction, substantiation of the amount of the expenses is not required if the employee is claiming a deduction that is equal to or less than the applicable standard mileage rate multiplied by the number of business miles substantiated by the employee minus the amount deemed substantiated under section 9.01 of this revenue procedure. The itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

(2) An employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(1) of this revenue procedure (relating to an allowance other than a FAVR allowance) may not claim a deduction based on actual expenses unless the employee does so consistently beginning with the first business use of the automobile after December 31, 1997. However, an employee whose business transportation expenses with respect to a leased automobile are deemed substantiated under section 9.01(2) of this revenue procedure (relating to a FAVR allowance) may not claim a deduction based on actual expenses.

.07 An employee may deduct an amount computed pursuant to section 5.01 of this revenue procedure only as an itemized deduction. This itemized deduction is subject to the 2-percent floor on miscellaneous itemized deductions provided in § 67.

.08 A self-employed individual may deduct an amount computed pursuant to section 5.01 of this revenue procedure in determining adjusted gross income under § 62(a)(1).

.09 If a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments under the arrangement will be

port the depreciation component of a periodic fixed payment to the employee.

.05 *FAVR allowance limitations.*

(1) A FAVR allowance may be paid only to an employee who substantiates to the payor for a calendar year at least 5,000 miles driven in connection with the performance of services as an employee of the employer or, if greater, 80 percent of the annual business mileage of that FAVR allowance. If the employee is covered by the FAVR allowance for less than the entire calendar year, these limits may be prorated on a monthly basis.

(2) A FAVR allowance may not be paid to a control employee (as defined in § 1.61–21(f)(5) and (6), excluding the $100,000 limitation in paragraph (f)(5)(iii)).

(3) At no time during a calendar year may a majority of the employees covered by a FAVR allowance be management employees.

(4) At all times during a calendar year at least 10 employees of an employer must be covered by one or more FAVR allowances.

(5) A FAVR allowance may be paid only with respect to an automobile (a) owned or leased by the employee receiving the payment, (b) the cost of which, when new, is at least 90 percent of the standard automobile cost taken into account for purposes of determining the FAVR allowance for the first calendar year the employee receives the allowance with respect to that automobile, and (c) the model year of which does not differ from the current calendar year by more than the number of years in the retention period.

(6) A FAVR allowance may not be paid with respect to an automobile leased by an employee for which the employee has used actual expenses to compute the deductible business expenses of the automobile for any year during the entire lease period. For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(7) The insurance cost component of a FAVR allowance must be based on the rates charged in the base locality for insurance coverage on the standard automobile during the current calendar year without taking into account such rate-increasing factors as poor driving records or young drivers.

(8) A FAVR allowance may be paid only to an employee whose insurance coverage limits on the automobile with respect to which the FAVR allowance is paid are at least equal to the insurance coverage limits used to compute the periodic fixed payment under that FAVR allowance.

.06 *Employee reporting.* Within 30 days after an employee's automobile is initially covered by a FAVR allowance, or is again covered by a FAVR allowance if such coverage has lapsed, the employee by written declaration must provide the payor with the following information: (a) the make, model, and year of the employee's automobile, (b) written proof of the insurance coverage limits on the automobile, (c) the odometer reading of the automobile, (d) if owned, the purchase price of the automobile or, if leased, the price at which the automobile is ordinarily sold by retailers (the gross capitalized cost of the automobile), and (e) if owned, whether the employee has claimed depreciation with respect to the automobile using any of the depreciation methods prohibited by section 8.04(1) of this revenue procedure or, if leased, whether the employee has computed deductible business expenses with respect to the automobile using actual expenses. The information described in (a), (b), and (c) of the preceding sentence also must be supplied by the employee to the payor within 30 days after the beginning of each calendar year that the employee's automobile is covered by a FAVR allowance.

.07 *Payor recordkeeping and reporting.*

(1) The payor or its agent must maintain written records setting forth (a) the statistical data and projections on which the FAVR allowance payments are based, and (b) the information provided by the employees pursuant to section 8.06 of this revenue procedure.

(2) Within 30 days of the end of each calendar year, the employer must provide each employee covered by a FAVR allowance during that year with a statement that, for automobile owners, lists the amount of depreciation included in each periodic fixed payment portion of the FAVR allowance paid during that calendar year and explains that by receiving a FAVR allowance the employee has elected to exclude the automobile from MACRS pursuant to § 168(f)(1). For automobile lessees, the statement must explain that by receiving the FAVR allowance the employee may not compute the deductible business expenses of the automobile using actual expenses for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

.08 *Failure to meet section 8 requirements.* If an employee receives a mileage allowance that fails to meet one or more of the requirements of section 8 of this revenue procedure, the employee may not be treated as covered by any FAVR allowance of the payor during the period of such failure. Nevertheless, the expenses to which that mileage allowance relates may be deemed substantiated using the method described in sections 5, 9.01(1), and 9.02 of this revenue procedure to the extent the requirements of those sections are met.

SECTION 9. APPLICATION

.01 If a payor pays a mileage allowance in lieu of reimbursing actual transportation expenses incurred or to be incurred by an employee, the amount of the expenses that is deemed substantiated to the payor is either:

(1) for any mileage allowance other than a FAVR allowance, the lesser of the amount paid under the mileage allowance or the applicable standard mileage rate in section 5.01 of this revenue procedure multiplied by the number of business miles substantiated by the employee; or

(2) for a FAVR allowance, the amount paid under the FAVR allowance less the sum of (a) any periodic variable rate payment that relates to miles in excess of the business miles substantiated by the employee and that the employee fails to return to the payor although required to do so, (b) any portion of a periodic fixed payment that relates to a period during which the employee is treated as not covered by the FAVR allowance and that the employee fails to return to the payor although required to do so, and (c) any optional high mileage payments.

.02 If the amount of transportation expenses is deemed substantiated under the

the geographic locality or region in which the employee resides. For purposes of determining the amount of operating costs, the base locality is generally the geographic locality or region in which the employee drives the automobile in connection with the performance of services as an employee of the employer.

(5) *Standard automobile.* A standard automobile is the automobile selected by the payor on which a specific FAVR allowance is based.

(6) *Standard automobile cost.* The standard automobile cost for a calendar year may not exceed 95 percent of the sum of (a) the retail dealer invoice cost of the standard automobile in the base locality, and (b) state and local sales or use taxes applicable on the purchase of such an automobile. Further, the standard automobile cost may not exceed $27,100.

(7) *Annual mileage.* Annual mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a calendar year. Annual mileage equals the annual business mileage divided by the business use percentage.

(8) *Annual business mileage.* Annual business mileage is the mileage a payor reasonably projects a standard automobile will be driven by an employee in connection with the performance of services as an employee of the employer during the calendar year, but may not be less than 6,250 miles for a calendar year. Annual business mileage equals the annual mileage multiplied by the business use percentage.

(9) *Business use percentage.* A business use percentage is determined by dividing the annual business mileage by the annual mileage. The business use percentage may not exceed 75 percent. In lieu of demonstrating the reasonableness of the business use percentage based on records of total mileage and business mileage driven by the employees annually, a payor may use a business use percentage that is less than or equal to the following percentages for a FAVR allowance that is paid for the following annual business mileage:

Annual business mileage	Business use percentage
6,250 or more but less than 10,000	45 percent
10,000 or more but less than 15,000	55 percent
15,000 or more but less than 20,000	65 percent
20,000 or more	75 percent

(10) *Retention period.* A retention period is the period in calendar years selected by the payor during which the payor expects an employee to drive a standard automobile in connection with the performance of services as an employee of the employer before the automobile is replaced. Such period may not be less than two calendar years.

(11) *Retention mileage.* Retention mileage is the annual mileage multiplied by the number of calendar years in the retention period.

(12) *Residual value.* The residual value of a standard automobile is the projected amount for which it could be sold at the end of the retention period after being driven the retention mileage. The Service will accept the following safe harbor residual values for a standard automobile computed as a percentage of the standard automobile cost:

Retention period	Residual value
2-year	70 percent
3-year	60 percent
4-year	50 percent

.03 *FAVR allowance in lieu of operating and fixed costs.*

(1) A reimbursement computed using a FAVR allowance is in lieu of the employee's deduction of all the operating and fixed costs paid or incurred by an employee in driving the automobile in connection with the performance of services as an employee of the employer, except as provided in section 9.06 of this revenue procedure. Such items as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, license and registration fees, and personal property taxes are included in operating and fixed costs for this purpose.

(2) Parking fees and tolls attributable to an employee driving the standard automobile in connection with the performance of services as an employee of the employer are not included in fixed and operating costs and may be deducted as separate items. Similarly, interest relating to the purchase of the standard automobile may be deducted as a separate item, but only to the extent that the interest is an allowable deduction under § 163.

.04 *Depreciation.*

(1) A FAVR allowance may not be paid with respect to an automobile for which the employee has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, or (c) used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. If an employee uses actual costs for an owned automobile that has been covered by a FAVR allowance, the employee must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(2) The total amount of the depreciation component for the retention period taken into account in computing the periodic fixed payments for that retention period may not exceed the excess of the standard automobile cost over the residual value of the standard automobile. In addition, the total amount of such depreciation component may not exceed the sum of the annual § 280F limitations on depreciation (in effect at the beginning of the retention period) that apply to the standard automobile during the retention period.

(3) The depreciation included in each periodic fixed payment portion of a FAVR allowance paid with respect to an automobile will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016. See section 8.07(2) of this revenue procedure for the requirement that the employer re-

§ 162(o), as amended by § 1203 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788 (August 5, 1997) for the rules that apply to these qualified reimbursements.

SECTION 6. RESERVED

SECTION 7. CHARITABLE, MEDICAL, AND MOVING STANDARD MILEAGE RATE

.01 *Charitable.* Section 170(i), as amended by § 973 of the Taxpayer Relief Act of 1997, provides a standard mileage rate of 14 cents per mile for purposes of computing the charitable deduction for use of an automobile in connection with rendering gratuitous services to a charitable organization under § 170, for taxable years beginning after December 31, 1997.

.02 *Medical and moving.* The standard mileage rate is 10 cents per mile for use of an automobile (a) to obtain medical care described in § 213, or (b) as part of a move for which the expenses are deductible under § 217. The standard mileage rates for medical and moving transportation expenses will be adjusted annually (to the extent warranted) by the Service, and any such adjustment will be applied prospectively.

.03 *Charitable, medical, or moving expense standard mileage rate in lieu of operating expenses.* A deduction computed using the applicable standard mileage rate for charitable, medical, or moving expense miles is in lieu of all operating expenses (including gasoline and oil) of the automobile allocable to such purposes. Costs for such items as depreciation (or lease payments), maintenance and repairs, tires, insurance, and license and registration fees are not deductible, and are not included in such standard mileage rates.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to the use of the automobile for charitable, medical, or moving expense purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local taxes (other than those included in the cost of gasoline) may be deducted as separate items, but only to the extent that the interest and taxes are allowable deductions under § 163 or 164, respectively.

SECTION 8. FIXED AND VARIABLE RATE ALLOWANCE

.01 *In general.*

(1) The ordinary and necessary expenses paid or incurred by an employee in driving an automobile owned or leased by the employee in connection with the performance of services as an employee of the employer will be deemed substantiated (in an amount determined under section 9 of this revenue procedure) when a payor reimburses such expenses with a mileage allowance using a flat rate or stated schedule that combines periodic fixed and variable rate payments that meet all the requirements of section 8 of this revenue procedure (a FAVR allowance).

(2) The amount of a FAVR allowance must be based on data that (a) is derived from the base locality, (b) reflects retail prices paid by consumers, and (c) is reasonable and statistically defensible in approximating the actual expenses employees receiving the allowance would incur as owners of the standard automobile.

.02 *Definitions.*

(1) *FAVR allowance.* A FAVR allowance includes periodic fixed payments and periodic variable payments. A payor may maintain more than one FAVR allowance. A FAVR allowance that uses the same payor, standard automobile (or an automobile of the same make and model that is comparably equipped), retention period, and business use percentage is considered one FAVR allowance, even though other features of the allowance may vary. A FAVR allowance also includes any optional high mileage payments; however, such optional high mileage payments are included in the employee's gross income, are reported as wages or other compensation on the employee's Form W–2, and are subject to withholding and payment of employment taxes when paid. See section 9.05 of this revenue procedure. An optional high mileage payment covers the additional depreciation for a standard automobile attributable to business miles driven and substantiated by the employee for a calendar year in excess of the annual business mileage for that year. If an employee is covered by the FAVR allowance for less than the entire calendar year, the annual business mileage may be prorated on a monthly basis for purposes of the preceding sentence.

(2) *Periodic fixed payment.* A periodic fixed payment covers the projected fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving the standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. A periodic fixed payment may be computed by (a) dividing the total projected fixed costs of the standard automobile for all years of the retention period, determined at the beginning of the retention period, by the number of periodic fixed payments in the retention period, and (b) multiplying the resulting amount by the business use percentage.

(3) *Periodic variable payment.* A periodic variable payment covers the projected operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of driving a standard automobile in connection with the performance of services as an employee of the employer in a base locality, and must be paid at least quarterly. The rate of a periodic variable payment for a computation period may be computed by dividing the total projected operating costs for the standard automobile for the computation period, determined at the beginning of the computation period, by the computation period mileage. A computation period can be any period of a year or less. Computation period mileage is the total mileage (business and personal) a payor reasonably projects a standard automobile will be driven during a computation period and equals the retention mileage divided by the number of computation periods in the retention period. For each business mile substantiated by the employee for the computation period, the periodic variable payment must be paid at a rate that does not exceed the rate for that computation period.

(4) *Base locality.* A base locality is the particular geographic locality or region of the United States in which the costs of driving an automobile in connection with the performance of services as an employee of the employer are generally paid or incurred by the employee. Thus, for purposes of determining the amount of fixed costs, the base locality is generally

or in accordance with any other Service-specified rate or schedule.

.04 *Flat rate or stated schedule.* A mileage allowance is paid at a flat rate or stated schedule if it is provided on a uniform and objective basis with respect to the expenses described in section 4.03 of this revenue procedure. Such allowance may be paid periodically at a fixed rate, at a cents-per-mile rate, at a variable rate based on a stated schedule, at a rate that combines any of these rates, or on any other basis that is consistently applied and in accordance with reasonable business practice. Thus, for example, a periodic payment at a fixed rate to cover the fixed costs (including depreciation (or lease payments), insurance, registration and license fees, and personal property taxes) of driving an automobile in connection with the performance of services as an employee of the employer, coupled with a periodic payment at a cents-per-mile rate to cover the operating costs (including gasoline and all taxes thereon, oil, tires, and routine maintenance and repairs) of using an automobile for such purposes, is an allowance paid at a flat rate or stated schedule. Likewise, a periodic payment at a variable rate based on a stated schedule for different locales to cover the costs of driving an automobile in connection with the performance of services as an employee is an allowance paid at a flat rate or stated schedule.

SECTION 5. BUSINESS STANDARD MILEAGE RATE

.01 *In general.* The standard mileage rate for transportation expenses paid or incurred on or after January 1, 1998, is 32.5 cents per mile for all miles of use for business purposes. This business standard mileage rate will be adjusted annually (to the extent warranted) by the Service, and any such adjustment will be applied prospectively.

.02 *Use of the business standard mileage rate.* A taxpayer may use the business standard mileage rate with respect to an automobile that is either owned or leased by the taxpayer. A taxpayer generally may deduct an amount equal to either the business standard mileage rate times the number of business miles traveled or the actual costs (both operating and fixed) paid or incurred by the taxpayer that are allocable to traveling those business miles.

.03 *Business standard mileage rate in lieu of operating and fixed costs.* A deduction using the standard mileage rate for business miles is computed on a yearly basis and is in lieu of all operating and fixed costs of the automobile allocable to business purposes (except as provided in section 9.06 of this revenue procedure). Such items as depreciation (or lease payments), maintenance and repairs, tires, gasoline (including all taxes thereon), oil, insurance, and license and registration fees are included in operating and fixed costs for this purpose.

.04 *Parking fees, tolls, interest, and taxes.* Parking fees and tolls attributable to use of the automobile for business purposes may be deducted as separate items. Likewise, interest relating to the purchase of the automobile as well as state and local taxes (other than those included in the cost of gasoline) may be deducted as separate items, but only to the extent that the interest or taxes are allowable deductions under § 163 or 164 respectively. If the automobile is operated less than 100 percent for business purposes, an allocation is required to determine the business and nonbusiness portion of the taxes and interest deduction allowable. However, § 163(h)(2)(A) expressly provides that interest is nondeductible personal interest when it is paid or accrued on indebtedness properly allocable to the trade or business of performing services as an employee. Section 164 also expressly provides that state and local taxes that are paid or accrued by a taxpayer in connection with an acquisition or disposition of property will be treated as part of the cost of the acquired property or as a reduction in the amount realized on the disposition of such property.

.05 *Depreciation.* For owned automobiles placed in service for business purposes, and for which the business standard mileage rate has been used for any year, depreciation will be considered to have been allowed at the rate of 12 cents a mile for 1994, 1995, 1996, 1997, and 1998, for those years in which the business standard mileage rate was used. If actual costs were used for one or more of those years, the rates above will not apply to any year in which such costs were used. The depreciation described above will reduce the basis of the automobile (but not below zero) in determining adjusted basis as required by § 1016.

.06 *Limitations.*

(1) The business standard mileage rate may not be used to compute the deductible expenses of (a) automobiles used for hire, such as taxicabs, or (b) two or more automobiles used simultaneously (such as in fleet operations).

(2) The business standard mileage rate may not be used to compute the deductible businsess expenses of an automobile leased by a taxpayer unless the taxpayer uses either the business standard mileage rate or a FAVR allowance (as provided in section 8 of this revenue procedure) to compute the deductible business expenses of the automobile for the entire lease period (including renewals). For a lease commencing on or before December 31, 1997, the "entire lease period" means the portion of the lease period (including renewals) remaining after that date.

(3) The business standard mileage rate may not be used to compute the deductible expenses of an automobile for which the taxpayer has (a) claimed depreciation using a method other than straight-line for its estimated useful life, (b) claimed a § 179 deduction, or (c) used the Accelerated Cost Recovery System (ACRS) under former § 168 or the Modified Accelerated Cost Recovery System (MACRS) under current § 168. By using the business standard mileage rate, the taxpayer has elected to exclude the automobile (if owned) from MACRS pursuant to § 168(f)(1). If, after using the business standard mileage rate, the taxpayer uses actual costs, the taxpayer must use straight-line depreciation for the automobile's remaining estimated useful life (subject to the applicable depreciation deduction limitations under § 280F).

(4) The business standard mileage rate and this revenue procedure may not be used to compute the amount of the deductible automobile expenses of an employee of the United States Postal Service incurred in performing services involving the collection and delivery of mail on a rural route if the employee receives qualified reimbursements (as defined in § 162(o)) for such expenses. See

under § 262, no portion of the cost of operating an automobile that is attributable to personal use is deductible.

.02 Section 274(d) provides, in part, that no deduction shall be allowed under § 162 with respect to any listed property (as defined in § 280F(d)(4) to include passenger automobiles and any other property used as a means of transportation) unless the taxpayer complies with certain substantiation requirements. The section further provides that regulations may prescribe that some or all of the substantiation requirements do not apply to an expense that does not exceed an amount prescribed by such regulations.

.03 Section 1.274(d)–1, in part, grants the Commissioner the authority to prescribe rules relating to mileage allowances for ordinary and necessary expenses of local travel and transportation away from home. Pursuant to this grant of authority, the Commissioner may prescribe rules under which such allowances, if in accordance with reasonable business practice, will be regarded as (1) equivalent to substantiation, by adequate records or other sufficient evidence, of the amount of such travel and transportation expenses for purposes of § 1.274–5T(c), and (2) satisfying the requirements of an adequate accounting to the employer of the amount of such expenses for purposes of § 1.274–5T(f).

.04 Section 62(a)(2)(A) allows an employee, in determining adjusted gross income, a deduction for the expenses allowed by Part VI (§ 161 and following), subchapter B, chapter 1 of the Code, paid or incurred by the employee in connection with the performance of services as an employee under a reimbursement or other expense allowance arrangement with a payor.

.05 Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)-(2)(A) if it—

(1) does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement. Section 62(c) further provides that the substantiation requirements described therein shall not apply to any expense to the extent that, under the grant of regulatory authority prescribed in § 274(d), the Commissioner has provided that substantiation is not required for such expense.

.06 Under § 1.62–2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements of business connection, substantiation, and returning amounts in excess of expenses as specified in the regulations. Section 1.62–2-(e)(2) specifically provides that substantiation of certain business expenses in accordance with rules prescribed under the authority of § 1.274(d)–1 will be treated as substantiation of the amount of such expenses for purposes of § 1.62-2. Under § 1.62–2-(f)(2), the Commissioner may prescribe rules under which an arrangement providing mileage allowances will be treated as satisfying the requirement of returning amounts in excess of expenses, even though the arrangement does not require the employee to return the portion of such an allowance that relates to miles of travel substantiated and that exceeds the amount of the employee's expenses deemed substantiated pursuant to rules prescribed under § 274(d), provided the allowance is reasonably calculated not to exceed the amount of the employee's expenses or anticipated expenses and the employee is required to return any portion of such an allowance that relates to miles of travel not substantiated.

.07 Section 1.62–2(h)(2)(i)(B) provides that if a payor pays a mileage allowance under an arrangement that meets the requirements of § 1.62-–2(c)(1), the portion, if any, of the allowance that relates to miles of travel substantiated in accordance with § 1.62–2(e), that exceeds the amount of the employee's expenses deemed substantiated for such travel pursuant to rules prescribed under §§ 274(d) and 1.274(d)–1, and that the employee is not required to return, is subject to withholding and payment of employment taxes. See §§ 31.3121(a)–3, 31.3231(e)–1(a)(5), 31.3306(b)–2, and 31.3401-(a)–4. Because the employee is not required to return this excess portion, the reasonable period of time provisions of § 1.62–2(g) (relating to the return of excess amounts) do not apply to this excess portion.

.08 Under § 1.62-2(h)(2)(i)(B)(*4*), the Commissioner may, in his or her discretion, prescribe special rules regarding the timing of withholding and payment of employment taxes on mileage allowances.

.09 Significant changes to this revenue procedure include:

(1) the increase in the charitable standard mileage rate (sections 2 and 7.01);

(2) the deletion of the rural mail carrier special mileage rate (in sections 2 and 6 of Rev. Proc. 96–63) and the addition of section 5.06(4) because of amendments made to § 162(o) by § 1203 of the Taxpayer Relief Act of 1997, Pub. L. No. 105– 34, 111 Stat. 788 (August 5, 1997); and

(3) the extension of the rules for using the business standard mileage rate or a fixed and variable rate (FAVR) allowance to apply to leased automobiles (sections 4, 5, 8, and 9).

SECTION 4. DEFINITIONS

.01 *Standard mileage rate.* The term "standard mileage rate" means the applicable amount provided by the Service for optional use by employees or self-employed individuals in computing the deductible costs of operating automobiles (including vans, pickups, or panel trucks) owned or leased for business purposes, or by taxpayers in computing the deductible costs of operating automobiles for charitable, medical, or moving expense purposes.

.02 *Transportation expenses.* The term "transportation expenses" means the expenses of operating an automobile for local travel or transportation away from home.

.03 *Mileage allowance.* The term "mileage allowance" means a payment under a reimbursement or other expense allowance arrangement that meets the requirements specified in § 1.62-2(c)(1) and that is

(1) paid with respect to the ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for transportation expenses in connection with the performance of services as an employee of the employer,

(2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and

(3) paid at the applicable standard mileage rate, a flat rate or stated schedule,

Attained age before the close of the taxable year:	
40 or less	$ 210
More than 40 but not more than 50	$ 380
More than 50 but not more than 60	$ 770
More than 60 but not more than 70	$2,050
More than 70	$2,570

.10 *Treatment of Dues Paid to Agricultural or Horticultural Organizations.* For tax years beginning in 1998, the limitation under § 512(d)(1), regarding the exemption of annual dues required to be paid by a member to an agricultural or horticultural organization, is $109.

.11 *Insubstantial Benefit Limitations for Contributions Associated with Charitable Fund-Raising Campaigns.*

(1) *Low cost article.* For tax years beginning in 1998, the unrelated business income of certain exempt organizations under § 513(h)(2) does not include a "low cost article" of $7.10 or less.

(2) *Other insubstantial benefits.* For tax years beginning in 1998, the $5, $25, and $50 guidelines in section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified and modified), for disregarding the value of insubstantial benefits received by a donor in return for a fully deductible charitable contribution under § 170, are $7.10, $35.50, and $71, respectively.

12 *Expatriation to Avoid Tax.* For calendar year 1998, the thresholds used under § 877(a)(2), regarding whether an individual's loss of United States citizenship had the avoidance of United States taxes as one of its principal purposes, are more than $109,000 for "average annual net income tax" and $543,000 or more for "net worth."

.13 *Luxury Automobile Excise Tax.* For calendar year 1998, the excise tax under §§ 4001 and 4003 is imposed on the first retail sale of a passenger vehicle (including certain parts or accessories installed within six months of the date after the vehicle was first placed in service), to the extent the price exceeds $36,000.

.14 *Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures.* For tax years beginning in 1998, the annual per person, family, or entity dues limitation to qualify for the reporting exception under § 6033(e)(3) (and section 4.02 of Rev. Proc. 95–35, 1995–2 C.B. 391), regarding certain exempt organizations with nondeductible lobbying expenditures, is $55 or less.

.15 *Notice of Large Gifts Received from Foreign Persons.* For tax years beginning in 1998, recipients of gifts from certain foreign persons may have to report these gifts under § 6039F if the aggregate value of gifts received in a taxable year exceeds $10,557.

.16 *Property Exempt from Levy.* For calendar year 1998, the value of property exempt from levy under § 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) may not exceed $2,570. The value of property exempt from levy under § 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) may not exceed $1,280.

.17 *Attorney Fee Awards.* For calendar year 1998, the attorney fee award limitation under § 7430(c)(1)(B)(iii) is $120 per hour.

.18 *Periodic Payments Received under Qualified Long-Term Care Insurance Contracts or under Certain Life Insurance Contracts.* For calendar year 1998, the stated dollar amount of the per diem limitation under § 7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is $180.

SECTION 4. EFFECTIVE DATE

.01 *General Rule.* Except as provided in section 4.02, this revenue procedure applies to tax years beginning in 1998.

.02 *Calendar Year Rule.* This revenue procedure applies to transactions or events occurring in calendar year 1998 for purposes of section 3.12 (the expatriation tax), section 3.13 (the excise tax on luxury automobiles), section 3.16 (the value of certain property exempt from levy), section 3.17 (the hourly limit on attorney fee awards), and section 3.18 (the per diem limitation for periodic payments received under qualified long-term care insurance contracts).

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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 I, sections 62, 162, 274, 1016; 1.62–2, 1.162–17, 1.274–5T, 1.274(d)–1, 1.1016–3.)

Rev. Proc. 97–58

SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 96–63, 1996–2 C.B. 420, by providing optional standard mileage rates for employees, self-employed individuals, or other taxpayers to use in computing the deductible costs paid or incurred on or after January 1, 1998, of operating an automobile for business, charitable, medical, or moving expense purposes. This revenue procedure also provides rules under which the amount of ordinary and necessary expenses of local travel or transportation away from home that are paid or incurred by an employee will be deemed substantiated under § 1.274–5T of the temporary Income Tax Regulations when a payor (the employer, its agent, or a third party) provides a mileage allowance under a reimbursement or other expense allowance arrangement to pay for such expenses. Use of a method of substantiation described in this revenue procedure is not mandatory and a taxpayer may use actual allowable expenses if the taxpayer maintains adequate records or other sufficient evidence for proper substantiation.

SECTION 2. SUMMARY OF STANDARD MILEAGE RATES

Business (section 5 below)	32.5 cents per mile
Charitable (section 7 below)	14 cents per mile
Medical and Moving (section 7 below)	10 cents per mile

SECTION 3. BACKGROUND AND CHANGES

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Under that provision, an employee or self-employed individual may deduct the cost of operating an automobile to the extent that it is used in a trade or business. However,

.02 *Unearned Income of Minor Children Taxed as if Parent's Income (the "Kiddie Tax").* For tax years beginning in 1998, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child's return that is subject to the "kiddie tax," is $700. (This amount is the same as the $700 standard deduction amount provided in section 3.04(2) of this revenue procedure.) In the alternative, the same $700 amount is used for purposes of § 1(g)(7) (that is, determining whether a parent may elect to include a child's gross income in the parent's gross income and for calculating the "kiddie tax").

.03 *Earned Income Tax Credit.*

(1) *In general.* For tax years beginning in 1998, the following amounts are used to determine the earned income tax credit under § 32(b). The "earned income amount" is the amount of earned income at or above which the maximum amount of the earned income tax credit is allowed. The "threshold phaseout amount" is the amount of modified adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The "completed phaseout amount" is the amount of modified adjusted gross income (or if greater, earned income) at or above which no credit is allowed.

Number of Children	*Maximum Amount of the Credit*	*Earned Income Amount*	*Threshold Phaseout Amount*	*Completed Phaseout Amount*
1	$2,271	$6,680	$12,260	$26,473
2 or more	$3,756	$9,390	$12,260	$30,095
None	$ 341	$4,460	$ 5,570	$10,030

The Internal Revenue Service, in the instructions for the Form 1040 series, provides tables showing the amount of the earned income tax credit for each type of taxpayer.

(2) *Excessive investment income.* For tax years beginning in 1998, the earned income tax credit is denied under § 32(i) if the aggregate amount of certain investment income exceeds $2,300.

.04 *Standard Deduction.*

(1) *In general.* For tax years beginning in 1998, the standard deduction amounts under § 63(c)(2) are as follows:

Filing Status	*Standard Deduction*
MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES (§ 1(a))	$7,100
HEADS OF HOUSEHOLDS (§ 1(b))	$6,250
UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS) (§ 1(c))	$4,250
MARRIED INDIVIDUALS FILING SEPARATE RETURNS (§ 1(d))	$3,550

(2) *Dependent.* For tax years beginning in 1998, the standard deduction amount under § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer may not exceed the greater of $700, or the sum of $250 and the individual's earned income.

(3) *Aged and blind.* For tax years beginning in 1998, the additional standard deduction amounts under § 63(f) for the aged and for the blind are $850 for each. These amounts are increased to $1,050 if the individual is also unmarried and not a surviving spouse.

.05 *Overall Limitation on Itemized Deductions.* For tax years beginning in 1998, the "applicable amount" of adjusted gross income under § 68(b), above which the amount of otherwise allowable itemized deductions is reduced under § 68, is $124,500 (or $62,250 for a separate return filed by a married individual).

.06 *Qualified Transportation Fringe.* For tax years beginning in 1998, the monthly limitation under § 132(f)(2)(A), regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass, is $65. The monthly limitation under § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is $175.

.07 *Income from United States Savings Bonds for Taxpayers Who Pay Qualified Higher Education Expenses.* For tax years beginning in 1998, the exclusion under § 135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above $78,350 for joint returns and $52,250 for other returns. This exclusion completely phases out for modified adjusted gross income of $108,350 or more for joint returns and $67,250 or more for other returns.

.08 *Personal Exemption.*

(1) *Exemption amount.* For tax years beginning in 1998, the personal exemption amount under § 151(d) is $2,700.

(2) *Phaseout.* For tax years beginning in 1998, the personal exemption amount begins to phase out at, and is completely phased out after, the following adjusted gross income amounts:

Filing Status	*Threshold Phaseout Amount*	*Completed Phaseout Amount After*
Code § 1(a)	$186,800	$309,300
Code § 1(b	$155,650	$278,150
Code § 1(c)	$124,500	$247,000
Code § 1(d)	$ 93,400	$154,650

.09 Eligible Long-Term Care Premiums. For tax years beginning in 1998, the limitations under § 213(d), regarding eligible long- term care premiums includible in the term "medical care," are as follows:

TABLE 1–Section 1(a).—MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES

If Taxable Income Is:	The Tax Is:
Not Over $42,350	15% of the taxable income
Over $42,350 but not over $102,300	$6,352.50 plus 28% of the excess over $42,350
Over $102,300 but not over $155,950	$23,138.50 plus 31% of the excess over $102,300
Over $155,950 but not over $278,450	$39,770 plus 36% of the excess over $155,950
Over $278,450	$83,870 plus 39.6% of the excess over $278,450

TABLE 2 - Section 1(b).—HEADS OF HOUSEHOLDS

If Taxable Income Is:	The Tax Is:
Not Over $33,950	15% of the taxable income
Over $33,950 but not over $87,700	$5,092.50 plus 28% of the excess over $33,950
Over $87,700 but not over $142,000	$20,142.50 plus 31% of the excess over $87,700
Over $142,000 but not over $278,450	$36,975.50 plus 36% of the excess over $142,000
Over $278,450	$86,097.50 plus 39.6% of the excess over $278,450

TABLE 3–Section 1(c).—UNMARRIED INDIVIDUALS (OTHER THAN SURVIVING SPOUSES AND HEADS OF HOUSEHOLDS)

If Taxable Income Is:	The Tax Is:
Not Over $25,350	15% of the taxable income
Over $25,350 but not over $61,400	$3,802.50 plus 28% of the excess over $25,350
Over $61,400 but not over $128,100	$13,896.50 plus 31% of the excess over $61,400
Over $128,100 but not over $278,450	$34,573.50 plus 36% of the excess over $128,100
Over $278,450	$88,699.50 plus 39.6% of the excess over $278,450

TABLE 4–Section 1(d).—MARRIED INDIVIDUALS FILING SEPARATE RETURNS

If Taxable Income Is:	The Tax Is:
Not Over $21,175	15% of the taxable income
Over $21,175 but not over $51,150	$3,176.25 plus 28% of the excess over $21,175
Over $51,150 but not over $77,975	$11,569.25 plus 31% of the excess over $51,150
Over $77,975 but not over $139,225	$19,885 plus 36% of the excess over $77,975
Over $139,225	$41,935 plus 39.6% of the excess over $139,225

TABLE 5–Section 1(e).—ESTATES AND TRUSTS

If Taxable Income Is:	The Tax Is:
Not Over $1,700	15% of the taxable income
Over $1,700 but not over $4,000	$255 plus 28% of the excess over $1,700
Over $4,000 but not over $6,100	$899 plus 31% of the excess over $4,000
Over $6,100 but not over $8,350	$1,550 plus 36% of the excess over $6,100
Over $8,350	$2,360 plus 39.6% of the excess over $8,350

26 CFR 601.602: Tax forms and instructions.
(Also Part I, §§ 1, 32, 63, 68, 132, 135, 151, 170, 213, 512, 513, 877, 4001, 4003, 6012, 6013, 6033, 6039F, 6334, 7430, 7702B; 1.1–1, 1.32–2, 1.63–1, 1.151–4, 1.170–1, 1.6012–1, 1.6013–1)

Rev. Proc. 97–57

Table of Contents

SECTION 1. PURPOSE

This revenue procedure sets forth inflation adjusted items for 1998.

SECTION 2. CHANGES MADE FROM PRECEDING YEAR

.01 In preceding years, this revenue procedure included a detailed description of each inflation adjusted item in former section 3, a technical explanation of the authority for each inflation adjustment in former section 4 and the inflation factors used to make the inflation adjustments in former section 5. To simplify this revenue procedure, section 3 has been revised, and sections 4 and 5 have been deleted.

.02 The limitations regarding the amount of eligible long-term care premiums includible in the term "medical care" under § 213(d)(10) of the Internal Revenue Code, as enacted by section 322 of the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104–191, 110 Stat. 1936 (1996), are adjusted for inflation for tax years beginning in 1998 (section 3.09).

.03 The value of property exempt from levy under § 6334(a)(2) (fuel, certain household items, arms for personal use, livestock, and poultry) and under § 6334(a)(3) (books and tools of a trade, business, or profession), as amended by section 502 of the Taxpayer Bill of Rights 2, Pub. L. No. 104–168, 110 Stat. 1452 (1996), is adjusted for inflation for calendar year 1998 (section 3.16).

.04 The stated dollar amount of the per diem limitation under § 7702B(d)(4), as enacted by section 321 of the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104–191, 110 Stat. 1936 (1996), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, s adjusted for inflation for calendar year 1998 (section 3.18).

SECTION 3. 1998 ADJUSTED ITEMS

.01 *Tax Rate Tables.* For tax years beginning in 1998, the tax rate tables under § 1 are as follows:

(c) Interest Expense: Complete lines 10 through 14, supplying all required information. This section 4.01(1)(c) does not apply to (i) amounts disallowed under § 163(d) unless Form 4952, Investment Interest Expense Deduction, is completed, or (ii) amounts disallowed under § 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Merely entering the amount of the donation on Schedule A, however, will not constitute adequate disclosure if the taxpayer receives a substantial benefit from the donation shown. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds $500, a properly completed Form 8283, Noncash Charitable Contributions, must be attached to the return. This section 4.01(1)(d) will not apply to any contribution of $250 or more unless the contemporaneous written acknowledgement requirement of § 170(f)(8) is satisfied.

(e) Casualty and Theft Losses: Complete Form 4684, Casualties and Thefts, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section 4.01(2), the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.01(1)(e) above must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section 4.01(2)(b) does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or nondeductible lobbying or political expenditures, including amounts that are required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section 4.01(2)(d) does not apply to "golden parachute" payments, as defined under § 280G. This section 4.01(2)(d) will not apply to the extent that remuneration paid or incurred exceeds the $1 million employee remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section 4.01(2)(e) does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Form 1120, Schedule M–1, Reconciliation of Income (Loss) per Books With Income per Return, provided:

(a) The amount of the deviation from the financial books and records is not the result of a computation that includes the netting of items; and

(b) The information provided reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, International Boycott Report.

(b) Intercompany Transactions: Transactions and amounts shown on Schedule M (Form 5471), Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons, lines 19 and 20, and Form 5472, Part IV, Monetary Transactions Between Reporting Corporations and Foreign Related Party, lines 7 and 18.

(5) Other:

(a) Moving Expenses: Complete Form 3903, Moving Expenses, or Form 3903-F, Foreign Moving Expenses, and attach to the return.

(b) Sale or Exchange of Your Main Home: Complete Form 2119, Sale of Your Home, and attach to the return.

(c) Employee Business Expenses: Complete Form 2106, Employee Business Expenses, or Form 2106–EZ, Unreimbursed Employee Business Expenses, and attach to the return. This section 4.01(5)(c) does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on a trip.

(d) Fuels Credit: Complete Form 4136, Credit for Federal Tax Paid on Fuels, and attach to the return.

(e) Investment Credit: Complete Form 3468, Investment Credit, and attach to the return.

SEC. 5. EFFECTIVE DATE

.01 This revenue procedure applies to any return filed on 1997 tax forms for a taxable year beginning in 1997, and to any return filed on 1997 tax forms in 1998 for short taxable years beginning in 1998.

26 CFR 601.201: Rulings and determination letters.
(Also Part I, § 636; 1.636–3.)

Rev. Proc. 97–55

SECTION 1. PURPOSE

This revenue procedure sets forth the conditions under which the Internal Revenue Service will consider issuing an advance ruling that a right to mineral is a production payment as defined in § 1.636–3(a) of the Income Tax Regulations.

SECTION 2. BACKGROUND

Section 1.636–3(a)(1) defines a production payment as a right to a specified share of the production from mineral in place, which is an economic interest in mineral in place and which has an expected economic life (at the time of its creation) of shorter duration than the economic life of the burdened property. The right may be limited by a dollar amount, a quantum of mineral, or a period of time. It may not reasonably be expected to extend in substantial amounts over the entire productive life of the burdened property.

SECTION 3. SCOPE

This revenue procedure applies to any production payment described in § 636 of the Internal Revenue Code.

SECTION 4. APPLICATION

The Internal Revenue Service generally will issue an advance ruling that a right to mineral is a production payment if the following conditions are met:

.01 The right is an economic interest in mineral in place as defined in § 1.611– 1(b), without regard to the application of § 636;

.02 The right is limited by a specified dollar amount, a specified quantum of mineral, or a specified period of time;

.03 It is reasonably expected, at the time the right is created, that it will terminate upon the production of not more than 90 percent of the reserves then known to exist; and

.04 The present value of the production expected to remain after the right terminates is 5 percent or more of the present value of the entire burdened property (determined at the time the right is created). The determination of present value takes into account all the facts and circumstances, in accordance with the provisions of § 1.611–2(e).

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.
(Also Part I, § 6662.)

Rev. Proc. 97–56

SEC. 1. PURPOSE

.01 This revenue procedure updates Rev. Proc. 96-58, 1996–2 C.B. 390 and identifies circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under § 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under § 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provision (including the negligence or disregard provisions of the § 6662 accuracy-related penalty).

.02 This revenue procedure applies to any return filed on 1997 tax forms for a taxable year beginning in 1997, and to any return filed on 1997 tax forms in 1998 for short taxable years beginning in 1998.

SEC. 2. CHANGES FROM REV. PROC. 96-58

Editorial changes only have been made in this revenue procedure.

SEC. 3. BACKGROUND

.01 If § 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of certain gross valuation misstatements.) Under § 6662(b)(2), § 6662 applies to the portion of an underpayment that is attributable to a substantial understatement of income tax.

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or $5,000 ($10,000 in the case of a corporation other than an S corporation or a personal holding company). Section 6662(d)(2) defines an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the return reduced by any rebate (within the meaning of § 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, § 6662(d)(2)(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed on the return or on a statement attached to the return, and there is a reasonable basis for the tax treatment of such item by the taxpayer.

.04 In general, this revenue procedure provides guidance in determining when disclosure is adequate for purposes of § 6662(d). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable. Guidance under § 6662(d) for returns filed in 1995, 1996, and 1997 is provided in Rev. Proc. 94–74, 1994–2 C.B. 823; Rev. Proc. 95–55, 1995–2 C.B. 457; and Rev. Proc.96–58, 1996–2 C.B. 390, respectively.

SEC. 4. PROCEDURE

.01 Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under § 6662(d) provided that the forms and attachments are completed in a clear manner and in accordance with their instructions. The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(1) Form 1040, Schedule A, Itemized Deductions:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

EXHIBIT L-1 - LIST OF FORMS REFERRED TO IN REVENUE PROCEDURE (continued)

2290	Heavy Vehicle Use Tax Return
3468	Investment Credit
3975	Tax Practitioner Annual Mailing List Application Update
4136	Credit for Federal Tax Paid on Fuels
4461	Application for Approval of Master or Prototype and Regional Prototype Defined Contribution Plan
4461-A	Application for Approval of Master or Prototype and Regional Prototype Defined Benefit Plan
4461-B	Application for Approval of Master or Prototype Plan, or Regional Prototype Plan Mass Submitter Return Adopting Sponsor
5300	Application for Determination for Employee Benefit Plan
5303	Application for Determination for Collectively Bargained Plan
5305	Individual Retirement Trust Account
5306	Application for Approval of Prototype or Employer Sponsored Individual Retirement Account
5307	Application for Determination for Adopters of Master or Prototype, Regional Prototype or Volume Submitter Plans
5310	Application for Determination for Terminating Plan
5310-A	Notice of Plan Merger or Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities; Notice of Qualified Separate Lines of Business
5498	Individual Retirement Arrangement Information
5500	Annual Return/Report of Employee Benefit Plan (With 100 or more participants)
5500 C/R	Annual Return/Report of Employee Benefit Plan (With fewer than 100 participants)
5500-EZ	Annual Return of One-Participant (Owners and Their Spouses) Retirement Plan
6406	Short Form Application for Determination For Minor Amendment of Employee Benefit Plan
8109	Federal Tax Deposit Coupon
8109-B	Federal Tax Deposit Coupon
8453	U.S. Individual Income Tax Declaration for Electronic Filing
8453-E	Employee Benefit Plan Declaration and Signature for Electronic/Magnetic Media Filing
8453-F	U.S. Income Tax Declaration and Signature for Electronic and Magnetic Media Filing
8453-P	U.S. Partnership Declaration and Signature for Electronic and Magnetic Media Filing
8633	Application to Participate in the Electronic Filing Program
9041	Application for Electronic/Magnetic Media Filing of Business and Employee Benefit Plan Returns

EXHIBIT L-1 - LIST OF FORMS REFERRED TO IN REVENUE PROCEDURE

FORM	TITLE
706	United States Estate (and Generation-Skipping Transfer) Tax Return
720	Quarterly Federal Excise Tax Return
940	Employer's Annual Federal Unemployment (FUTA) Tax Return
940-EZ	Employer's Annual Federal Unemployment (FUTA) Tax Return
941	Employer's Quarterly Federal Tax Return
941 Sch. B	Employer's Record of Federal Tax Liability
943	Employer's Annual Tax Return for Agricultural Employees
945	Annual Return of Withheld Federal Income Tax
945-A	Annual Record of Federal Tax Liability
990-C	Farmers' Cooperative Association Income Tax Return
990-PF	Return of Private Foundation or Section 4947(a)(1) Trust Treated as a Private Foundation
990-T	Exempt Organization Business Income Tax Return
1040	U.S. Individual Income Tax Return
1040-ES	Estimated Tax for Individuals
1040A	U.S. Individual Income Tax Return
1040EZ	Income Tax Return for Single and Joint Filers with No Dependents
1040PC	1040PC Format U.S. Individual Income Tax Return
1041	U.S. Income Tax Return for Estates and Trusts
1041-ES	Estimated Tax for Estates and Trusts
1042	Annual Withholding Tax Return for U.S. Source Income of Foreign Persons
1042-S	Foreign Person's U.S. Source Income Subject to Withholding
1065	U.S. Partnership Return of Income
1096	Annual Summary and Transmittal of U.S. Information Returns
1098	Mortgage Interest Statement
1099-A	Acquisition or Abandonment of Secured Property
1099-B	Proceeds from Broker and Barter Exchange Transactions
1099-C	Cancellation of Debt
1099-DIV	Dividends and Distributions
1099-G	Certain Government Payments
1099-INT	Interest Income
1099-MISC	Miscellaneous Income
1099-OID	Original Issue Discount
1099-PATR	Taxable Distributions Received from Cooperatives
1099-R	Distributions form Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, Etc.
1099-S	Proceeds from Real Estate Transactions
1120	U.S. Corporation Income Tax Return

EXHIBIT C

Checklist of IRS Substitute Forms Submitted on ....., 1997:

Company: .....
Contact: .....
Phone: .....
Fax: .....
Source Code: .....

Approved	Approved with Corrections	Must be Resubmitted	Form Number	Comments

Authorized Name: _____

Title: _____

Reviewer's Name: _____

Telephone: _____

Date: _____

Exhibit CG-8 (Schedule B)

Schedule B (Form 1040) — INTEREST AND DIVIDEND INCOME — 1995 * 08 — OMB no. 1545-0074

_____ SSN _____

Part I - Interest Income

		Amount
1	_____ (1)	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	Less tax-exempt interest.....To Form 1040, line 8b....	_____
2	Add the amounts on line 1.....(2)	_____
3	Excludable savings bond interest from Form 8815.....(3)	_____
4	Subtract line 3 from line 2.....To Form 1040, line 8a (4)	_____

Part II - Dividend Income

		Amount
5	Dividend income (include capital gain dist, nontaxable dist, etc.)	
	_____ (5)	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
	_____	_____
6	Add the amounts on line 5.....(6)	_____
7	Capital gain distributions.....(7) _____	
8	Nontaxable distributions.....(8) _____	
9	Add lines 7 and 8.....(9)	_____
10	Subtract line 9 from line 6. To Form 1040, line 9...(10)	_____

Part III - Foreign Accounts and Foreign Trusts

If you had over $400 of interest or dividends OR had a foreign account or were a grantor of, or a transferor to, a foreign trust, must complete:

11a At any time during 1995, did you have an interest in or a signature authority over a financial account in a foreign country (such as a bank account, securities account, or other financial account)?.. ___

b If Yes, name of foreign country. _____

12 Were you the grantor of, or transferor to, a foreign trust that existed during 1995, whether or not you have any beneficial interest in it? If Yes, you may have to file Form 3520, 3520-A, or 926.. ___

D260 For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Exhibit CG-A (Schedule A)

Schedule A (Form 1040) — **ITEMIZED DEDUCTIONS** — 1995 * 07 OMB no. 1545-0074

_____ SSN _____

MEDICAL AND DENTAL EXPENSES*******

1 Medical and dental expenses.....(1) _____
2 Amount from Form 1040, line 32....(2) _____
3 Multiply line 2 by 7.5% (.075).....(3) _____
4 Subtract line 3 from line 1, not less than zero.....(4) _____

TAXES YOU PAID*******

5 State and local income taxes.....(5) _____
6 Real estate taxes.....(6) _____
7 Personal property taxes.....(7) _____
8 Other taxes. List type and amount.
_____.....(8) _____
9 Add lines 5 thru 8.....(9) _____

INTEREST YOU PAID*******

10 Home mortgage interest and points reported to you on Form 1098.....(10) _____
11 Home mtg int not reported on Form 1098. If to seller, person's name, id no., and address:
_____
_____
_____.....(11) _____
12 Points not reported to you on Form 1098....(12) _____
13 Investment interest. Att Form 4952 if req..(13) _____
14 Add lines 10 thru 13.....(14) _____

GIFTS TO CHARITY*******

15 Gifts by cash or check.....(15) _____
16 Other than cash or check. If over $500, you MUST attach Form 8283.....(16) _____
17 Carryover from prior year.....(17) _____
18 Add lines 15 thru 17.....(18) _____

CASUALTY AND THEFT LOSSES*******

19 Casualty or theft loss(es) from Form 4684.....(19) _____

JOB EXPENSES & MOST OTHER MISCELLANEOUS DEDUCTIONS*******

20 Unreim employee exp (Form 2106)_____
_____ _____
_____ _____ ..(20) _____
21 Tax preparation fees.....(21) _____
22 Other expenses:
_____ _____
_____ _____ ..(22) _____
23 Add lines 20 thru 22.....(23) _____
24 Amount from Form 1040, line 32...(24) _____
25 Multiply line 24 by 2% (.02).....(25) _____
26 Subtract line 25 from line 23, not less than zero....(26) _____

OTHER MISCELLANEOUS DEDUCTIONS*******

_____ _____.....(27) _____

TOTAL ITEMIZED DEDUCTIONS*******

28 If Form 1040, line 32 more than $114,700 ($57,350 MFS), see page A-5. Else add right column of lines 4-27....(28) _____

****

D260 For Paperwork Reduction Act Notice, see Form 1040 Instructions.

Exhibit B-2 (Acceptable Format)

Schedules A&B (Form 1040) 1997 — OMB No. 1545-0074 — Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. — **Your social security number**

Schedule B—Interest and Dividend Income

Attachment Sequence No. **08**

Part I Interest Income

(See pages 13 and B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

		Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1
2	Add the amounts on line 1	2
3	Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4

Part II Dividend Income

(See pages 13 and B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

Note: *If you had over $400 in gross dividends and/or other distributions on stock, you must also complete Part III.*

			Amount
5	List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8 ▶	5	
6	Add the amounts on line 5	6	
7	Capital gain distributions. Enter here and on Schedule D, line 14*	7	
8	Nontaxable distributions. (See the inst. for Form 1040, line 9.)	8	
9	Add lines 7 and 8	9	
10	Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶	10	

**If you don't need Schedule D to report any other gains or losses, see the instructions for Form 1040, line 13, on page 14.*

Part III Foreign Accounts and Trusts

(See page B-2.)

You must complete this part if you **(a)** had over $400 of interest or dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.

		Yes	No
11a	At any time during 1997, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ▶		
12	During 1997, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520 or 926. See page B-2		

For Paperwork Reduction Act Notice, see Form 1040 instructions. — **Schedule B (Form 1040) 1997**

Exhibit B-1 (Preferred Format)

Schedules A&B (Form 1040) 1997 — OMB No. 1545-0074 — Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. — **Your social security number**

Schedule B—Interest and Dividend Income

Attachment Sequence No. **08**

Part I Interest Income

(See pages 13 and B-1.)

Note: If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note: *If you had over $400 in taxable interest income, you must also complete Part III.*

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1	
2	Add the amounts on line 1	2	
3	Excludable interest on series EE U.S. savings bonds issued after 1989 from Form 8815, line 14. You MUST attach Form 8815 to Form 1040	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	

Part II Dividend Income

(See pages 13 and B-1.)

Note: If you received a Form 1099-DIV or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total dividends shown on that form.

Note: *If you had over $400 in gross dividends and/or other distributions on stock, you must also complete Part III.*

			Amount
5	List name of payer. Include gross dividends and/or other distributions on stock here. Any capital gain distributions and nontaxable distributions will be deducted on lines 7 and 8 ▶	5	
6	Add the amounts on line 5	6	
7	Capital gain distributions. Enter here and on Schedule D, line 14*	7	
8	Nontaxable distributions. (See the inst. for Form 1040, line 9.)	8	
9	Add lines 7 and 8	9	
10	Subtract line 9 from line 6. Enter the result here and on Form 1040, line 9 ▶	10	

**If you don't need Schedule D to report any other gains or losses, see the instructions for Form 1040, line 13, on page 14.*

Part III Foreign Accounts and Trusts

(See page B-2.)

		Yes	No
	You must complete this part if you **(a)** had over $400 of interest or dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.		
11a	At any time during 1997, did you have an interest in or a signature or other authority over a financial account in a foreign country, such as a bank account, securities account, or other financial account? See page B-2 for exceptions and filing requirements for Form TD F 90-22.1		
b	If "Yes," enter the name of the foreign country ▶		
12	During 1997, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520 or 926. See page B-2		

For Paperwork Reduction Act Notice, see Form 1040 instructions. — **Schedule B (Form 1040) 1997**

Exhibit A-2 (Acceptable Format)

SCHEDULES A&B (Form 1040)

Department of the Treasury Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedules A and B (Form 1040).**

OMB No. 1545-0074

1997

Attachment Sequence No. **07**

Name(s) shown on Form 1040 | **Your social security number**

Medical and Dental Expenses		**Caution:** *Do not include expenses reimbursed or paid by others.*			
	1	Medical and dental expenses (see page A-1)	1		
	2	Enter amount from Form 1040, line 33	2		
	3	Multiply line 2 above by 7.5% (.075)	3		
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-			4
Taxes You Paid (See page A-1.)	5	State and local income taxes	5		
	6	Real estate taxes (see page A-2)	6		
	7	Personal property taxes	7		
	8	Other taxes. List type and amount ▶	8		
	9	Add lines 5 through 8			9
Interest You Paid (See page A-2.)	10	Home mortgage interest and points reported to you on Form 1098	10		
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11		
Note: Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12		
	13	Investment interest. Attach Form 4952, if required. (See page A-3.)	13		
	14	Add lines 10 through 13			14
Gifts to Charity If you made a gift and got a benefit for it, see page A-3.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-3	15		
	16	Other than by cash or check. If any gift of $250 or more, see page A-3. You **MUST** attach Form 8283 if over $500	16		
	17	Carryover from prior year	17		
	18	Add lines 15 through 17			18
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.)			19
Job Expenses and Most Other Miscellaneous Deductions (See page A-5 for expenses to deduct here.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You **MUST** attach Form 2106 or 2106-EZ if required. (See page A-4.) ▶	20		
	21	Tax preparation fees	21		
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22		
	23	Add lines 20 through 22	23		
	24	Enter amount from Form 1040, line 33	24		
	25	Multiply line 24 above by 2% (.02)	25		
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-			26
Other Miscellaneous Deductions	27	Other—from list on page A-5. List type and amount ▶			27
Total Itemized Deductions	28	Is Form 1040, line 33, over $121,200 (over $60,600 if married filing separately)? **NO.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 35, the **larger** of this amount or your standard deduction. **YES.** Your deduction may be limited. See page A-5 for the amount to enter.		▶	28

Exhibit A-1 (Preferred Format)

SCHEDULES A&B
(Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Schedule A—Itemized Deductions

(Schedule B is on back)

▶ **Attach to Form 1040.** ▶ **See Instructions for Schedules A and B (Form 1040).**

OMB No. 1545-0074

1997

Attachment Sequence No. **07**

Name(s) shown on Form 1040 | **Your social security number**

Medical and Dental Expenses		**Caution:** *Do not include expenses reimbursed or paid by others.*		
	1	Medical and dental expenses (see page A-1)	1	
	2	Enter amount from Form 1040, line 33	2	
	3	Multiply line 2 above by 7.5% (.075)	3	
	4	Subtract line 3 from line 1. If line 3 is more than line 1, enter -0-		4
Taxes You Paid (See page A-1.)	5	State and local income taxes	5	
	6	Real estate taxes (see page A-2)	6	
	7	Personal property taxes	7	
	8	Other taxes. List type and amount ▶	8	
	9	Add lines 5 through 8		9
Interest You Paid (See page A-2.)	10	Home mortgage interest and points reported to you on Form 1098	10	
	11	Home mortgage interest not reported to you on Form 1098. If paid to the person from whom you bought the home, see page A-3 and show that person's name, identifying no., and address ▶	11	
Note: Personal interest is not deductible.	12	Points not reported to you on Form 1098. See page A-3 for special rules	12	
	13	Investment interest. Attach Form 4952, if required. (See page A-3.)	13	
	14	Add lines 10 through 13		14
Gifts to Charity If you made a gift and got a benefit for it, see page A-3.	15	Gifts by cash or check. If you made any gift of $250 or more, see page A-3	15	
	16	Other than by cash or check. If any gift of $250 or more, see page A-3. You **MUST** attach Form 8283 if over $500	16	
	17	Carryover from prior year	17	
	18	Add lines 15 through 17		18
Casualty and Theft Losses	19	Casualty or theft loss(es). Attach Form 4684. (See page A-4.)		19
Job Expenses and Most Other Miscellaneous Deductions (See page A-5 for expenses to deduct here.)	20	Unreimbursed employee expenses—job travel, union dues, job education, etc. You **MUST** attach Form 2106 or 2106-EZ if required. (See page A-4.) ▶	20	
	21	Tax preparation fees	21	
	22	Other expenses—investment, safe deposit box, etc. List type and amount ▶	22	
	23	Add lines 20 through 22	23	
	24	Enter amount from Form 1040, line 33	24	
	25	Multiply line 24 above by 2% (.02)	25	
	26	Subtract line 25 from line 23. If line 25 is more than line 23, enter -0-		26
Other Miscellaneous Deductions	27	Other—from list on page A-5. List type and amount ▶		27
Total Itemized Deductions	28	Is Form 1040, line 33, over $121,200 (over $60,600 if married filing separately)? **NO.** Your deduction is not limited. Add the amounts in the far right column for lines 4 through 27. Also, enter on Form 1040, line 35, the **larger** of this amount or your standard deduction. **YES.** Your deduction may be limited. See page A-5 for the amount to enter.	▶	28

Forms for Electronically Filed Returns, *Continued*

Guidelines for Preparing Substitute Forms in the Electronic Filing Program

A participant in the electronic filing program who wants to develop a substitute form should follow the guidelines for preparing substitute forms throughout this publication, and send a sample of the form for approval to the Substitute Forms Coordinator at the address in Chapter 2. Forms 8453 prepared using a font where all IRS-approved wording will not fit on a single page will not be accepted as a substitute form. This applies primarily to dot-matrix printers, although forms prepared similarly on laser and inkjet printers will also be rejected. **PLEASE NOTE:** Use of unapproved forms could result in suspension of the participant from the electronic filing program.

FTD Magnetic Tape Payments

Instructions for Reporting Agents

Publication 1315 provides the requirements and instructions for reporting agents who sumit Federal Tax Deposits (FTD) payment information on magnetic tape. Magnetic tape submissions for FTD can be made for Forms 940, 941, 942, 943, 720, CT–1, 990–PF, 990–T, 990–C, 1042, 1120, and Schedule A (Form 941) Backup Withholding.

Instructions for Banks and Fiduciaries

Revenue Procedure 89–49 (Pub. 1374) provides the requirements and instructions for certain banks and fiduciaries to submit quarterly Form 1041–ES payments on magnetic tape through the Federal Tax Deposit (FTD) system.

Effect on Other Documents

Effect on Other Documents

This revenue procedure supersedes Revenue Procedure 96–48, I.R.B. 1996–48.

Chapter 9
Alternative Methods of Filing

Forms for Electronically Filed Returns

Electronic Filing Program

Since the 1986 filing season, the Service has been accepting current processing year electronically filed refund returns. Since tax year 1991, we accept balance due returns that are filed electronically. Electronic filing is a method by which qualified filers transmit tax return information directly to an IRS Service Center over telephone lines in the format of the official Internal Revenue Service forms.

Applying for the Electronic Filing Program

Anyone wishing to participate in the Electronic Filing Program for individual income tax returns must submit a Form 8633, Application To Participate in the Electronic Filing Program. (**Note:** For business returns, prospective participants must submit a Form 9041, Application For Electronic/Magnetic Media Filing of Business and Employee Benefit Plan Returns.)

Mailing Intructions

If an application is filed for...	Mail it to:
Form 8633 for Individual Income Taxes (regular mail)	Internal Revenue Service Andover Service Center Attn: EFU Acceptance - Stop 983 P.O. Box 4099 Woburn, MA 01888-4099
Form 8633 for Individual Income Taxes (overnight mail)	Internal Revenue Service Andover Service Center Attn: EFU Acceptance -Stop 983 310 Lowell Street Andover, MA 05501
Form 9041 for Forms 1065	Internal Revenue Service Andover Service Center Attn: EFU Acceptance - Stop 983 P.O. Box 4050 Woburn, MA 01888-4050
Form 9041 for Forms 1041	Internal Revenue Service Philadelphia Service Center Attn: DP 115 11601 Roosevelt Blvd. Philadelphia, PA 19154
Form 9041 for Forms 5500, 5500-C/R, and 5500-EZ	Internal Revenue Service Attn: EFU (EPMF), Stop 261 P.O. Box 30309, A.M.F. Memphis, TN 38310

Obtaining the Taxpayer Signature

The taxpayer signature does not appear on the electronically transmitted tax return and is obtained by the qualified electronic filer on Form 8453, U. S. Individual Income Tax Declaration for Electronic Filing, for Forms 1040, 1040A, and 1040EZ. Form 8453, which serves as a transmittal for the associated non electronic (paper) documents, such as Forms W–2, W–2G, and 1099–R, is a one-page form and can only be approved through the Substitute Forms Program in that format. For specific information about electronic filing, refer to Publication 1345, Handbook for Electronic Filers of Individual Income Tax Returns. (**Note:** For business returns, the electronic/magnetic media participants must use the official Form 8453–E, F or P, or an approved substitute that duplicates the official form in language, format, content, color, and size.)

Format Arrangement *Continued*

- The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data entry field EVEN if there is no reference code preceding the data entry field on the official form. The reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first digit of the data field.
- The size of the page must be the same as the official form (8½″ × 11″).
- The acceptable type is "Helvetica".
- The spacing of the type must be 6 lines/inch vertical, 10 or 12 print characters per inch horizontally.
- A ½ to 1/4" margin must be maintained across the top, bottom, and both sides (exclusive of any pin-fed holes).
- The substitute form must be of the same number of pages as the official one.
- The preprinted brackets in the money fields should be retained.
- The filer must COMPLETELY fill in all the specified numbers or referenced lines as they appear on the official form (not just totals) BEFORE attaching any supporting statement.
- Supporting statements are NEVER to be used until the required official form they support are first totally filled in (completed). A blank or incomplete form that refers to a supporting statement, in lieu of completing a tax return, is unacceptable.
- Descriptions for captions, lines, etc., appearing in the substitute forms may be limited to one print line by using abbreviations and contractions, and by omitting articles, prepositons, etc. However, sufficient key words must be retained to permit ready identification of the caption, line, or item.
- Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040", "See instruction", etc., may be omitted from the form.

Filing Instructions

Instructions for filing substitute forms are the same as for filing official forms.

Procedures for Printing Internal Revenue Service Envelopes, *Continued*

Guidelines for Having Envelopes Preprinted

Use of preparer company names, addresses, and logos is permissible as long as prescribed clear areas are not invaded. The government recommends that the envelope stock have an average opacity not less than 89 percent and contain a minimum of 50 percent waste paper. Use of carbon-based ink is essential for effective address and bar code reading. Envelope construction can be of side seam or diagonal seam design. The government recommends that the size of the envelope should be 5-3/4″ by 9″. Continuous pin-fed construction is not desirable but is permissible if the glued edge is at the top. This requirement is firm because mail opening equipment is designed to slice or otherwise open the bottom edge of each envelope.

Envelopes/ Zip Codes

The above procedures or guidelines are written for the user having envelopes preprinted. Many practitioners may not wish to have volumes of the different envelopes with differing ZIP codes/form designations preprinted for reasons of low volume, warehousing, waste, etc. In this case, the practitioner can type or machine print the addresses with the appropriate ZIP codes to accommodate sorting. If the requirements/guidelines outlined in this section cannot be met, then use of only the appropriate five digit service center ZIP code is needed.

Procedures for Substitute Form 5471 and Form 5472

Form 5471 and Form 5472

This section covers instructions for producing substitutes for:

- Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations and accompanying Schedules J, M, N, and O.
- Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code).

Paper and Computer-Generated Substitutes

Paper and computer-generated substitutes for Form 5471 and the accompanying Schedules J, M, N, and O, and Form 5472 that totally conform to the specifications contained in this procedure may be privately printed, but must have prior approval and are subject to annual review from the Internal Revenue Service.

Official Forms Can Be Obtained From Most Service Offices

Copies of the official forms for the reporting year may be obtained from most Service offices. The Service provides only cut sheets of these forms. Continuous fan-folded/pin-fed forms are not provided.

Quality Substitute Forms

The Service will accept quality substitute tax forms that are consistent with the official forms they represent AND that do not have an adverse impact on our processing. Therefore, only those substitute forms that conform to, and do not deviate from, the corresponding official forms are acceptable.

Computer-Prepared Tax Forms

If the substitute returns and schedules meet the guidelines prescribed herein, the Service will (for filing purposes) accept computer-prepared Forms 5471 and 5472 filled in by a computer, word processing equipment or similar automated equipment or a combination of computer-prepared/generated and filled in information. They may be filed separately or attached to individual or business income tax returns.

Format Arrangement

The specifications for Form 5471 and 5472 are as follows:

- The Substitute must follow the design of the official form as to format, arrangement, item caption, line numbers, line references, and sequence. It must be an exact textual and graphic MIRROR image of the official form for it to be acceptable.
- The filer must use one of the official ten character amount formats. All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present. It must follow a consistent format.

Sorting of Returns by Form Type

The sorting of returns by form type is accomplished by the preprinted bar codes on return envelopes that are included in each specific type of form or package mailed to the taxpayer. The 32 bit bar code located to the left of the address on each envelope identifies the type of form that person is filing and assists the Service in consolidating like returns for processing. Failure to use the envelopes furnished by the Service results in additional processing time and effort, and possibly delays the timely deposit of funds, processing of returns, and issuance of refund checks.

Sorting of Returns by ZIP + 4 or 9 Digit ZIP Codes

The Internal Revenue Service will not furnish or sell bulk quantities of preprinted tax return envelopes to taxpayers or tax practitioners. A suitable alternative has been developed that will accommodate the sorting needs of both the IRS and the U.S. Postal Service. The new alternative is based on the use of ZIP + 4 or 9 digit ZIP codes for mailing various types of tax returns to the different area service centers. Essentially, the Postal Service will utilize the last four digits to identify and sort the various form types into separate groups for processing. The list of add-on four digits or + 4 portion of the 9 digit ZIP codes with the related form designations is provided below and is to become a permanent part of the five digit service center ZIP codes shown above.

Add-on Four Digits or + 4 Portion of the 9 Digit ZIP Codes

Form ZIP + FOUR	Package
XXXXX-0001	Reserved
XXXXX-0002	1040
XXXXX-0005	941
XXXXX-0006	940
XXXXX-0008	943
XXXXX-0011	1065
XXXXX-0012	1120
XXXXX-0013	1120S
XXXXX-0014	1040EZ
XXXXX-0015	1040A
XXXXX-0020	5500-CR
XXXXX-0024	5500EZ
XXXXX-0027	990
XXXXX-0031	2290
XXXXX-0044	5500

Reproducible Program Is Abolished

The Reproducible Program that in past years supplied the envelope Reproduction Proofs was abolished September 30, 1996. The IRS will no longer provide camera copy to practitioners for the production of envelopes. Practitioners must develop their own camera copy.

Specifications for Filing Substitute Schedules K–1

Schedule K–1 Requirements

Prior approval is NOT required for a substitute Schedule K–1 that accompanies Form 1065 (for partnership), a Form 1120S (for small business corporation), or a Form 1041 (for fiduciary) when the substitute Schedule K–1 meets all of the following requirements.

- The Schedule K–1 must contain the payer and recipient's name, address and SSN/EIN.
- The Schedule K–1 must contain all the items required for use by the taxpayer.
- The line items must be in the same order and arrangement as those on the official form.
- Each taxpayer's information must be on a separate sheet of paper. Therefore, all continuously printed substitutes must be separated, by taxpayer, before filing with the Service.
- Schedule K–1 for recipients must have instructions for required line items attached.
- You may be subject to penalties if you file Schedules K–1 with the Service and furnish Schedules K–1 to partners, shareholders, or beneficiaries that do not conform to the specifications of this revenue procedure.
- The amount of each partner's shareholder's or beneficiary's share of each line item must be shown. The furnishing of a total amount of each line item and a percentage (or decimal equivalent) to be applied to such total amount by the partner, shareholder, or beneficiary does not satisfy the law and the specifications of this revenue procedure.
- If you file Schedules K–1 not conforming to the above specifications, IRS may consider these as not processable and return them to you to be filed correctly. You may also be subjected to the penalty as mentioned

Procedures for Printing Internal Revenue Service Envelopes

Procedures for Printing IRS Envelopes

Organizations are permitted to produce substitute tax return envelopes. Use of substitute return envelopes that comply with the requirements set forth in this section will assist in delivery of mail by the U.S. Postal Service and facilitate internal sorting once the envelopes are received at the Internal Revenue Service Centers.

The permanent five-digit ZIP codes must be utilized when mailing returns to the prescribed service center:

Service Center	Zip Code
Atlanta, GA	39901
Kansas City, MO	64999
Austin, TX	73301
Philadelphia, PA	19255
Memphis, TN	37501
Andover, MA	05501
Cincinnati, OH	45999
Holtsville, NY	00501
Ogden, UT	84201
Fresno, CA	93888

Substitute Forms Format Requirements *Continued*

Property	Substitute Forms Format Requirements
Color Quality of Paper	• Paper For Copy A must be white chemical wood bond, or equivalent, 20 pound (basis 17 × 22-500), plus or minus 5 percent; or offset book paper, 50 pound (basis 25 × 38-500). No optical brighteners may be added to the pulp or paper during manufacture. The paper must consist of principally bleach chemical woodpulp or recycled printed paper. It also must be suitable sized to accept ink without feathering. • Copies B, C, D (for Recipient), and E (For Withholding Agent) are provided in the official assembly solely for the convenience of the withholding agent. Withholding agents may choose the format, design, color and quality of the paper used for these copies.
Color and Quality of Ink	All printing must be in a high quality non-gloss black ink. Bar codes should be free from picks and voids.
Typography	Type must be substantially identical in size and shape to corresponding type on the official form. All rules on the document are either 1 point (0.015") or 3 point (0.045"). Vertical rules must be parallel to the left edge of the document; horizontal rules, parallel to the top edge.
Dimensions	• The official form is 8″ wide × 5-1/2″ deep, exclusive of a ½ snap stub on the left side of the form. The snap feature is not required on substitutes. • The width of a substitute Copy A must be a minimum of 7″ and a maximum of 8″, although adherence to the size of the official form is preferred. If the width of substitute Copy A is reduced from that of the official form, the width of each field on the substitute form must be reduced proportionately. The left margin must be 1/2″ and free of all printing other than that shown on the official form. • The depth of a substitute Copy A must be a minimum of 5 1/6″ and a maximum of 5 1/2″.
Carbons	Carbonized forms or "spot carbons" are not permissible. Interleaved carbons, if used, must be of good quality to preclude smudging and should be black.
Other Copies	Copies B, C, and D are required to be furnished for the convenience of payees who are required to send a copy of the form with other federal and state returns they file. Copy E may be desired as a withholding agent's record/copy.
Assembly	If all five parts are present, the parts of the assembly shall be arranged from top to bottom as follows: Copy A (Original) "For Internal Revenue Service," Copies B, C, and D "For Recipient," and Copy E "For Withholding Agent."

Chapter 8
Miscellaneous Forms and Programs

Paper Substitutes for Form 1042–S

Paper Substitutes

Paper substitutes for Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, that totally conform to the specifications contained in this procedure may be privately printed without prior approval from the Internal Revenue Service. Proposed substitutes not conforming to these specifications must be submitted for consideration.

Timeframe for Submission of Form 1042–S

The request should be submitted by November 15 of the year prior to the year the form is to be used. This is to allow the Service adequate time to respond and the submitter adequate time to make any corrections. These requests should contain a copy of the proposed form, the need for the specific deviation(s), and the number of information returns to be printed.

Revisions

Form 1042–S is subject to annual review and possible change. Withholding agents and form suppliers are cautioned against overstocking supplies of the privately printed substitutes.

Obtaining Copies

Copies of the official form for the reporting year may be obtained from most Service offices. The Service provides only cut sheets (no carbon interleaves) of these forms. Continuous fan-fold/pin-fed forms are not provided.

Instructions For Withholding Agents

Instructions for withholding agents:

- Only original copies may be filed with the Service. Carbon copies and reproductions are not acceptable.
- The term "Recipient's U.S. taxpayer identification number" for an individual means the social security number (SSN) or individual taxpayer identification number (ITIN), consisting of nine digits separated by hyphens as follows: 000-00-0000. For all other recipients, the term means employer identification number (EIN). The EIN consists of nine digits separated by hyphen as follows: 00-0000000. The taxpayer identification number (TIN) must be in one of these formats.
- Withholding agents are requested to type or machine print whenever possible, provide quality data entries on the forms (that is, use black ribbon and insert data in the middle of blocks well separated from other printing and guidelines), and take other measures to guarantee a clear, sharp image. Withholding agents are not required, however, to acquire special equipment solely for the purpose of preparing these forms.
- On corrected returns, the words CORRECTED RETURN must be typed in all capital letters in the top 1/4", right of center margin. All required information must be completed on a corrected return since it replaces and supersedes the information return previously filed.
- Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single form before they are filed with the Service. The dimensions are found below. Computer cards are acceptable provided they meet all requirements regarding layout, content, and size.

Substitute Forms Format Requirements

Property	Substitute Forms Format Requirements
Printing	Privately printed substitute Forms 1042–S must be exact replicas of the official forms with respect to layout and contents. Only the dimensions of the substitute form may differ and the printing of the Government Printing Office symbol must be deleted. The exact dimensions are found below.
Line Entries	Line 1 must be present, line 2 may be omitted if it is not needed. If line 2 is omitted, also omit line 3.
Boxes	None of the boxes can be omitted. Each box (a through h) must be present and in the exact order. The box for each payment amount must contain the appropriate caption.

OCR Scannable Application Forms for Employee Plans

OCR Scannable Documents

Forms 4461, 4461–A, 4461–B, 5300, 5303, 5307, 5310–A, and 6406 are OCR scannable documents submitted to key district offices for employee plans matters. They may be submitted as computer-generated substitute forms if the requirements of this section are satisfied.

OCR Data Sheet Requirements

An OCR data sheet must be generated according to the following requirements:

- Set at least 1" margin at top, bottom, and both sides.
- A data element consists of a less than sign (delimiter), information or at least 5 blank spaces, and a greater than sign (delimiter). All data elements from page one of the application forms listed above must be printed on the OCR data sheet, even if no information is entered between the delimiters.
- Each data element must start at the left margin.
- One line for each data field, except for employer and plan name fields which may be two lines. However, only one set of delimiters may bracket the field, even if the field is on two lines.
- Each data element must appear on the OCR data sheet in the same sequence as printed on the preprinted form, reading top to bottom and from left to right.
- Each data field must be sequentially numbered at left commencing with 1. See Notice 90-38 for examples of the acceptable format.
- The data sheet must be printed on 8½" × 11" white nonrecycled paper suitable for use with printing equipment and duplicating machines. A photocopy is not acceptable. Heavyweight bond paper and onion skin paper are not acceptable.
- Use 10 pitch type in a standard business font (e.g., courier, elite, pica).
- Add at least two spaces before and after each less than and greater than sign (delimiters).
- Do not fold or staple the OCR data sheet. It may remain loose, or be paper or spring clipped to the application.
- At the top of the OCR data sheet add the heading "OCR Data Sheet, File With Application Form (Enter Form Number), Approval Number" (leave nine spaces for approval number).

Where To Send OCR Data Sheet for Approval

The OCR data sheet must be submitted for approval to EP OCR Forms Coordinator, E:EP:FC, Room 2232, 1111 Constitution Ave., NW, Washington, DC 20024.

Submission Requirements

The OCR data sheet must be submitted with a complete word-for-word identical copy of the application form except as described below. This copy may be a photocopy or a computer-generated substitute form. Computer-generated substitute forms may be submitted for approval to the address above. However, except for the OCR data sheet, such approval is not required if the requirements of this revenue procedure are satisfied. If approval is requested, leave nine spaces for the approval number above the OMB approval number.

Procedures for Filing the OCR Data Sheet

The OCR data sheet replaces the first copy of page 1 of the application which must otherwise be submitted in duplicate. To avoid confusion when generating the OCR data sheet, the following wording should be deleted from page 1 of the application: "File page 1 of the form in duplicate" and "Both copies of this page must be signed". If the Procedural Requirements Checklist is being generated, the following line item statements should be modified as indicated. The question "Has page one been submitted in duplicate" should be modified to read, "Have you submitted the OCR data sheet?", and the question "Have you signed both copies of page 1 of the application?" should be modified to read "Have you signed the application?"

Nonscannable EP Application Forms

Nonscannable EP application forms, e.g., Form(s) 5305 and 5306, may be computer generated. They need not be submitted for approval if the requirements of this revenue procedure are satisfied. If approval is desired, these forms may be submitted to the Substitute Forms Coordinator.

Computer Generated Alternative Returns, 1040PC Format Return, *Continued*

Software Packages Must Be Purchased

Preparers, or taxpayers, must purchase IRS-accepted tax preparation software packages that include the 1040PC print option. All that is necessary to participate in 1040PC is a personal computer, accepted software, a printer, and plain white paper. The 1040PC is attractive to tax preparers and taxpayers who might not be interested or capable of electronic filing.

Options Available to Taxpayers

The Direct Deposit option is available to taxpayers filing 1040PC returns. Balance due returns may also be filed using 1040PC. The payment may be forwarded to the Service Center with a separate payment voucher (Form 1040–V).

Use of the 1040PC Program

All software used to generate the 1040PC Format Return must be tested and accepted by the Internal Revenue Service. Testing will validate 1040PC returns generated by the software and that the software program is in compliance with validity and consistency checks in the IRS 1040PC project specifications. Software developers who wish to participate in the 1040PC program must submit Form 9356, Application for Software Developers to Participate in the 1040PC Answer Sheet for Individual Income Tax Returns, to the 1040PC Filing Section.

Acceptance Code

Upon successful completion of software acceptance testing, the software developer will be issued a software acceptance code that will be embedded into the software and print on every 1040PC return generated. This is not the same as the Source Code issued by the Substitute Forms Program or the approval number which is generated for OCR Scannable Application Forms for Employee Plans.

References/ Information on the 1040PC Format Return

The Internal Revenue Service believes that 1040PC will prove beneficial to taxpayers, tax preparers, and the Service. For specific information about the alternative computer-generated 1040PC Format Return, refer to Publication 1678, Project 1040PC, Handbook for 1040PC Format Preparers and Publication 1630, Project 1040PC, Specifications for Software Developers. You may also call (202) 283-0823 or write:

Internal Revenue Service
1040PC Filing Office, T:S:P:S
5000 Ellin Rd
Lanham, MD 20706

Form 941 Requirements—OCR

Form 941 Not Machine Read

The Service is not currently machine reading (scanning) Form 941 or Schedule B (Form 941). Previous instructions labeled "Special Form 941 Requirements" have been removed from this revenue procedure.

Special Form 1040EZ Optical Character Recognition/Image Character Recognition (OCR/ICR) Requirements, *Continued*

Specific Ink Requirements *Continued*

Property	Requirements
Face Screen	Forms contain a green-screened background equal to a 15% tone of 110-line screen. Follow registration marks on repro-proof for screen positioning. Handprinted boxes are included on Page 1 of the reproduction proof and should be printed as a 50% value of the recommended OCR/ICR green ink. Inks used for hand-printed boxes must reflect at least 90% of the background on which it is printed as measured in the visible range.
Face Margins	Approximately 2/6″ head from top trimmed edge to screen (½″ to black image). 1/6″ outside from trimmed edges to screen.
Back Margins	½″ head, 5/16″ foot, and 5/16″ sides.
Back Screen	Back copy should be screened for 70% tone value.

Typography
Type must be substantially identical in both size and shape with corresponding type on the official form reproduction proof.

Proper Alignment and Position of Handprinted Characters

To assure proper alignment and position of handprinted characters representing return lines 1 through 10 tax data, they must be handprinted (entered) into the preprinted amount field boxes on the form. A #2 lead wooden pencil, or blue, and/or black ink pen (ball point, fountain, or felt-tipped) is recommended as the writing tool that will consistently provide the required stroke width and print contrast on entered characters.

Reading of Handprinted Character Techniques

Reading of handprinted characters requires adherence to the following techniques:

- Enter numeric amount digits carefully and clearly. Fill at least 2/3 of the individual character box height, keeping the character within the box with no overlapping or touching characters. Specific required digit constraints are shown below.
- When entering "fours", keep the top open.
- When entering "ones", do not use serifs.
- When entering "twos", do not add extra loops.
- All character lines must be connected with no gaps.

Note: All the general and detailed provisions of this revenue procedure apply (in addition to this specific OCR/ICR Section) to the development of substitute OCR/ICR Forms 1040EZ.

Computer Generated Alternative Returns, 1040PC Format Return

Introduction

The Internal Revenue Service offers an electronic approach for filing individual income tax returns. The 1040PC Format Return is an alternative to the conventional preprinted tax return. The 1040PC is an answer sheet return, generated on a personal computer in a three-column format, that prints only tax data that is input into the software. Tax returns are filed by tax preparers and taxpayers using commercially available tax preparation software packages that include the 1040PC Format Return print option.

1040PC Format Returns

1040PC Format Returns are computer-prepared, printed on plain white paper, signed and mailed to the designated processing center, and processed like any other conventionally filed return.

Chapter 7
OCR Forms

Special Form 1040EZ Optical Character Recognition/Image Character Recognition (OCR/ICR) Requirements

Form 1040EZ Designed in OCR/ICR Format

The Form 1040EZ is designed in OCR/ICR format. The IRS has the capability to machine read this form by optical character recognition/image character recognition (OCR/ICR) equipment. Form 1040EZ data may also be filed electronically or on a 1040PC format return.

An acceptable substitute OCR/ICR Form 1040EZ must generally be an exact replica of the official OCR/ICR reproduction proof with respect to layout, content, and required OCR/ICR characteristics.

Paper Requirements for OCR/ICR Form 1040EZ

The special paper requirements which must be met for the development of a substitute (privately printed) OCR/ICR Form 1040EZ include the following:

Property	Requirements
Color and quality of paper	Paper must be white, OCR/ICR grade bond, with no fluorescent additives or water marks, and with zero rag content.
Reflectivity of paper	Must be 80% or greater.
Opacity	The paper opacity ratio must be 80% or more.
Paper Weight	Specified paper weight is 20 lb. OCR/ICR bond (.0035").
Dirt	Must not exceed 10 parts per million.
Finish (smoothness)	Must be between 90 and 160 units (Sheffield).
Porosity	Paper should have a Gurley reading between 15 and 95.
Gloss	Paper with shiny or lustrous appearance (glossy) should be avoided.
Size	Form trim size must be 8″ × 11″.

Specific Ink Requirements

The specific ink requirements which must be met for this form include the following:

Property	Requirements
Print Color	The face of the form prints in black and green, the back prints in black only (70 % screen).
Ink	Green ink used must be highly reflective OCR/ICR type, such as Flint J-27975, or an exact match. Black ink used must be nonreflective.
Face Registration	Black to green must be .02″ (plus or minus) both horizontally and vertically.

Additional Instructions for All Forms

Use of Your Own Internal Control Numbers and Identifying Symbols

Internal control numbers and identifying symbols of the computer preparer may be shown on the substitute, if the use of such numbers or symbols is acceptable to the taxpayer and the taxpayer's representative. If shown, such information must not be printed in the top ½-inch clear area of any form or schedule requiring a signature. With the exception of the actual tax return form (i.e., Forms 1040, 1120, 940, 941, 5500 Series, etc.), you may print in the left vertical and bottom left margins. The bottom left margin you may use extends 3½ inches from the left edge of the form.

Descriptions for Captions, Lines, etc.

Descriptions for captions, lines, etc., appearing on the substitute forms may be limited to one print line by using abbreviations and contractions, and by omitting articles, prepositions, etc. However, sufficient key words must be retained to permit ready identification of the caption, line, or item.

Derivation of Final Totals

Explanatory detail and/or intermediate calculations for derivation of final line totals may be included on the substitute. We prefer that such calculations be submitted in the form of a supporting statement. If intermediate calculations are included on the substitute, the line on which they appear may not be numbered or lettered. Intermediate calculations may not be printed in the right column. This column is reserved for official numbered and lettered lines that correspond to the ones on the official form. If a supporting statement is submitted, intermediate calculations or subtotals may be formatted at the preparer's option.

Instructional Text Prescribed for the Official Form

Text prescribed for the official form, which is solely instructional in nature, e.g., "Attach this schedule to Form 1040," "See instructions," etc., may be omitted from the substitute form.

Mixing of Forms on the Same Page Prohibited

Information for more than one schedule or form may not be shown on the same printout page. Both sides of the paper may be printed for multiple page official forms; but it is unacceptable to intermix single page schedules of forms, except for Schedules A and B (Form 1040), which are printed back to back by the Service.

Schedule E can be printed on both sides of the paper, because the official form is multiple page, with page 2 continued on the back. However, do not print Schedule E on the front page and Schedule SE on the back, or Schedule A on the front and Form 8615 on the back, etc. Both pages of a substitute form must match the official form version it represents, except that the back page may be blank if the Service form only contains the instructions thereon.

Identifying Computer-Prepared Substitutes

Identify all computer-prepared substitutes clearly; print the form designation ½″ from the top margin and 1½″ from the left margin; print the title centered on the first line of print; and print the taxable year and, where applicable, the sequence number on the same line ½ to 1″ from right margin. Include the taxpayer's name and SSN on all forms and attachments. Also, print the OMB number as reflected on the official form.

Negative Amounts

Negative (or loss) monetary amount entries should be enclosed in brackets, or signed minus, to assist in the accurate computation and input of form data. On many official forms the Service preprints brackets in selected negative data fields, and these designations should be retained or inserted on affected substitute forms.

Chapter 6
Format and Content of Substitute Returns

Acceptable Formats for Computer-Generated Forms and Schedules

Exhibits and Use of Acceptable Computer-Generated Formats

Exhibits of acceptable computer-generated formats for the schedules usually attached to the Form 1040 are shown in the Exhibits section of this revenue procedure.

- If your computer-generated forms appear exactly like the exhibits, no prior authorization is needed.
- Those who want to computer-generate forms not shown here may do so, but they must design such forms themselves by following the manner and style of those in the Exhibits section of this revenue procedure, and by taking care to observe other requirements and conditions stated here. The Service encourages the submission of all proposed forms covered by this revenue procedure.

Instructions

The format of each substitute schedule or form must follow the format of the official schedule or form as to item captions, line references, line numbers, sequence, form arrangement and format, etc. Basically, try to make the form look like the official one, with readability and consistency being primary factors. You may use periods and/or other similar special characters to separate the various parts and sections of the form. DO NOT use alpha or numeric characters for these purposes. With the exceptions in the paragraph below, all line numbers and items must be printed even though an amount is not entered on the line.

Line Numbers

When a line on an official form is designated by a number or a letter, that designation (reference code) must be used on a substitute form. The reference code must be printed to the left of the corresponding captioned line and also immediately preceding the data entry field even if there is no reference code immediately preceding the data entry field on the official form. If an entry field contains multiple lines but shows the line references only one time on the left and right side of the form, do not use more than the same number of line references on the substitute return.

In addition, the reference code that is immediately before the data field must either be followed by a period or enclosed in parentheses. There also must be at least two blank spaces between the period or the right parenthesis and the first digit of the data field. (See example below.)

Decimal Points

A decimal point (i.e., a period) should be used for each money amount regardless of whether the amount is reported in dollars and cents or in whole dollars, or whether or not the vertical line that separates the dollars from the cents is present. The decimal points must be vertically aligned when possible.

Example:

```
5 STATE & LOCAL INC.
  TAX.....5 495.00
6 REAL ESTATE
  TAXES.....6
7 PERSONAL PROPERTY
  TAXES.....7 198.00
        or
5 STATE & LOCAL INC.
  TAX.....(5) 495.00
6 REAL ESTATE
  TAXES.....(6)
7 PERSONAL PROPERTY
  TAXES.....(7) 198.00
```

Multiple Page Forms

When submitting multiple page forms, send all pages of the form in the same package. If you are not producing certain pages, please note that in your cover letter.

Changes Permitted to Form 1040 Graphics

General	No prior approval is needed for the following changes (for use with computer-prepared forms only).
Line 4 of Form 1040	This line may be compressed horizontally (to allow for a larger entry area for the name of the qualifying child) by using the following caption: "Head of household; child's name" (name field).
Line 6c of Form 1040	The vertical lines separating columns (1) through (4) may be removed. The captions may be shortened to allow a one-line caption for each column.
Other Lines	Any other line whose caption takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.
Line 21 - Other Income	The fill-in portion of this line may be expanded vertically to three lines. The amount entry box must remain a single entry.
Line 39 of Form 1040 - Tax	You may change the line caption to read "Tax" and computer print the words "Total includes tax from" and either "Form(s) 8814", or "Form 4972".
Line 44 of Form 1040	You may change the caption to read: "Other credits from Form" and computer-print only the form(s) that apply.
Color Screening	It is not necessary to duplicate the color screening used on the official form. A substitute Form 1040 may be printed in black and white only, with no color screening.
Other Changes Prohibited	No other changes to the Form 1040 graphics are permitted without prior approval except for the removal of instructions and references to instructions.

Changes Permitted to Form 1040A Graphics

General	No prior approval is needed for the following changes (for use with computer-prepared forms only).
Line 4 of Form 1040A	This line may be compressed horizontally (to allow for same line entry for the name of the qualifying child) by using the following caption: "Head of household; child's name" (name field).
Other Lines	Any line whose caption takes up two or more vertical lines may be compressed to one line by using contractions, etc., and by removing instructional references.
Page 2 of Form 1040A	All lines must be present and numbered in the order shown on the official form. These lines may also be compressed.
Color Screening	It is not necessary to duplicate the colorscreening used on the official form. A substitute Form 1040A may be printed in black and white only, with no color screening.
Other Changes Prohibited	No other changes to the Form 1040A graphics are allowed without prior approval, except for the removal of instructions and references to instructions.

Changes Permitted to Graphics (Forms 1040A and 1040)

Adjustments

You may make minor vertical and horizontal spacing adjustments to allow for computer or word-processing printing. This includes widening the amount columns or tax entry areas so long as the adjustments do not exceed other provisions stated in revenue procedures. No prior approval is needed for these changes.

Name and Address Area

The horizontal rules and instructions within the name and address area may be removed and the entire area left blank; no line or instruction can remain in the area. However, the statement regarding use of the IRS mail label should be retained. The heavy ruled border (when present) that outlines the name and address area must not be removed, relocated, expanded, or contracted.

Required Format

When the name and address area is left blank, the following format must be used when printing the taxpayer's name and address. Otherwise, unless the taxpayer's preprinted label is affixed over the information entered in this area, the lines must be filled in as shown:

- 1st name line (35 characters maximum)
- 2nd name line (35 characters maximum)
- In-care-of name line (35 characters maximum)
- City, State (24 char. max.), one blank char., & ZIP (five char.)

Conventional Name and Address Data

When there is no in-care-of name line, the name and address will consist of only three lines (single filer) or four lines (joint filer).
Name and address (joint filer) with no in-care-of name line:

JOHN Z. JONES
MARY I. JONES
1234 ANYWHERE ST., APT 111
ANYTOWN, STATE 12321

Example of In-Care-Of Name Line

Name and address (single filer) with in-care-of name line:

JOHN Z. JONES
C/O THOMAS A. JONES
4311 SOMEWHERE AVE.
SAMETOWN, STATE 54345

Social Security Number (SSN) and Employer Identification Number (EIN) Area

The vertical lines separating the format arrangement of the SSN/EIN may be removed. When the vertical lines are removed, the SSN and EIN formats must be 000-00-0000 or 00-0000000, respectively.

Cents Column

- You may remove the vertical rule that separates the dollars from the cents.
- All entries in the amount column should have a decimal point following the whole dollar amounts whether or not the vertical line that separates the dollars from the cents is present.
- You may omit printing the cents, but all amounts entered on the form must follow a consistent format. You are strongly urged to round off the figures to whole dollar amounts, following the official return instructions.
- Where several amounts are summed together, the total should be rounded off subsequent to the addition (i.e, individual amounts should not be rounded off for computation purposes).
- When printing money amounts, you must use one of the following ten-character formats: (a) 0,000,000. (b) 000,000.00
- When there is no entry for a line, leave the line blank.

"Paid Preparer's Use Only" Area

On all forms, the paid preparer's information area may not be rearranged or relocated. You may add three lines and remove the horizontal rules in the preparer's address area.

Chapter 5
Requirements for Specific Tax Returns

Tax Returns (Form 1040, 1040A, 1120, Etc.)

Acceptable Forms

There are acceptable computer-generated versions of a tax return form (e.g., Form 1040, 1040A, 1120, etc., which requires a signature and that establishes tax liability) that are permitted under the following conditions:

- These substitute returns must be printed on plain white paper.
- Substitute returns and forms must conform to the physical layout of the corresponding Service form although the typeface may differ. The text should match the text on the officially published form as closely as possible; condensed text and abbreviations will be considered on a case-by-case basis.

Exception: All jurats (perjury statements) must be reproduced verbatim. No text can be added, deleted, or changed in meaning. It must be readily identifiable as a valid tax return.

- Various computer-graphic print media such as laser printing, dot matrix addressable printing, etc., may be used to produce the substitute forms.
- The substitute return must be the same exact number of pages, and contain the same line text as the official return.
- All computer-generated tax returns MUST be submitted for approval prior to their original use. Should you receive an approval letter for a return and the following year's return has no changes except the preprinted year, the latter return is not subject to approval. **Exception**: If the approval letter specifies a one-time exception for your return, the next year's return must be approved.

Computer-Generated Condensed Format Versions

The accepted condensed print format version for individual returns is the 1040PC "answer sheet format" tax return. The approval process for Form 1040PC differs from that of traditional forms. See Chapter 7 for additional information.

Prohibited Forms

The following are prohibited:

- Tax returns (e.g., Forms 1040, etc.) computer-generated on lined or color-barred paper.

- Tax returns that differ from the official IRS forms in a manner that makes them not standard or processable.

Changes Permitted to Forms 1040 and 1040A

Certain changes (listed below) are permitted to the graphics of the form without prior approval, but these changes apply only to acceptable preprinted forms. Changes not requiring prior approval are good only for the annual filing period, which is the current Tax Year. Such changes are valid in subsequent years only if the official form does not change.

Other Changes Not Listed

All changes not listed here require prior approval from the Service BEFORE the form may be filed.

Federal Tax Forms on CD-ROM

Information About Federal Tax Forms CD-ROM

The IRS also offers access to current and prior year tax forms and instructions through its Federal Tax Forms CD-ROM, Publication 1796. The CD will contain over 600 current year tax forms, instructions, and Taxpayer Information Publications (TIPs). Also included are prior year forms and instructions from 1991 and some prior year. All necessary software to view the files must be installed from the CD-ROM. Software for Microsoft Windows 3.x and Macintosh System 7.5 and later is included on the disk. The software will also run under Windows 95. All products are presented in Adobe's Portable Document Format (PDF). A copy of the Adobe Acrobat Reader is on the CD. In addition, the TIPs will be provided in the Standard Generalized Markup Language (SGML). The cost of the CD is $20 and it will be released in February 1998. Please reference stock number 648-097-00003-4. Those who order before December 2, 1997 will also receive the January early release CD containing tax products issued to that point.

System Requirements and How To Order the Federal Tax Forms CD-ROM

For system requirements and to order the 1996 Federal Tax Forms CD-ROM, Publication 1796 (stock number 648-097-00003-4), contact the Government Printing Office's (GPO) Superintendent of Documents:

- by telephone—(202) 512-1800; select option 1;
- by fax—(202) 512-2250;
- through GPO's Federal Bulletin Board—(202) 512-1387; after sign on type "/go irs";
- through GPO's World Wide Web site at http://www.gpo.gov/su_docs;
- by mail using the order form contained in IRS Publication 1045 (Information for Tax Practitioners); or
- by mail to:
  Superintendent of Documents
  P.O. Box 371954
  Pittsburgh, PA 15250-7954.

Electronic Tax Products

The Internet

Copies of tax forms with instructions, publications, and other tax related materials may be obtained via the Internet. Forms can be downloaded in several file formats (PDF-Portable Document Format, PS - PostScript, and PCL - Printer Control Language). Those choosing to use PDF files for viewing on personal computer can also download a free copy of the Adobe Acrobat Reader.

- World Wide Web - http://www.irs.ustreas.gov
- FTP—ftp.irs.ustreas.gov
- Telnet—iris.irs.ustreas.gov

This service is free but time on the Internet is subject to the fees charged by your Internet provider.

Fedworld (BBS)

The Internal Revenue Information Systems (IRIS) Bulletin Board can be reached via FedWorld, an aggregation of federal BBS maintained by the Department of Commerce. IRIS can be reached directly by modem at (703) 321-8020; FedWorld's main number is (703) 321-3339. These are toll calls.

Tax Fax

The most frequently requested tax forms, instrucitons, and other information are available through IRS Tax Fax. **Prior to 12/1/97 dial (703) 487-4160. The new number starting 12/1/97 will be (703) 368-9694.** Call from your fax machine and follow the voice prompts. Your request will be transmitted directly back to you. Each call is limited to requesting three items; users pay the telephone line charges.

Report of Print Dates

The Service makes available a text file that shows print dates for returns processing forms. It is in three parts:

- Schedule of anticipated print dates of annual returns,
- Schedule of anticipated print dates of quarterly returns, and
- Schedule of last revision dates for continuous use only forms.

The file name is 0prtdate.txt and is located in the File Transfer Protocol (FTP) library of the Internet at ftp://ftp.fedworld.gov/pub/irs-utl and in the IRS/UTL library on the IRIS Bulletin Board. The file will be updated weekly during peak printing periods and as necessary at other times. NOTE: All dates in the FTP area are reloaded daily and do not reflect the most recent posting of the report. IRIS Bulletin Board shows the most recent posting by date.

Ordering Publications

Sources of Publications

The publications listed below may be ordered by calling 1-800-TAX-FORM (1-800-829-3676). Identify the requested document by IRS publication number:

- Pub. 1141, the revenue procedure on specifications for private printing for Forms W–2 and W–3.
- Pub. 1167, the revenue procedure on substitute printed, computer- prepared, and computer-generated tax forms and schedules. This publication is available from the IRS Internet website.
- Pub. 1179, the revenue procedure on paper substitute information returns (Forms 1096, 1098, 1099 series, 5498, and W–2G).
- Pub. 1192, Catalog of Reproducible Forms and Instructions.
- Pub. 1220, the revenue procedure on electronic or magnetic tape and magnetic diskette reporting for information returns (Forms 1098, 1099 series, 5498, and W–2G).
- Pub. 1223, the revenue procedure on substitute Forms W–2c and W–3c.
- Pub. 1239, Specifications for Filing Form 8027, Employer's Annual Information Return of Tip Income and Allocated Tips, on Magnetic Tape.
- Pub. 1245, Magnetic Tape Reporting for Forms W–4.
- Pub. 1345, Handbook for Electronic Filers of Individual Income Tax Returns (Tax Year 1997). (This is an annual publication; tax year is subject to change). This publication is available from the IRS Internet website.
- Pub. 1345–A, Handbook for Electronic Filers of Individual Income Tax Returns (Tax Year 1997) (Supplement). This publication, printed in the late fall, supplements Publication 1345.
- Pub. 1355, the revenue procedure on the requirements for substitute Form 1040–ES.

Where To Order

If you are mailing your order, the address to use is determined by your location.

If you are located in:

- Alaska, Arizona, California, Colorado, Hawaii, Idaho, Kansas, Montana, Nevada, New Mexico, Oklahoma, Oregon, Utah, Washington, Wyoming, Guam, Northern Marianas, or American Samoa
  - mail your request to:
    Western Area Distribution Center
    Rancho Cordova, CA 95743-0001
- Alabama, Arkansas, Illinois, Indiana, Iowa, Kentucky, Louisiana, Michigan, Minnesota, Mississippi, Missouri, Nebraska, North Dakota, Ohio, South Dakota, Tennessee, Texas, or Wisconsin
  - mail your request to:
    Central Area Distribution Center
    P.O. Box 8903
    Bloomington, IL 61702-8903
- Connecticut, Delaware, District of Columbia, Florida, Georgia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, North Carolina, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, as well as all foreign countries and Puerto Rico
  - mail your request to:
    Eastern Area Distribution Center
    P.O. Box 85074
    Richmond, VA 23261-5074
- Taxpayers in the Virgin Islands should mail their requests to:
  V.I. Bureau of Internal Revenue
  9601 Estate Thomas
  Charlotte Amalie, St. Thomas, VI 00802

Chapter 4
Additional Resources

Guidance From Other Revenue Procedures

General

Guidance for the substitute tax forms not covered in this revenue procedure and the revenue procedures that govern their use are as follows:

- Revenue Procedure 94–79, IRS Publication 1355, Requirements and Conditions for the Reproduction, Private Design, and Printing of Substitute Forms 1040–ES.

- Revenue Procedures 96–24 and 96–24a, IRS Publication 1141, General Rules and Specifications for Private Printing of Substitute Forms W–2 and W–3.

- Revenue Procedure 97–32* and 97–32A, IRS Publication 1179, Specifications for Paper Document Reporting and Paper Substitutes for Forms 1096, 1098, 1099 Series, 5498, and W–2G.

*Due to a numbering error, some copies of Revenue Procedure 97–32 may display 97–43 instead. Please refer to the publication number and title to be sure that you have the correct publication.

- Revenue Procedure 96–11, IRS Publication 1187, Specifications for Filing Form 1042–S, Foreign Person's U.S. Source Income Subject to Withholding, on Magnetic Tape.

- Revenue Procedure 96–36, IRS Publication 1220, Specifications for Filing Forms 1098, 1099, 5498, and W–2G Magnetically or Electronically.

- Revenue Procedure 95–18, IRS Publication 1223, Specifications for Private Printing of Substitute Forms W–2c and W–3c.

Miscellaneous Information for Substitute Forms

Filing Substitute Forms

To be acceptable for filing, a substitute return or form must print out in a format that will allow the party submitting the return to follow the same instructions as for filing official forms. These instructions are in the taxpayer's tax package or in the related form instructions. The form must be on the appropriate size paper, be legible, and include a jurat where one appears on the published form.

Caution to Software Publishers

The IRS has received returns produced by software packages with approved output where either the form heading was altered or the lines were spaced irregularly. This produces an illegible or unrecognizable return or a return with the wrong number of pages. We realize that many of these problems are caused by individual printer differences but they may delay input of return data and, in some cases, generate correspondence to the taxpayer. Therefore, in the instructions to the purchasers of your product, both individual and professional, please stress that their returns will be processed more efficiently if they are properly formatted. This includes:

- Having the correct form numbers and titles at the top of the return, and
- Submitting the same number of pages as if the form were an official IRS form, with the line items on the proper pages.

Use Preaddressed IRS Label

If you are a practitioner filling out a return for a client or a software publisher who prints instruction manuals, stress the use of the preaddressed label provided in the tax package the IRS sent to the taxpayer, when available. The use of this label (or its precisely duplicated label information) is extremely important for the efficient, accurate, and economical processing of a taxpayer's return. Labeled returns indicate that a taxpayer is an established filer and permits us to automatically accelerate processing of those returns. This results in quicker refunds, more accurate names/addresses and postal deliveries, and less manual review by IRS functions.

Caution to Producers of Software Packages

If you are producing a software package that generates name and address data onto the tax return, do not under any circumstances program either the Service preprinted check digits or a practitioner-derived Name Control to appear on any return prepared and filed with the Internal Revenue Service.

Programming to Print Forms

Whenever applicable:

- Use only the following label information format for single filers:
  000-00-0000
  JOHN Q. PUBLIC
  310 OAK DRIVE
  HOMETOWN, STATE 94000

- Use only the following information for joint filers:
  000-00-0000 000-00-0000
  JOHN Q. PUBLIC
  MARY I. PUBLIC
  310 OAK DRIVE
  HOMETOWN, STATE 94000

Examples of Approved Formats

Examples of Approved Formats From the Exhibits

Two sets of exhibits (Exhibits A–1, A–2, B–1, and B–2) are at the end of this revenue procedure. These are examples of how the guidelines in this revenue procedure may be used in some specific cases. Vertical spacing is six (6) lines to the inch. These examples are from a prior year and are not to be used as substitute forms.

Examples of Acceptable computer-generated formats

Examples of acceptable computer-generated formats are also shown in the Exhibits section of this revenue procedure. Exhibits CG-A and CG-B show computer-generated Schedules A and B. Vertical spacing is six (6) lines to the inch. You may also refer to them as examples of how the guidelines in this revenue procedure may be used in specific cases. A combination of upper and lower case print fonts is acceptable in producing the computer-generated forms included in this procedure. This same logic for computer-generated forms can be applied to any IRS form that is normally reproducible as a substitute form, with the exception of tax return forms as discussed elsewhere.

Margins

Margin Size

The format of a reproduced tax return when printed on the page must have margins on all sides at least as large as the margins on the official form. This allows room for IRS employees to make the necessary entries on the form during processing.

- A 1/2″ to 1/4″ inch margin must be maintained across the top, bottom, and both sides (exclusive of any pin-fed holes) of all computer-generated substitutes.
- The marginal, perforated strips containing the pin-fed holes must be removed from all forms prior to filing with the Internal Revenue Service.

Marginal Printing

Non-tax material allowed in limited areas.

- Printing is never allowed in the top right margin of the tax return form (i.e., Forms 1040, 1040A, 1040EZ, 1120, 940, 941, 5500 Series, etc.). The Service uses this area to imprint a Document Locator Number for each return.
- With the exception of the actual tax return forms (i.e., Forms 1040, 1040A, 1040EZ, 1120, 940, 941, etc.), you may print in the left vertical margin and in the left half of the bottom margin.

Prior approval is not required for the marginal printing allowed when printed on an official form or on a photocopy of an official form.

The marginal printing allowance is also the guide for the preparation of acceptable substitute forms. There is no exception to the requirement that no printing is allowed in the top right margin of the tax return form.

Printing

Printing Medium	The private printing of all substitute tax forms must be by conventional printing processes, photocopying, computer-graphics, or similar reproduction processes.
Legibility	All forms must have a high standard of legibility, both as to printing and reproduction and as to fill-in matter. Entries of taxpayer data may be no smaller than eight points. The Internal Revenue Service reserves the right to reject those with poor legibility. The ink and printing method used must ensure that no part of a form (including text, graphics, data entries, etc.) develops "smears" or similar quality deterioration. This includes any subsequent copies or reproductions made from an approved master substitute form, either during preparation or during IRS processing.
Type Font	Many federal tax forms are printed using "Helvetica" as the basic type font. We request that you use this type font when composing substitute forms.
Print Spacing	Substitute forms should be printed using a 6 lines/inch vertical print option. They should also be printed horizontally in 10 pitch pica (i.e., 10 print characters per inch) or 12 pitch elite (i.e., 12 print positions per inch).
Image Size	The image size of printed substitute form should be as close as possible to that of the official form. You may omit any text on both computer-prepared and computer-generated forms that is solely instructional.
Title Area Changes	To allow a large top margin for marginal printing and more lines per page, the title line(s) for all substitute forms (not including the form's year designation and sequence number, when present), may be photographically reduced by 40 percent or reset as one line of type. When reset as one line, the type size may be no smaller than 14-point. You may omit "Department of the Treasury, Internal Revenue Service" and all reference to instructions in the form's title area.
Remove Government Printing Office Symbol and IRS Catalog Number	When privately printing substitute tax forms, the Government Printing Office symbol and/or jacket number must be removed. In the same place, using the same type size, print the Employer Identification Number (EIN), the Social Security Number (SSN) of the printer or designer, or the IRS assigned source code. (We prefer this last number be printed in the lower left area of the first page of each form.) Also remove the IRS Catalog Number, if one is present in the bottom center margin, and the Recycle Symbol, if the substitute is not produced on recycled paper.
Printing On One Side of Paper	While it is preferred that both sides of the paper be used for substitute and reproduced forms, resulting in the same page arrangement as that of the official form or schedule, the IRS will not reject your forms if only one side of the paper is used.
Photocopy Equipment	The Internal Revenue Service does not undertake to approve or disapprove the specific equipment or process used in reproducing official forms. Photocopies of forms must be entirely legible and satisfy the conditions stated in this and other revenue procedures.
Reproductions	Reproductions of official forms and substitute forms that do not meet the requirements of this revenue procedure may not be filed instead of the official forms. Illegible photocopies are subject to being returned to the filer for resubmission of legible copies.
Removal of Instructions	You may remove all references to instructions. No prior approval is needed. One exception is that the statement, "For Paperwork Reduction Act Notice, See Instructions", must be retained or a similar statement provided on each form.

Paper

Paper Content

The paper must be:
- Chemical wood writing paper that is equal to or better than the quality used for the official form
- At least 18 pound (17″ × 22″, 500 sheets), or
- At least 50 pound offset book (25″ × 38″, 500 sheets).

Paper with Chemical Transfer Properties

There are several kinds of paper prohibited for substitute forms. These are:
- Carbon-bonded paper
- Chemical transfer paper except when the following specifications are met:
  - Each ply within the chemical transfer set of forms must be labeled.
  - Only the top ply (ply one and white in color), the one that contains chemical on the back only (coated back), may be filed with the Service.

Example

A set containing three plies would be constructed as follows: one ply (coated back), "Federal Return, File with IRS"; ply two (coated front and back), "Taxpayer's copy", and ply three (coated front), "Preparer's copy."

- The file designation, "Federal Return, File with IRS," for ply one must be printed in the bottom right margin (just below the last line of the form) in 12-point, bold-face type.

- It is not mandatory, but recommended, that the file designation "Federal Return, File with IRS," be printed in a contrasting ink for visual emphasis.

Carbon Paper

Do not attach any carbon paper to any return you file with the Internal Revenue Service.

Paper and Ink Color

We prefer that the color and opacity of paper substantially duplicates that of the original form. This means that your substitute must be printed in black ink and may be on white or on the colored paper the IRS form is printed on. Forms 1040A and 1040 substitute reproductions may be in black ink without the colored shading. The only exception to this rule is Form 1041–ES, which should always be printed with a very light gray shading in the color screened area. This is necessary to assist us in expeditiously separating this form from the very similar Form 1040–ES.

Page Size

Substitute or reproduced forms and computer prepared/generated substitutes may be the same size as the official form (8″ × 11″ in most cases) or they may be the standard commercial size (8½″ × 11″) exclusive of pinfeed holes. The thickness of the stock cannot be less than .003 inch.

Assembly of Forms *Continued*

If the Form Is	Then Sequence Is
1040	• Form 1040, schedules • Schedules and forms in sequence number order
Any other (Form 1120, 1120S, 1065, 1041, etc.)	• the tax return • lettered schedules (Schedule D, etc.) in alphabetical order • numbered forms in numerical order

- Supporting statements must be in the same sequence as the forms they support, and
- Additional information required or voluntarily submitted.

In this way, they are received in the order in which they must be processed. If you do not send them to us in this order, the Internal Revenue Service has to delay the return package to disassemble them and place them in order before processing is continued.

Chapter 3
Physical Aspects and Requirements

General Guidelines for Substitute Forms

General Information

The Official Form is the Standard. Because a substitute form is a variation from the official form, you should know the requirements of the official form for the year of use before you modify it to meet your needs. The Internal Revenue Service provides several means of obtaining the most frequently used tax forms. These include the Internet, fax-on-demand, CD-ROM and an electronic forms bulletin board (see chapter 4).

Design

Each form must follow the design of the official form as to format arrangement, item caption, line numbers, line references, and sequence.

State Tax Information Prohibited

State tax information must not appear (be visible) on the federal tax return or associated form or schedule which is filed with the Internal Revenue Service, except where amounts are claimed on or required by the federal return, e.g., state and local income taxes, Schedule A (Form 1040).

Vertical Alignment of Amount Fields

If	Then
a form is to be manually prepared	• the federal column must have a vertical line or some type of indicator in the amount field to separate dollars from cents if the official form has a vertical line. • the cents column must be at least 2/10" wide.
a form is to be computer-generated	• vertically align the amount entry fields where possible. • use one of the following amount formats: • 0,000,000. • 0,000,000.00
a form is to be computer-prepared	• you may remove the vertical line in the amount field that separates dollars from cents. • use one of the following amount formats: • 0,000,000. • 0,000,000.00

Attachment Sequence Number

- Most individual income tax forms have a required "attachment sequence number" located just below the year designation in the upper right corner of the form. The Internal Revenue Service uses this number to indicate the order in which forms are to be attached to the tax return so they may be processed in that order. Some of the attachment sequence numbers may change each year.

On Computer-prepared forms:
- It must be printed in no less than 12-point boldface type and centered below the form's year designation.
- The sequence number must be placed following the year designation for the tax form and separate with an asterisk.
- It is not necessary to duplicate the "Attachment Sequence Number" wording, except for the actual number.

Paid Preparer's Information and Signature Area

On Forms 1040EZ, 1040A, 1040, and 1120, etc., the "Paid Preparer's Use Only" area may not be rearranged or relocated. You may, however, add three extra lines to the paid preparer's address area without prior approval. This applies to other tax forms as well. Please note that the preparer's area on Form 1040EZ is on the bottom of page 2. Substitute Forms 1040EZ with the preparer area in any location other than the bottom of page 2 will not be accepted.

Assembly of Forms

If developing software or forms for use by others, please inform your customers/clients that the order in which the forms are arranged may affect the processing of the package. A return must be arranged in this order:

Office of Management and Budget (OMB) Requirements for All Substitute Forms

OMB Requirements for All Substitute Forms

Legal Requirements of the Paperwork Reduction Act of 1995 ("Act"). Public Law 104-13 requires that:

- OMB approve all IRS tax forms that are subject to the Act,
- Each IRS form contains (in the upper right corner) the OMB number, if any, and
- Each IRS form (or its instructions) states why IRS needs the information, how it will be used, and whether or not the information is required to be furnished.

This information must be provided to every user of official or substitute tax forms.

Application of Act to Substitute Forms

On forms to which OMB numbers have been assigned:

- All substitute forms must contain in the upper right corner the OMB number that is on the official form.
- Format Required - OMB No. XXXX-XXXX (Preferred) or OMB # XXXX-XXXX.

Required Explanation to Users

You must also inform the users of your substitute forms of the IRS use and collection requirements stated in the instructions for the official Internal Revenue Service form.

- If you provide your users or customers with the official IRS instructions, page 1 of each form must retain either the Paperwork Reduction Act Notice, or a reference to it as the IRS does on the official forms (usually in the lower left corner of the forms).
- If the IRS instructions are not provided to users of your forms, the exact text of the Paperwork Reduction Act Notice must be furnished on the form or separately.
- This notice reads, in part, "We ask for this information to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to insure that you are complying with these laws and to allow us to figure and collect the right amount of tax..."
- You must also include a copy of the alternative statement provided to users of your forms with the forms you submit for approval.

Obtaining OMB Number and Notice

The OMB number and Paperwork Reduction Act Notice may be obtained from the official form (or its instructions), any format produced by the IRS (e.g., Compact Disc (CD), Internet download, or Bulletin Board System (BBS) download).

Continuous Use Forms

Forms without preprinted tax years are called "continuous use" forms. Many of these forms had expiration dates, but these are being phased out. Continuous use forms are revised when a legislative change affects the form or a change will facilitate processing.

Internet Program Chart

A chart of print dates (for annual and quarterly forms) and most current revision dates (for continuous use forms) will be maintained on the Internet. For further details, see the section on Internet access in Chapter 4 of this revenue procedure.

Required Copies

Generally, you must send us one copy of each form being submitted for approval. However, if you are producing forms for different computer systems (e.g., IBM (or compatible) vs. MacIntosh) or different types of printers (laser vs. dot matrix), and these forms differ significantly in appearance, submit one copy for each type of system or printer.

Requestor's Responsibility After Receipt of Approval

Following the receipt of initial approval for a substitute forms package, or of a software output program to print substitute forms, it is the responsibility of the originator (designer or distributor) to provide each subsequent client firm or individual with the pertinent Service forms requirements that must be met for continuing acceptability.
Examples of this responsibility include:

- The use of prescribed print paper, font size, legibility, state tax data deletion,
- The legal requirements of the Paperwork Reduction Act Notice for informing all users of substitute forms of the official use and collection requirements stated in the instructions for the official IRS forms, completion of documents, etc.

Source Code

The Substitute Forms Program Coordinator Office, T:FP:S, will assign a unique source code to each firm that submits substitute paper forms for approval. This will be a permanent control number that should be used on every form created by a particular firm.

- This source code should be printed at the bottom left margin area on the first page of every approved substitute paper form.
- The source code for paper returns consists of three alpha characters.
- This source code should not be used on optically scanned (OCR) forms, except for certain specified Forms 1040–ES.

Guidelines for Obtaining IRS Approval, *Continued*

Accompanying Statement

When the sample substitute is submitted, there should be an accompanying statement that lists the form number of each substitute requested and detail those items that deviate from the official form in position, arrangement, appearance, line numbers, additions, deletions, etc. Included with each of the items should be a detailed reason or justification for the change and an approximation of the number of forms expected to be filed.

When requesting approval for multiple forms, the statement should be presented as a checksheet. Checksheets are not mandatory, but do facilitate the approval process. The checksheet may look like the example (Exhibit C) displayed in the back of this procedure or may be one of your own design. Please include your fax number on the checksheet.

Approval/Non-Approval Notice

The Substitute Forms Coordinator will fax the checksheet or an approval letter back to the originator if a fax number has been provided, unless:

- the requester has asked for a formal letter, or;
- significant corrections are required to the submitted forms.

Notice of approval may contain qualifications for use of the substitutes. Notices of non-approval letters may specify the changes required for approval, and may also require resubmission of the form(s) in question. Telephone contact is used when possible.

Duration of Approval

Most signature tax returns and many of their schedules and related forms have the tax (liability) year printed in the upper right corner. Approvals for these forms are usually good for one calendar year (January through December of the year of filing). Quarterly tax forms in the 94X series, and Form 720, require approval for any quarter in which the form has been revised.

- If the preprinted year is the only change made to a form, the form for the upcoming year is not subject to review.
- Otherwise, each new filing season requires a new approval.

Limited Continued Use of Approved Change

Limited continued use of a change approved for one tax year may be allowed for the same form in the following tax year. Examples of such limitations and requirements are the use of abbreviated words, revised form spacing, compressed text lines, shortened captions, etc., which do not change the consistency of lines or text on the official forms.

If substantial changes are made to the form, new substitutes must be submitted for approval. If only minor editorial changes are made to the form, it is not subject to review.

If you received written approval of a previous tax year substitute form governed by this revenue procedure and continue to use the approved change on your current tax year substitute form, you may revise your form to include this change and, without additional written approval, use it as a current tax year substitute form, provided you comply with the requirements in this revenue procedure.

When Approval Is Not Required

If you received written approval for a specific change on a specific form last year, such as deleting the vertical lines used to separate dollars and cents on some forms and schedules, e.g., Schedules A & B of Form 1040, you may again make the same change on the same form this year if the item changed is present on this year's official form.

- The new substitute does not have to be sent to the IRS and written approval is not required.
- However, the new substitute must conform to the official current year IRS form in other respects: date, Office of Management and Budget (OMB) approval number, attachment sequence number, Paperwork Reduction Act Notice statement, arrangement, item caption, line number, line reference, data sequence, etc.
- It must also comply with this revenue procedure—which may have eliminated, added to, or otherwise changed the guideline(s) which affected the change approved last year.

Exception: Those written approvals which state that the approved change or form would not be allowed in any other tax year, or for a temporary, limited, or interim approval pending resolution of a failure to meet one or more IRS-prescribed requirements.

- This authorization for continued use of an approved change is limited to the continuation of design logic from an immediately prior tax year substitute form to a current tax year substitute form.

Guidelines for Obtaining IRS Approval

Basic Requirements

Preparers who desire to file substitute privately designed and printed tax forms and/or computer-generated and computer-prepared tax forms must develop such substitutes using the guidelines for substitute forms established in this chapter. These substitutes, unless excepted by revenue procedure, must be approved by the IRS before being filed.

1040PC Format Return

A software developer who wants to market, distribute, or use for its own clientele, a tax preparation package featuring the 1040PC tax return format, must first file an application to participate in the program. Only after successfully fulfilling test requirements will a developer's software package be accepted by the IRS to produce 1040PC tax returns.

Conditional Approval Based on Advanced Proofs

The Internal Revenue Service cannot grant final approval of your substitute form until the official form has been published. However, the IRS usually releases advance proof copies of selected major tax forms that are subject to further changes and OMB approval before their release in final format for printing and distribution to the public.

We encourage submission of proposed substitutes of these advance proof forms, and will grant conditional approval based solely on these early proofs. These advance proofs are subject to significant change before forms are finalized. If these advance proofs are used as the basis for your substitute forms, you will be responsible for subsequently updating your final forms to agree with the final official version before use. These revisions need not be submitted for further approval.

NOTE: Conditional approval will not be granted after the final version of an official form is published.

Any alteration of forms must be within the limits acceptable to the Service. It is possible that, from one filing period to another, a change in law or a change in internal need (processing, audit, compliance, etc.) may change the allowable limits for the alteration of the official form.

When specific approval of any substitute form (other than those specified in Chapter 2, IRS Contacts) is desired, a sample of the proposed substitute should be forwarded for consideration by letter to the Substitute Forms Program Coordinator at the address shown in Chapter 2.

To expedite multiple forms approval, we prefer that your proposed forms be submitted in separate sets by return. For example, Forms 1040 and their normally related schedules or attachments should be submitted separately from Forms 1120, 1065, 5500 Series, etc., if at all possible. Schedules and forms (e.g., Forms 3468, 4136, etc.) that can be used with more than one type of return (e.g., 1040, 1041, 1120, etc.) should be submitted only once for approval, regardless of the number of different tax returns with which they may be ultimately associated. In addition, all pages of a multipage form or return should be submitted in the same package.

Approving Offices

As no IRS office except the ones specified in this procedure are authorized to approve substitute forms, unnecessary delay may result if forms are sent elsewhere for approval. All forms submitted to any other office must be forwarded to the appropriate office for formal control and review. The Substitute Forms Program Coordinator may then coordinate the response with the program analyst responsible for the processing of that form. Such coordination may include allowing the analyst to officially approve the form. No IRS office is authorized to allow deviations from this revenue procedure.

Service's Review of Software Programs, etc.

The IRS does not review or approve the logic of specific software programs, nor confirm the calculations entered on forms output from these programs that are submitted for approval. The accuracy of the program itself remains the responsibility of the software package developer, distributor, or user. The Substitute Forms Program is primarily concerned with the prefiling quality review of the final forms output, produced by whatever means, that are expected to be processed by IRS field offices. For the above reasons, it is suggested that you submit forms without including any "taxpayer" information such as names, addresses, monetary amounts, etc.

When to Send Proposed Substitutes

Proposed substitutes, which are required to be submitted per this revenue procedure, should be sent as much in advance of the filing period as possible. This is to allow adequate time for analysis and response.

Restrictions on Changes

Things You CANNOT Do to IRS Forms Suitable for Substitute Tax Forms

You cannot, without prior IRS approval, change any Internal Revenue Service tax form or use your own (non-approved) versions (preprinted labels), including graphics, unless specifically permitted by this revenue procedure.

You cannot adjust any of the graphics on Forms 1040, 1040A, and 1040EZ (except in those areas specified in Chapter 5 of this revenue procedure) without prior approval from the IRS Substitute Forms Program.

You cannot use your own preprinted label on tax returns filed with IRS, unless you fully comply with the exception criteria specified in the section on use of preaddressed IRS labels in this revenue procedure.

Vouchers

Overview

All payment vouchers (Forms 940–V, 940–EZ(V), 941–V, 943–V, 945–V, 1040–V, and 2290–V) must be reproduced. Substitute vouchers must be the same size as the officially printed vouchers. Vouchers that are prepared for printing on a laser printer may include a scanline.

Scanline Fields

NNNNNNNNN AA AAAA NN N NNNN NNN
A B C D E F G

A - Social Security Number/Employer Identification Number (SSN/EIN) has 9 numeric spaces.
B - Check Digit has 2 alpha spaces.
C - Name Control has 4 alphanumeric spaces.
D - Master File Tax (MFT) Code has 2 numeric spaces (see below).
E - Taxpayer Identification Number (TIN) Type has 1 numeric space (see below)
F - Tax period has four numeric spaces in year/month format (YYMM).
G - Transaction Code has 3 numeric spaces.

MFT Code

Code Number for:
- Form 1040 family - 30;
- Form 940/940-EZ - 10;
- Form 941 - 01;
- Form 943 - 11;
- Form 945 - 16; and
- Form 2290 - 60.

TIN Type

Type Number for:
- Form 1040 family - 0; and
- Forms 940, 940–EZ, 941, 943, 945, and 2290–2.

Voucher Size

The voucher size must be exactly 8.0″ × 3.25″. The document scanline must be vertically positioned 1.625 inches from the bottom of the scanline to the bottom of the voucher. The right most character of the scanline must be placed 3.5 inches from the right leading edge of the document. The maximum vertical displacement is .06 inches. The minimum required horizontal clear space between characters is .014 inches. The line to be scanned must have a clear band 0.25 inches in height from top to bottom of the scanline, and from border to border of the document. "Clear band" means no printing except for dropout ink.

Print and Paper Weight

Vouchers must be printed in black ink using OCR A or OCR B, size 1 font. The paper must be 20 to 24 pound OCR bond paper weight.

Highlights of Permitted Changes and Requirements

Methods of Reproducing Internal Revenue Service Forms

Official versions are supplied by the Internal Revenue Service, such as those in the taxpayer's tax package, those printed in revenue procedures, and over-the-counter forms available at IRS and other governmental public offices or buildings. Forms are also available on CD-ROM, and on-line via Fedworld and the Internet.

There are methods of reproducing Internal Revenue Service printed tax forms suitable for use as substitute tax forms without prior approval.

- You can photocopy most tax forms and use them instead of the official ones. The entire substitute form, including entries, must be legible.

- You can reproduce any current tax form as cut sheets, snapsets, and marginally punched, pin-fed forms so long as you use an official IRS version as the master copy.

- You can reproduce a "signature form" as a valid substitute form. Many tax forms (including returns) have a taxpayer signature requirement as part of the form layout. The jurat/perjury statement/signature line areas must be retained and worded exactly as on the official form. The requirement for a signature by itself does not prohibit a tax form from being properly computer-generated.

- You can computer-generate Answer Sheet Format Tax Returns on plain bond paper using IRS-accepted software for the 1040PC format for return types 1040EZ, 1040, 1040A, and attachments, forms, and schedules.

Chapter 2

General Guidelines for Submissions and Approvals

General Specifications for Approval

Overview

If you produce any tax returns and forms using IRS guidelines on permitted changes, you can generate your own substitutes without further approval. If your changes are more extensive, you must get official approval before using substitute forms. These changes include the use of typefaces and sizes other than those found on the official form and the condensing of line item descriptions to save space.

Schedules

Schedules are considered to be an integral part of a complete tax return when assigned consecutive page numbers and printed contiguously with page 1 of the return.

Example of Schedules That Must Be Submitted With the Return

Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, is an example of this situation, where Schedules A through S have pages numbered as part of the basic return. For a Form 706 to be approved, the entire form including Schedules A through S must be submitted.

Examples of Schedules That Can Be Submitted Separately

However, Schedules 1, 2, and 3 of Form 1040A are examples of schedules that can be separately computer-generated. Although IRS printed as a continuation of Form 1040A, none of these schedules have page numbers that require them to be filed with Form 1040A, and may, therefore, be separated from Form 1040A and submitted as computer-generated substitute schedules.

Use and Distribution of Unapproved Forms

The Internal Revenue Service is continuing a program to identify and contact tax return preparers, forms developers, and software publishers who use or distribute unapproved forms that do not conform to this revenue procedure. The use of unapproved forms impedes processing of the returns.

Agreement

Important Stipulation of This Revenue Procedure

Any person or company who uses substitute forms and makes all or part of the changes specified in this revenue procedure agrees to the following stipulations:

- The Internal Revenue Service presumes the changes are made in accordance with these procedures and, as such, will be noninterruptive to the processing of the tax return.
- Should any of the changes prove to be not exactly as described, and as a result become disruptive to the Internal Revenue Service during processing of the tax return, the person or company agrees to accept the determination of the IRS as to whether or not the form may continue to be used during the filing season.
- Also agrees to work with the IRS in correcting noted deficiencies. Notification of deficiencies may be made by any combination of fax, letter, email, or phone contact and may include the return of unacceptable forms for resubmission of acceptable forms.

Definitions

Substitute Form	A tax form (or related schedule) that differs in any way from the official version and is intended to replace the entire form that is printed and distributed by the Service. This term also covers those approved substitute forms exhibited in this revenue procedure.
Printed (or Preprinted) Form	A form produced using conventional printing processes. Also, a printed form which has been reproduced by photocopying or similar processes.
Preprinted Pin-Fed Form	A printed form that has marginal perforations for use with automated and high-speed printing equipment.
Computer-Prepared Substitute Form	A preprinted form in which the taxpayer's tax entry information has been inserted by a computer, computer-printer, or other computer type equipment, such as word-processing equipment.
Computer-Generated Substitute Tax Return or Form	A tax return or form that is entirely designed and printed by the use of a computer printer, such as a laser printer, etc., on plain white paper. This return or form must conform to the physical layout of the corresponding Service form although the typeface may differ. The text should match the text on the officially printed form as closely as possible; condensed text and abbreviations will be considered on a case-by-case basis. **Exception: All jurats (perjury statements) must be reproduced verbatim.**
Manually-Prepared Form	A preprinted reproduced form in which the taxpayer's tax entry information is entered by an individual using a pen, pencil, typewriter, or other non-automated equipment.
Computer-Generated Answer Sheet Format Tax Return	A tax return that contains only the taxpayer's significant line entries, and is formatted three columns per page with tax form headings, a summary, and jurat. This return is printed on plain white paper using a computer printer.
Graphics	Those parts of a printed tax form that are not tax amount entries nor called-for information. Generally, these are line numbers, captions, shadings, instructions, special indicators, borders, rules, and strokes created by typesetting, photographics, photocomposition, etc.
Acceptable Reproduced Form	A legible photocopy of an original form.
Supporting Statement (Supplemental Schedule)	A document providing detailed information to support an entry for a line(s) on an official or approved substitute form and filed with (attached to) a tax return. (A supporting statement is not a tax form and does not take the place of an official form, unless specifically permitted elsewhere in this procedure.)
Specific Forms Terms	The following terms are used throughout this revenue procedure in reference to all substitute forms, with the exception of the 1040PC "answer sheet format" tax return.
Format	The overall physical arrangement and general layout of a substitute form.
Sequence	The same numeric and logical placement order of data, as reflected on the official form version. Sequence is an integral part of the total format requirement.
Line Reference (Code)	The line numbers, letters or alphanumerics used to identify each captioned line on the official forms, and printed to the immediate left of each caption or data entry field.
Item Caption	The textual portion of each line on the form identifying the specific data elements required.
Data Entry Field	All areas designated on a form for the insertion of data, such as dollar amounts, quantities, responses, checkboxes, etc.

Nature of Changes

Changes to the Revenue Procedure

- Information on IRS Contact offices has been consolidated.
- Payment vouchers size requirements have been revised and specifications moved from exhibits to text.
- Graphics changes revised for Form 1040, Page 2.
- A sample exhibit of a checklist of forms for use in submitting substitute forms has been included.
- Instructions for machine reading (scanning) Form 941 OCR or Schedule B (Form 941) have been deleted.
- Previous instructions labeled "Special Form 941 Requirements" have been removed from this revenue procedure.
- The office phone number and address for 1040PC Project Office has been updated.
- A paragraph has been added on Tax Fax and CD-ROM ordering instructions have been updated.
- Various editorial changes have been made.

IRS Contacts

Where To Send Substitute Forms

Send your substitute forms to the following offices:

Form	Office and Address
W–2, W–3	Internal Revenue Service Attn: Substitute Form W–2 Coordinator CP:CO:SC:A 5000 Ellin Road Lanham, MD 20706
1096, 1098, 1099 Series, 5498, and W–2G	Internal Revenue Service Attn: IRP Coordinator T:S:P:S 5000 Ellin Road Lanham, MD 20706
4461, 4461–A, 4461–B, 5300, 5323, 5327, 5310, 5310–A, and 6406	Internal Revenue Service Attn: EP OCR Forms Coordinator E:EP:FC 1111 Constitution Avenue, NW Room 2232 IR Washington, DC 20224
All others	Internal Revenue Service Attn: Substitute Forms Program T:FP:S 1111 Constitution Avenue, NW Room 2708 IR Washington, DC 20224

Chapter 1

Introduction to Substitute Forms

Overview of Revenue Procedure 97–54

Purpose

This revenue procedure provides the general requirements and conditions for the development, printing, and approval of all substitute tax forms to be acceptable for filing in lieu of official IRS forms.

Unique Forms

Certain unique, specialized forms require the use of other additional revenue procedures to supplement this publication. See Chapter 4.

Scope

The Internal Revenue Service accepts quality substitute tax forms that are consistent with the official forms, and that do not have an adverse impact on our processing. The IRS Substitute Forms Program administers the formal acceptance and processing of these forms nationwide. While this program deals primarily with paper documents, it also interfaces with other processing and filing media such as:

- magnetic tape,
- optical character recognition, and
- electronic filing, etc.

Only those substitute forms that comply fully with the requirements set forth herein are acceptable. Exhibit L–1 lists the form numbers mentioned in this document and their titles. This revenue procedure is updated as required to reflect pertinent tax year form changes and to meet processing and/or legislative requirements.

Forms Covered by This Revenue Procedure

The following types of forms are covered by this revenue procedure:

- IRS tax returns and their related forms and schedules.
- Applications for permission to file returns electronically and forms submitted as required documentation for electronically filed returns.
- Powers of Attorney.
- Estimated tax payment vouchers.
- Forms and schedules relating to partnerships, exempt organizations, and employee plans.

Forms NOT Covered by This Revenue Procedure

The following types of forms are not covered:

- W–2, W–3, 1096, 1098, 1099 series, 5498, and W–2G (see following table).
- Federal Tax Deposit (FTD) coupons, which may not be reproduced.
- Requests for information or documentation initiated by the Service.
- Forms used internally by the Service.
- State tax forms.
- Forms developed outside IRS (except for Form TD F 90–22.1, Report of Foreign Bank and Financial Accounts).

CHAPTER EIGHT—MISCELLANEOUS FORMS AND PROGRAMS

CHAPTER NINE—ALTERNATIVE METHODS OF FILING

EXHIBITS

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graph, the phrase "while away from home" generally has the same meaning as that phrase has for purposes of § 162 and the regulations thereunder.

.08 Section 1.170A–1(h)(1) provides that no part of a payment that a taxpayer makes to or for the use of an organization described in § 170(c) that is in consideration of goods or services is a contribution or gift unless the taxpayer intends to and actually does pay an amount that exceeds the fair market value of the goods or services received. *See United States v. American Bar Endowment,* 477 U.S. 105 (1986).

.09 Federal advisory committees are governed by the Federal Advisory Committee Act, 5 U.S.C. app. §§ 1–15 (1994) (Act), and the regulations thereunder. A federal advisory committee is a "useful and beneficial means of furnishing expert advice, ideas, and diverse opinions to the Federal Government." Act § 2(a). Under the Act, a federal agency may accept the services without compensation of a federal advisory committee member. 41 C.F.R. § 101–6.1033(d) (1996). An advisory committee member may be reimbursed by the federal agency for travel expenses, including a per diem in lieu of lodging, meal, and incidental expenses. 41 C.F.R. § 1.101–6.1033(e) (1996).

SECTION 3. LAW

Whether payments are ordinary and necessary business expenses under § 162, or are "contributions or gifts" within the meaning of § 170, depends on whether the payments bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of substantial benefit or financial return commensurate with the amount of the payment, or whether the payments are completely gratuitous. *See* Rev. Rul. 72–314, 1972–1 C.B. 44 (amounts paid by stock brokerage business to a charitable organization whose purpose is to reduce neighborhood tensions and combat community deterioration are deductible under § 162 because the payments are business related and could reasonably be expected to produce commensurate financial return for the business); Rev. Rul. 72–293, 1972–1 C.B. 95 (payments to the United States Transportation Exposition may be deducted under § 162 or 170 depending on the facts and circumstances); Rev. Rul. 65–285, 1965–2 C.B. 56 (out-of-pocket expenses of invitees to the National Conference on Law and Poverty are deductible under § 170 because invitees are rendering services without compensation to the United States); and *Singer Co. v. United States,* 449 F.2d 413 (Ct. Cl. 1971) (discounts on a taxpayer's sales of sewing machines to certain qualified donees, including churches, hospitals, and government agencies, were deductible (under prior law) as charitable contributions under § 170 because the taxpayer did not expect to receive substantial benefit from those discounts; discounts provided on similar sales to schools, however, were not deductible as charitable contributions under § 170 because the taxpayer expected to receive substantial benefit from those discounts in the form of increased future sales).

SECTION 4. PROCEDURE

.01 The federal income tax deductibility of unreimbursed expenses of a federal advisory committee member under § 162 or 170 depends in part on whether the committee member reasonably expects to receive substantial benefit or commensurate financial return as a result of incurring the expenses. Determining expected benefit or financial return often can be difficult when the committee member is engaged in a trade or business related to the subjects discussed by a federal advisory committee while performing services without compensation for that committee.

.02 Therefore, if a taxpayer incurs an unreimbursed travel or other out-of-pocket expense while performing services without compensation as a member of a federal advisory committee, the Service will not challenge the taxpayer's deduction of the expense as a charitable contribution under § 170, provided the taxpayer satisfies the requirements of that section other than those relating to the expectation of any benefit or financial return. If a taxpayer incurs an unreimbursed travel or other out-of-pocket expense while performing services without compensation as a member of a federal advisory committee and the expense is reasonably related to the taxpayer's trade or business, the Service will not challenge the taxpayer's deduction of the expense as an ordinary and necessary business expense under § 162, provided the taxpayer satisfies the requirements of that section other than those relating to the expectation of any benefit or financial return.

SECTION 5. OTHER APPLICABLE LAW

Any deduction within the scope of this revenue procedure must conform to other specific applicable requirements of law, such as the requirement to substantiate deducted expenses. *See* §§ 170(f)(8), 1.170A–13, 274(d), and 1.274–5T. Also, limits on the deductibility of expenses incurred for lobbying purposes may apply in certain situations. *See* §§ 162(e), 1.162–20, 1.162–28, 1.162–29, 170(f)(6), 1.170A–1(j)(11), 170(f)(9), and 1.170A–1(j)(6).

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26 CFR 601.201: Rulings and determination letters (Also Part I, §§ 355; 1.355–2.)

Rev. Proc. 97–53

SECTION 1. PURPOSE

This revenue procedure modifies Rev. Proc. 97–3, 1997–1 I.R.B. 85, (January 6, 1997), which sets forth provisions of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Domestic) and the Associate Chief Counsel (Employee Benefits and Exempt Organizations) relating to matters where the Service will not issue advance rulings or determination letters.

SECTION 2. BACKGROUND

Section 5 of Rev. Proc. 97–3 lists areas under extensive study in which rulings or determination letters will not be issued until the Service resolves the issue through publication of a revenue ruling, revenue procedure, regulations, or otherwise. Section 5.17 of Rev. Proc. 97–3 provides that rulings or determination letters will not be issued under § 355(a)(1) of the Code with respect to certain distributions until the Service resolves issues related to these distributions. The no rule position of section 5.17 was originally set forth in Rev. Proc. 96–39, 1996–2 C.B. 300, which was superseded by Rev. Proc. 97–3.

SECTION 3. PROCEDURE

Rev. Proc. 97–3 is modified by deleting section 5.17.

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective on November 10, 1997, the date it is made available to the public.

Country	Date of Departure On or After	On or Before
Afghanistan	April 23, 1979	(still in effect)
Bosnia and Herzegovina	April 7, 1992	(still in effect)
Central African Republic	May 21, 1996	September 12, 1996
Croatia	April 7, 1992	(still in effect)
Iran	September 1, 1978	(still in effect)
Lebanon	August 31, 1979	(still in effect)
The Former Yugoslav Republic of Macedonia	June 13, 1992	(still in effect)
Montenegro[1]	June 13, 1992	(still in effect)
Serbia[1]	June 13, 1992	(still in effect)
Somalia	December 21, 1990	(still in effect)

[1]Montenegro and Serbia, formerly part of the Socialist Federal Republic of Yugoslavia, have asserted the formation of a joint independent state, but this entity has not been formally recognized as a state by the United States.

.05 Accordingly, for purposes of § 911 of the Code, an individual who left one of the foregoing countries during the specified period shall be treated as a qualified individual with respect to the period during which that individual was a bona fide resident of, or present in, that foreign country if the individual establishes a reasonable expectation of meeting the requirements of § 911(d) but for those conditions.

.06 To qualify for relief under § 911(d)-(4), an individual must have established residency or have been physically present in the foreign country on or prior to the date that the Secretary of the Treasury determines that individuals were required to leave the foreign country. Individuals who establish residency or are first physically present in the foreign country after the date that the Secretary prescribes, but during the period for which the Secretary determines that individuals were required to leave the foreign country, shall not be treated as qualified individuals under § 911(d)(4) pursuant to § 911(d)(4)(C). For example, individuals who establish residency or are first physically present in Iran after September 1, 1978, are not eligible to qualify for the exemption prescribed in § 911(d)(4). The same holds true with respect to individuals who move to Afghanistan after April 23, 1979, or Lebanon after August 31, 1979.

SEC. 3. INQUIRIES

A taxpayer who needs assistance on how to claim this exclusion, or on how to file an amended return, should contact a local IRS Office or, for a taxpayer residing or traveling outside the United States, the nearest overseas IRS office.

SEC. 4. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 92-63, 1992-2 C.B. 421 is obsoleted.

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26 CFR 601.162: Business Expenses.
(Also Part I, §§ 170; 1.162-15, 1.170A–1)

Rev. Proc. 97–52

SECTION 1. PURPOSE

This revenue procedure provides guidance on the deductibility, under § 162 or 170 of the Internal Revenue Code, of unreimbursed travel and other out-of-pocket expenses incurred by a member of a federal advisory committee while performing services without compensation for the federal government as a member of that committee.

SECTION 2. BACKGROUND

.01 Section 162(a) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

.02 Section 162(b) provides that no deduction is allowed under § 162(a) for any contribution or gift that would be allowable as a deduction under § 170 were it not for the percentage limitations, the dollar limitations, or the requirements regarding the time of payment, set forth in § 170.

.03 Section 1.162–15 of the Income Tax Regulations provides, in part, that no deduction is allowable under § 162(a) for a contribution or gift by an individual or a corporation if any part thereof is deductible under § 170(a).

.04 Section 170(a)(1) allows as a deduction any charitable contribution (as defined in § 170(c)) payment of which is made within the taxable year.

.05 Section 170(c)(1) provides, in part, that the term "charitable contribution" means a contribution or gift to or for the use of the United States, but only if the contribution or gift is made for exclusively public purposes.

.06 Section 1.170A–1(c)(5) provides that transfers of property to an organization described in § 170(c) that bear a direct relationship to the taxpayer's trade or business and that are made with a reasonable expectation of financial return commensurate with the amount of the transfer may constitute allowable deductions as trade or business expenses under § 162 rather than as charitable contributions under § 170.

.07 Section 1.170A–1(g) provides that no deduction is allowable under § 170 for the contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization, contributions to which are deductible, may constitute a deductible contribution. For example, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible. For the purposes of this para-

SECTION 2. BACKGROUND

Many computer systems use two digits rather than four digits to represent the year in a date field (for example, "97" to represent 1997). A two-digit year field, however, may be inadequate to represent years after 1999. For data involving the year 2000, for example, computer systems may not recognize "00" as a year, or may treat that year as 1900 instead of 2000. Thus, many computer systems may fail to operate, or may operate improperly, if the software is not converted or replaced to recognize four-digit years (*i.e.*, made "year 2000 compliant"). In order to ensure that their computer systems are year 2000 compliant, taxpayers may pay or incur costs to manually convert their existing software, to develop new software to replace their existing software, to purchase or lease new software to replace their existing software, or to develop or purchase software tools to assist them in converting their existing software to be year 2000 compliant ("year 2000 costs").

SECTION 3. TREATMENT OF YEAR 2000 COSTS

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

SECTION 4. RESEARCH CREDIT

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

SECTION 5. APPLICATION

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

SECTION 6. EFFECT ON OTHER DOCUMENTS

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

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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 I, § 911, 1.911–1)

Rev. Proc. 97–51

SEC. 1. PURPOSE

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

02. The Internal Revenue Service previously has listed countries for which the eligibility requirements of § 911(d)(1) of the Code are waived under § 911(d)(4) because of adverse conditions in those countries during the time periods stated. See Rev. Proc. 96–33, 1996–1 C.B. 720, Rev. Proc. 95–45, 1995–2 C.B. 421, Rev. Proc. 94–31, 1994–1 C.B. 625, and Rev. Proc. 94–15, 1994–1 C.B. 575. This revenue procedure relists countries where the adverse conditions are still in effect. The Central African Republic is added to the list for 1996. Rev. Proc. 96–33, Rev. Proc. 95–45, Rev. Proc. 94–31, and Rev. Proc. 94–15 remain in full force and effect; the older periods listed therein are omitted from this revenue procedure solely for brevity.

SEC. 2. BACKGROUND

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

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

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

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

revenue procedure, provided the changes are made in the consent year. Any such changes in methods are effected on a cut-off basis (that is, no § 481(a) adjustment will be made). For any subsequent taxable year, § 446(e) consent must be separately requested under applicable administrative procedures if a member has failed to conform its accounting practices to the treatment of intercompany transactions required as a result of obtaining a consent pursuant to this revenue procedure. *See* Rev. Proc. 97–27, 1997–21 I.R.B. 10, or its successor. Any such changes in methods are effected on a cut-off basis (that is, no § 481(a) adjustment will be made).

.03 A consent shall not preclude the application of § 482 to members of a consolidated group.

.04 A consent granted under § 1.1502–13(e)(3) to treat intercompany transactions on a separate entity basis does not apply for purposes of taking into account losses and deductions deferred under § 267(f).

SECTION 8. REVOCATION OF CONSENT UNDER § 1.1502–13(e)(3)

.01 Consent to treat intercompany transactions on a separate entity basis under § 1.1502–13(e)(3) is revoked automatically for any taxable year in which the Effect on CTI, when averaged with the Effect on CTI for each of the two preceding taxable years, is greater than 10 percent. The consolidated group must attach a statement to its original return for the taxable year in which the consent is revoked, indicating that the consent under § 1.1502–13(e)(3) has been revoked pursuant to this Section 8.01.

.02 The Service's consent under § 1.1502–13(e)(3) is granted for any consolidated group to revoke a valid consent received from the Service under § 1.1502–13(e)(3) to treat intercompany transactions on a separate entity basis, and thus treat intercompany transactions on a single entity basis, provided a statement is attached to the consolidated group's original return for the taxable year in which the revocation is to be effective indicating its revocation of the consent pursuant to this Section 8.02. In cases where a valid consent from the Service to report intercompany transactions on a separate entity basis was not previously obtained and the consolidated group wants to change from separate entity reporting to single entity reporting, see Section 9.

.03 Notwithstanding that the Service has granted consent under § 1.1502–13(e)(3) and that such consent has not been revoked pursuant to Section 8.01 or 8.02, the district director may, upon examination of tax returns for years subsequent to the consent year, recommend that the ruling granting such consent be modified or revoked if the conditions and circumstances under which the ruling was granted have changed substantially and it is determined that single entity reporting is necessary in order to clearly reflect CTI under § 446. If the district director recommends that the ruling granting such consent be modified or revoked, the district director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 97–2, 1997–1 I.R.B. 64, or its successor, will be followed.

.04 When consent under § 1.1502–13(e)(3) is revoked pursuant to Section 8.01, 8.02 or 8.03, each member of the consolidated group must report those intercompany transactions for which consent has been revoked on a single entity basis for the taxable year of the revocation and all subsequent taxable years (ending prior to the first taxable year for which the group does not file a consolidated return) unless consent is received pursuant to a new request submitted under Section 4.

.05 Section 446(e) consent is granted under § 1.1502–13(e)(3)(iii) for any changes in methods of accounting for intercompany transactions that are necessary solely to conform a member's methods to a revocation of consent made pursuant to this revenue procedure, provided the changes are made in the taxable year for which the revocation is made. Any such changes in methods are effected on a cut-off basis (that is, no § 481(a) adjustment will be made). For any subsequent taxable year, § 446(e) consent must be separately requested under applicable administrative procedures if a member has failed to conform its accounting practices to the treatment of intercompany transactions required as a result of a revocation made pursuant to this revenue procedure. *See* Rev. Proc. 97–27, or its successor. Any such changes in methods are effected on a cut-off basis (that is, no § 481(a) adjustment will be made).

SECTION 9. REQUESTS FOR CONSENT TO CHANGE FROM SEPARATE ENTITY REPORTING TO SINGLE ENTITY REPORTING IN CASES WHERE A VALID CONSENT FROM THE SERVICE TO REPORT INTERCOMPANY TRANSACTIONS ON A SEPARATE ENTITY BASIS WAS NOT PREVIOUSLY OBTAINED

The Service's consent under § 446(e) to change from separate entity reporting to single entity reporting must be separately requested under applicable administrative procedures in cases where a valid consent from the Service to report intercompany transactions on a separate entity basis was not previously obtained. *See* Rev. Proc. 97–27, or its successor. Any such changes in methods of accounting are effected on a cut-off basis (that is, no § 481(a) adjustment will be made).

SECTION 10. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 82–36 is modified and superseded.

SECTION 11. EFFECTIVE DATE

This revenue procedure is effective October 27, 1997, the date it is published in the Internal Revenue Bulletin.

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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 I, §§ 41, 446, 481; 1.446–1, 1.481–1, 1.481–4.)

Rev. Proc. 97–50

SECTION 1. PURPOSE

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

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

ing request pursuant to Rev. Proc. 97–1, or its successor. All applicable items of information listed in Section 5 must be included in the request.

.02 The filing requirement of § 1.1502–13(e)(3) will be deemed satisfied where the request for consent is timely filed with the Service and contains all available information. The request must provide an explanation of any omitted information, and state that the omitted information will be submitted not later than the earlier of the following two dates: (1) 90 days after the original due date of the return, or (2) the date the consolidated return is filed with the Service Center.

SECTION 5. INFORMATION TO BE INCLUDED IN REQUESTS FOR CONSENT UNDER § 1.1502–13(e)(3)

.01 Each of the items of information requested in this Section 5 must be addressed in the request for consent under § 1.1502–13(e)(3). If an item is not applicable, the letters "N.A." should be inserted after that item. The presentation of the information should follow the format of this revenue procedure as closely as possible.

.02 Information needed in order to make a determination regarding a request for consent to treat some or all intercompany transactions on a separate entity basis:

1. The date the consolidated group elected to file consolidated returns.

2. The taxable year used by the consolidated group.

3. A calculation of the difference, for the consent year and for each of the two taxable years preceding the consent year, between (a) CTI computed by treating all intercompany transactions on a single entity basis and (b) CTI computed by treating those intercompany transactions for which consent is requested, and those intercompany transactions for which consent has previously been obtained, on a separate entity basis. For any taxable year, the percentage difference between (a) and (b) in the preceding sentence is hereinafter referred to as the "Effect on CTI."

4. An analysis of all intercompany transactions for the consent year and for each of the two taxable years preceding the consent year. This analysis must include the number and a description of all intercompany transactions and the dollar amounts thereof.

5. An analysis of the effect of treating those intercompany transactions for which consent is requested on a separate entity basis on the following items for the consent year:

(a) Net operating loss carryovers.

(b) Capital loss carryovers.

(c) Tax credits (for example, foreign tax credits) in the consent year as well as carryovers to the consent year.

With respect to any carryovers referred to in items (a) through (c) above, the analysis should include amounts for each of the carryover years and the date the losses or credits expire.

6. An analysis of whether any sales of property for which consent is requested between members of the consolidated group that would be depreciable or depletable property in the hands of the buying member would result in long-term capital gain to the selling member, taking into account the provisions of §§ 1239, 1245, and 1250, relating to gain from dispositions of certain depreciable property or certain depreciable realty.

7. An analysis of whether any of the members involved in those intercompany transactions for which consent is requested are subject to the separate return limitation year rules or the change of ownership rules under §§ 382 or 383, and a calculation of any amounts subject to limitation under those rules.

8. A description of the type or types of property to which the consent would apply.

9. An analysis of the frequency of those intercompany transactions for which consent is requested, whether they occur in the ordinary course of the consolidated group's business, and whether the amounts or prices charged in connection with these intercompany transactions are for fair market value based on arm's-length bargaining, providing examples thereof. Also include a discussion of whether gains from these intercompany transactions have resulted from arm's length charges or prices.

10. An explanation as to why the consent is being requested, why the consolidated group believes it should not be required to treat these intercompany transactions on a single entity basis, and how treating such transactions on a separate entity basis will clearly reflect CTI under § 446.

SECTION 6. FACTORS AND GUIDELINES USED BY THE SERVICE IN CONSIDERING REQUESTS FOR CONSENT UNDER § 1.1502–13(e)(3)

.01 Whether it is difficult for the consolidated group to account for those intercompany transactions for which consent is requested when they are treated on a single entity basis and, if so, why it is difficult to do so.

.02 Whether the Effect on CTI for the consent year or the average of the Effect on CTI for the consent year and each of the preceding two taxable years is greater than 10 percent. Consent under § 1.1502–13(e)(3) will not be granted in cases where either (a) the Effect on CTI is greater than 10 percent for the consent year or (b) the average of the Effect on CTI for the consent year and each of the two preceding taxable years is greater than 10 percent. However, consent will generally be granted in cases where (a) the Effect on CTI is less than 10 percent for the consent year and (b) the average of the Effect on CTI for the consent year and each of the two preceding taxable years is less than 10 percent.

.03 Whether the consolidated group will secure the benefit of any deduction, credit, or other allowance that it would not otherwise secure if consent to treat those intercompany transactions for which consent is requested on a separate entity basis were not granted.

.04 Whether the gains that are the subject of the consent to treat intercompany transactions on a separate entity basis have resulted from arm's-length charges or prices.

SECTION 7. EFFECT OF THE CONSENT UNDER § 1.1502–13(e)(3)

.01 A consent under § 1.1502–13(e)(3) shall, unless revoked pursuant to Section 8, apply to all members of the consolidated group for the consent year and all subsequent taxable years ending prior to the first taxable year for which the group does not file a consolidated return.

.02 Section 446(e) consent is granted under § 1.1502–13(e)(3)(iii) for any changes in methods of accounting for intercompany transactions that are necessary solely to conform a member's methods to a consent obtained pursuant to this

U.S.C. 3507) under control number 1545–1562.

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

The collection of information in this revenue procedure is in Sections 4.01(2) and 4.02(2). This information is required to be submitted to the applicable service center in order to obtain relief for late S corporation elections. This information will be used to satisfy the reasonable cause requirement in § 1362(b)(5). The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting burden is 100 hours.

The estimated annual burden per respondent varies from .5 hours to 1.5 hours, depending on individual circumstances, with an estimated average of 1 hour. The estimated number of respondents is 100.

The estimated annual frequency of responses is once.

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.

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6 CFR 601.201: Rulings and determination letters. (Also §§ 1502; 1.1502–13.)

Rev. Proc. 97–49

SECTION 1. PURPOSE

This revenue procedure provides the procedures by which a taxpayer may (1) obtain the consent of the Internal Revenue Service (the "Service") to treat some or all intercompany transactions on a separate entity basis under § 1.1502–13(e)(3) of the Income Tax Regulations, (2) revoke such consent, or have such consent revoked by the Service, and (3) obtain the Service's consent to change from separate entity reporting to single entity reporting where a valid consent from the Service to report intercompany transactions on a separate entity basis was not previously obtained.

This revenue procedure modifies and supersedes Rev. Proc. 82–36, 1982–1 C.B. 490.

SECTION 2. BACKGROUND

.01 The consolidated return regulations generally require that intercompany transactions be treated in a manner that produces the effect of transactions between divisions of a single corporation (that is, the regulations treat intercompany transactions on a "single entity basis"). The single entity approach for intercompany transactions is an integral part of the overall tax treatment of affiliated groups filing consolidated returns ("consolidated groups") under § 1502 of the Internal Revenue Code. Treating intercompany transactions on a single entity basis is required to clearly reflect consolidated taxable income ("CTI"). However, in certain circumstances, the Service may exercise discretion and grant consent, under § 1.1502–13(e)(3), to a consolidated group to treat some or all intercompany transactions (other than intercompany transactions with respect to stock or obligations of members of a consolidated group) on a separate entity basis (that is, without the application of § 1.1502–13). Consent under § 1.1502–13(e)(3) may require changes in the methods of accounting for intercompany transactions of members of a consolidated group.

.02 Section 4 sets forth the time and manner in which requests for consent under § 1.1502–13(e)(3) must be filed.

.03 Section 5 provides a checklist which is similar to the checklist set forth in Rev. Proc. 82–36 to facilitate the filing and handling of requests under § 1.1502–13(e)(3) by specifying the information that should be included so that applications will be as complete as possible when originally filed. However, because the information necessary to rule on a particular case depends upon all the facts and circumstances, information in addition to that listed in this revenue procedure may be requested by the Service prior to determining whether consent will be granted.

.04 Section 6 sets forth certain factors and guidelines used by the Service in considering requests for consent under § 1.1502–13(e)(3).

.05 Section 7 sets forth the effect of receiving the Service's consent under § 1.1502–13(e)(3).

.06 Section 8 describes the procedures applicable to the revocation of consent under § 1.1502–13(e)(3). Section 8 provides that consent will generally not be revoked simply because the effect of the consent causes a substantial increase or decrease in CTI in any one taxable year. When consent was granted under Rev. Proc. 82–36, the Service typically stated in the ruling letter that the consent would be revoked whenever the effect of the consent would cause a substantial increase or decrease in CTI.

.07 Section 9 sets forth the manner in which requests for consent to change from separate entity reporting to single entity reporting must be filed in cases where a valid consent from the Service to report intercompany transactions on a separate entity basis was not previously obtained.

.08 The authority and general procedures with respect to the issuance of advance rulings are set forth in Rev. Proc. 97–1, 1997–1 I.R.B. 11, or its successor, and are applicable to requests under § 1.1502–13(e)(3).

SECTION 3. APPLICABILITY

This revenue procedure applies to (1) all requests to obtain the Service's consent to treat some or all intercompany transactions on a separate entity basis under § 1.1502–13(e)(3), (2) all revocations of such consent, whether the revocation is made by the consolidated group or by the Service, and (3) all requests to obtain the Service's consent to change from separate entity reporting to single entity reporting in cases where a valid consent from the Service to report intercompany transactions on a separate entity basis was not previously obtained.

SECTION 4. TIME AND MANNER IN WHICH REQUESTS FOR CONSENT UNDER § 1.1502–13(e)(3) MUST BE FILED

.01 Requests for consent under § 1.1502–13(e)(3) must be filed with the Service on or before the due date of the consolidated return (not including extensions of time) for the first taxable year for which the consent would apply (the "consent year"). These requests for consent must be submitted as a private letter rul-

(b) "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

.02 *Situation 2: Automatic Relief Where First Intended S Corporation Year Filed as a C Corporation.*

(1) *Eligibility for Automatic Relief.* Automatic relief is available in situation 2 if all of the following conditions are met:

(a) The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) was not filed timely for a taxable year that began prior to January 1, 1997;

(b) The corporation received notification from the Service that the Form 2553 was not filed timely, that the corporation must file as a C corporation for the first taxable year the corporation intended to be an S corporation, and that the election would be treated as an S corporation election for the following taxable year;

(c) The corporation and all of its shareholders reported their income (if any) properly treating the corporation as a C corporation for the first taxable year the corporation intended to be an S corporation;

(d) The corporation and all of its shareholders reported their income consistent with S corporation status for all subsequent years;

(e) The period of limitations on assessment under § 6501(a) has not lapsed for any of the taxable years of the corporation beginning on or after the date the corporation intended to be taxable as an S corporation; and

(f) The period of limitations on assessment under § 6501(a) has not lapsed for any taxable year of any of the corporation's shareholders in which any taxable year described in paragraph (e) above ends.

(2) *Procedural Requirements for Automatic Relief.* The corporation must file with the applicable service center (or district director if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97–48." Attached to the Form 2553 must be a dated declaration signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that:

(a) the corporation and the shareholder reported their income (on all affected returns) consistent with the requirements for automatic relief under section 4.02 of this revenue procedure;

(b) the corporation and the shareholder agree to amend their tax returns for the first year and any other affected returns to reflect S corporation status; and

(c) "Under penalties of perjury, to the best of my knowledge and belief, the facts presented in support of this election are true, correct, and complete."

.03 *Relief for Late S Corporation Elections.* A corporation that satisfies the requirements of either section 4.01 or 4.02 of this revenue procedure will be deemed to have reasonable cause for the failure to file a timely S corporation election and will automatically be granted relief to file the election for S corporation status to commence on the date that it intended to have the S corporation election become effective. The Service will notify the corporation of the acceptance of its untimely filed S corporation election under this revenue procedure, or the denial of a request that fails to satisfy the requirements of this revenue procedure.

.04 *Deemed Shareholders.* Any reference in this revenue procedure to a shareholder of an S corporation shall be treated as including a reference to those persons whose consent is required under § 1.1362–6(b) of the Income Tax Regulations.

SECTION 5. EXAMPLES

.01 *S corporation return filed and no notification from the Service. A, B,* and *C* formed *X* corporation on January 1, 1996. *X* intended to file an S corporation election; however, *X* did not file a timely Form 2553 (Election by a Small Business Corporation). On March 13, 1997, *X* files a Form 1120S (S corporation income tax return) for the 1996 taxable year, and *A, B,* and *C* file their individual tax returns as if *X* were an S corporation. In November 1997, *X* realizes that an S corporation election was not timely filed. Neither *X* nor its shareholders received any notification from the Service of any problem regarding the S corporation status of *X*. In this case, the shareholders and *X* meet the requirements of section 4.01 of this revenue procedure. Consequently, *X* will be granted automatic late S corporation election relief if *A, B, C,* and *X* file a request for relief in accordance with the procedures described in this revenue procedure.

.02 *C corporation return for first year. A* formed *X* corporation on January 1, 1990. *X* intended to file an S corporation election effective as of January 1, 1995; however, *X* did not file a Form 2553 (Election by a Small Business Corporation) until May 5, 1995. On June 15, 1995, *X* received a letter from the Service notifying *X* that its S corporation election was denied for the 1995 taxable year because the S corporation election was not timely filed, and that the election would be treated as effective for the 1996 taxable year. *X* filed a Form 1120 (C corporation income tax return) for the 1995 taxable year and *A* filed the individual tax return for 1995 as if *X* were a C corporation. For the 1996 taxable year, *X* filed a Form 1120S (S corporation income tax return) and *A* filed the individual tax return as if *X* were an S corporation. The period of limitations on assessment under § 6501(a) has not lapsed for either the 1995 or the 1996 taxable years for either *X* or for *A*. In this case, *A* and *X* meet the requirements of section 4.02 of this revenue procedure. Consequently, *X* will be granted automatic late S corporation election relief if *X* and *A* file a request for relief in accordance with the procedures described in this revenue procedure.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for all applications for relief satisfying the requirements of section 4 of this revenue procedure, including those applications now being considered by the Service.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability. (Also Part I, § 1362; 1.1362–6.)

Rev. Proc. 97–48

SECTION 1. PURPOSE

This revenue procedure grants automatic relief under § 1362(b)(5) of the Internal Revenue Code for certain late S corporation elections.

SECTION 2. BACKGROUND

Section 1361(a)(1) defines an "S corporation," with respect to any taxable year, as a small business corporation for which an S election is in effect for that year.

Section 1362(a)(1) provides that, except in a situation described in § 1362(g), a small business corporation may elect to be treated as an S corporation.

Section 1362(b)(1) provides that the corporation may make an election to be treated as an S corporation (A) at any time during the preceding taxable year, or (B) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year. Under § 1362(b)(3), if an S corporation election is made for a taxable year after the 15th day of the 3rd month of that taxable year and on or before the 15th day of the 3rd month of the following taxable year, then the S corporation election is treated as made for the following taxable year.

Section 1362(b)(5) provides that if (A) an election under § 1362(a) is made for any taxable year (determined without regard to § 1362(b)(3)) after the date prescribed by § 1362(b) for making the election for the taxable year or no election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat the election as timely made for the taxable year (and § 1362(b)(3) shall not apply).

SECTION 3. SCOPE

This revenue procedure provides special procedures to obtain relief for certain late S corporation elections. The revenue procedure only applies to the following two situations:

(1) A corporation intends to be an S corporation, the corporation and its shareholders reported their income consistent with S corporation status for the taxable year the S corporation election should have been made and for every subsequent year, and the corporation did not receive notification from the Service regarding any problem with the S corporation status within 6 months of the date on which the Form 1120S for the first year was timely filed; and

(2) For periods prior to January 1, 1997, a corporation intends to be an S corporation; however, due to a late S corporation election the corporation was not permitted to be an S corporation for the first taxable year specified in the election (because late S corporation election relief was not available during this period), the corporation and the shareholders treated the corporation as an S corporation for all succeeding years, and all relevant taxable years for both the corporation and all of its shareholders are open.

This revenue procedure does not provide relief for late shareholder elections including a qualified subchapter S trust (QSST) election or electing small business trust (ESBT) election.

The procedures in this revenue procedure are in lieu of the letter ruling procedure that is used to obtain relief for a late S corporation election under § 1362(b)(5). Accordingly, user fees do not apply to corrective action under this revenue procedure.

A corporation that is not eligible for relief under this revenue procedure may request relief by applying for a private letter ruling. The Service will not ordinarily issue a private letter ruling under § 1362(b)(5) if the period of limitations on assessment under § 6501(a) has lapsed for any taxable year in which an election should have been made or any taxable year that would have been affected by the election had it been timely made. The procedural requirements for requesting a private letter ruling are described in Rev. Proc. 97–1, 1997–1 I.R.B. 11 (or its successor). See, also, Rev. Proc. 97–40, 1997–33 I.R.B. 50, for the special procedure to request relief for late S corporation elections that are filed within 6 months of the original due date of the election.

SECTION 4. AUTOMATIC RELIEF FOR LATE S CORPORATION ELECTIONS UNDER THIS REVENUE PROCEDURE

.01 *Situation 1: Automatic Relief Where Return Filed as an S Corporation.*

(1) *Eligibility for Automatic Relief.* Automatic relief is available in situation 1 if all of the following conditions are met:

(a) The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) was not filed timely;

(b) The corporation and all of its shareholders reported their income consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year (if any);

(c) At least 6 months have elapsed since the date on which the corporation filed its tax return for the first year the corporation intended to be an S corporation; and

(d) Neither the corporation nor any of its shareholders was notified by the Internal Revenue Service of any problem regarding the S corporation status within 6 months of the date on which the Form 1120S for the first year was timely filed.

(2) *Procedural Requirements for Automatic Relief.* The corporation must file with the applicable service center (or district director if under examination) a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97–48." Attached to the Form 2553 must be a dated declaration signed by an officer of the corporation authorized to sign and all persons who were shareholders at any time during the period that the corporation intended to be an S corporation, attesting (but, in the case of a shareholder, only with respect to that shareholder) that:

(a) the corporation and the shareholder reported their income (on all affected returns) consistent with S corporation status for the year the S corporation election should have been made, and for every subsequent taxable year; and

Exhibit 3

PIN/Userid/Password Receipt

I, [*insert "name of Authorized Signatory, title, Electronic Filer's name and address"*] acknowledge receipt of the [*insert "userid/password" or "PIN" as appropriate*] for the Form 941 ELF Program.

I understand that I am bound by the requirements and responsibilities regarding [*insert userid/password, or "PIN" as appropriate*] as set forth in Rev. Proc. 97–47, and Publication 1855.

[Note: the following paragraph only applies to the PIN receipt] I accept and adopt the PIN as my signature for signing tax returns filed for [*insert "Electronic Filer's name"*] in the Form 941 ELF Program. I also understand that by entering the PIN, I will be declaring, under penalties of perjury, that to the best of my knowledge and belief, the tax returns being submitted electronically are true, correct, and complete.

For userid/password: [Signature of employee recipient]

For PIN: [Signature of Electronic Filer's Authorized Signatory]

NOTE: Separate receipts are required for a user identification/password and a PIN.

Exhibit 2

Letter of Application to Participate in the Form 941 ELF Program as a Software Developer

AAA Pay Developers
111 Main St.
Columbus, NY 11111
EIN XX–XXXXXXX

[Date]

Internal Revenue Service
Memphis Service Center
Electronic Filing Help Desk
P.O. Box 30309 AMF
Memphis, TN 38130
Attention: ELF Unit Stop 26

To Whom It May Concern:

This letter is an application to participate in the electronic filing program for Forms 941 ("Form 941 ELF Program").

I understand and agree to the following which is a prerequisite for participation in the Form 941 ELF Program as a software developer:

I will comply with all electronic security restrictions set forth in section 10.04 of Rev. Proc. 97–47 and

Publication 1855, Technical Specifications Guide for the Electronic Filing System of Form 941, Employer's Quarterly Federal Tax Return.

[Name, title] of [firm name] is the individual to contact concerning the userid/password. [Name] can be reached at [telephone number]. [Name] has read and understands the rules that apply to the use of the userid/password.

[Name, title] of [firm name and address] is the designated recipient of the Personal Identification Number (PIN). [Name] is authorized to administer and use the PIN as the signature of [firm name] to test software for use in filing tax returns in the Form 941 ELF Program.

I will provide software to begin submitting returns using the Form 941 ELF Program for returns due XX quarter 19XX.

I will use [name of software brand or development name] translation software and EDI release version [number] for electronic transmissions. The software package will be marketed to [reporting agents filing more than XXX returns (no fewer than 10 returns)]. The software is a [standalone or payroll package interface].

Please contact [name, title & telephone number] to discuss this letter of application.

[Signature of Software
Developer's Authorized Signatory]

APPENDIX

Exhibit 1

Letter of Application to Participate in the Form 941 ELF Program as an Agent

AAA Payroll, Inc.
111 Main St.
Columbus, NY 11111
EIN XX-XXXXXXX

[Date]

Internal Revenue Service
Memphis Service Center
Electronic Filing Help Desk
P.O. Box 30309 AMF
Memphis, TN 38130
Attention: ELF Unit Stop 26

To Whom It May Concern:

This letter is an application to participate in the electronic filing program for Forms 941 ("Form 941 ELF Program").

I understand and agree to the following which are prerequisites for participation in the Form 941 ELF Program:

1. I will keep copies of the Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers (or its equivalent) on file at my principal place of business for a period no less than required under the period of limitation for assessment for the last return filed under its authority. I will provide these Authorizations for examination by the Service upon request.
2. I will abide by the recordkeeping requirements set forth in section 10.02 of Rev. Proc. 97–47.
3. I will provide my clients documentation of filed returns as set forth in section 10.03 of Rev. Proc. 97–47.
4. I will comply with all electronic security restrictions set forth in section 10.04 of Rev. Proc. 97–47 and Publication 1855, Technical Specifications Guide for the Electronic Filing System of Form 941, Employer's Quarterly Federal Tax Return.
5. I agree to submit returns that meet the eligibility requirements set forth in section 3.03 of Rev. Proc. 97–47.

[Name, title] of [firm name] is the individual to contact concerning the userid/password. [Name] can be reached at [telephone number]. [Name] has read and understands the rules that apply to the use of the userid/password.

[Name, title] of [firm name and address] is the designated recipient of the Personal Identification Number (PIN). [Name] is authorized to administer and use the PIN as the signature of [firm name] to sign and file tax returns in the Form 941 ELF Program.

I will begin submitting returns using the Form 941 ELF Program for returns due XX quarter 19XX. I estimate that I will be submitting XXX number of returns (no fewer than 10 returns).

I expect to use [software brand name] translation software and EDI release version [number] for electronic transmissions.

I have included with this application a Reporting Agent's List and an Authorization for each taxpayer on my Reporting Agent's List.

Please contact [name, title & telephone number] to discuss this letter of application.

[Signature of Electronic
Filer's Authorized Signatory]

Attachments:

(1) Agent's List

(2) Authorizations for taxpayers on the Agent's List

should be directed to the following address and telephone number:

Internal Revenue Service
Memphis Service Center
Electronic Filing Help Desk
P.O. Box 30309 AMF
Memphis, TN 38130
Attention: ELF Unit Stop 26

The telephone number of this office is (901) 546-2690 (not a toll-free number).

SECTION 22. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 96–9 is amplified, clarified, modified, and superseded.

.02 Section 6.05 of Rev. Proc. 96–17, 1996–1 C.B. 633, is modified to provide the same relief as set forth in section 5.05 of this revenue procedure (regarding an Agent not having to replace a previously submitted Authorization under certain circumstances).

SECTION 23. EFFECTIVE DATE

.01 *In general.* This revenue procedure is effective for returns due after October 20, 1997 (without regard to extensions).

.02 *Grandfather rule.* A taxpayer or an Agent that has filed an application for acceptance in the Form 941 ELF Program on or before the effective date of this revenue procedure, may be treated as an Electronic Filer that is an Agent for purposes of this revenue procedure. The taxpayer or Agent must have been eligible to apply for acceptance in the Form 941 ELF Program under Rev. Proc. 96–19, and must comply with all the applicable provisions of this revenue procedure other than the section 5.03(5) requirement of an Agent's List containing the names of 10 or more taxpayers.

SECTION 24. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1557.

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

The collections of information in this revenue procedure are in sections 5, 6, 7, 8, 10, 12, and 13. This information is required by the Service to implement the Form 941 ELF Program and to enable taxpayers to file their Forms 941 electronically. The information will be used to ensure that taxpayers receive accurate and essential information regarding the filing of their electronic returns and to identify persons involved in the filing of electronic returns. The collections of information are required to retain the benefit of participating in the Form 941 ELF Program. The likely respondents are business or other for-profit institutions, federal, state or local governments, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and recordkeeping burden is 9,305 hours.

The estimated annual burden per respondent/recordkeeper varies from 9 hours to 47 hours, depending on individual circumstances, with an estimated average of 46.53 hours. The estimated number of respondents and recordkeepers is 200.

The estimated annual frequency of responses is on occasion.

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.

sequent determination of whether a reason for suspension has been corrected is not subject to review or appeal.

.06 If an Electronic Filer does not timely submit a written request for an administrative review, the service center director will issue a suspension letter.

.07 Failure to submit a written request for an administrative review within the 30-day period described in section 15.03 of this revenue procedure irrevocably terminates the Electronic Filer's right to an administrative review of the proposed suspension.

SECTION 16. EFFECT OF SUSPENSION

.01 An Electronic Filer's suspension will continue for the length of time specified in the suspension letter, or until the conditions for terminating the suspension have been met, whichever is later.

.02 In the case of an Electronic Filer that is an Agent, the following additional rules apply:

(1) if a Form 941 is due (without regard to extensions) within 60 days from the date on the suspension letter, the Agent may file the Form 941 under the Form 941 ELF Program;

(2) if a Form 941 is due (without regard to extensions) more than 60 days from the date on the suspension letter, the Agent may not file the Form 941 under the Form 941 ELF Program;

(3) if a suspended Agent has a power of attorney from a taxpayer that authorizes the Agent to sign and file Form 941, the suspended Agent will be able to sign and file a paper Form 941 for the taxpayer. See section 11.03 of this revenue procedure. Form 8655 does not authorize the filing of paper Forms 941 outside of the Form 941 ELF Program; and

(4) an Agent must provide written notification of a suspension to a taxpayer at least 45 days before the due date of the taxpayer's first return affected by the suspension. This notification must be provided even though the Agent may believe that the Agent will be able to meet the conditions for terminating the suspension before the due date.

.03 An Electronic Filer will be able to participate in the Form 941 ELF Program from which the Electronic Filer was suspended, without reapplying to the Form 941 ELF Program, after:

(1) the stated suspension period expires; and

(2) the reason(s) for suspension are corrected.

SECTION 17. APPEAL OF SUSPENSION

.01 If an Electronic Filer receives a suspension letter from the National Coordinator, the Electronic Filer is entitled to appeal, by written protest, to the National Director of Appeals. The written protest must be sent to the National Coordinator, who will forward it to the National Director of Appeals. During the appeals process, the suspension remains in effect.

.02 The written protest must be received by the National Coordinator within 30 calendar days of the date of the suspension letter. The written protest must contain detailed reasons, with supporting documentation, for termination of the suspension.

.03 Within 15 calendar days of receipt of a written protest, the National Coordinator will forward the file on the Electronic Filer and the material described in section 17.02 of this revenue procedure to the National Director of Appeals.

.04 Failure to appeal within the 30-day period described in section 17.02 of this revenue procedure irrevocably terminates the Electronic Filer's right to appeal the suspension.

SECTION 18. PENALTY FOR A FAILURE TO TIMELY FILE A RETURN

Section 6651(a)(1) provides that for each month (or part thereof) a return is not filed when required (determined with regard to any extensions of time for filing), there is a penalty of 5 percent of the unpaid tax not to exceed 25 percent, absent reasonable cause. A taxpayer does not establish reasonable cause simply by engaging a competent Agent to file the taxpayer's return. However, if the Agent has reasonable cause under § 6651(a) for failing to timely file the taxpayer's return, the taxpayer will also have reasonable cause for that failure, and the failure-to-file penalty will be abated.

SECTION 19. FILING FORMS W–4 WITH THE INTERNAL REVENUE SERVICE

.01 An employer is required to send to the Service by the due date of the quarterly return copies of all Forms W–4, Employee's Withholding Allowance Certificates, received during the quarter from any employee still employed at the end of the quarter who claims:

(1) more than 10 withholding exemptions; or

(2) exemption from withholding and is expected to earn more than $200 per week.

Employers should not send other Forms W–4 unless notified by the Service in writing to do so.

.02 If an employer's Form 941 is filed under the Form 941 ELF Program, copies of required paper Forms W-4 along with a cover letter providing the employer's name, address, EIN, and the number of Forms W–4 included must be sent to the service center that would have received the employer's paper Form 941. See Publication 15, Circular E, Employer's Tax Guide, for more information on sending Forms W–4 to the Service.

.03 Required Forms W–4 information may also be filed on magnetic media (5 1/4 inch diskettes, 3 1/2 inch diskettes, or magnetic tape). See Publication 1245, Specifications for Filing Form W–4, Employee's Withholding Allowance Certificate, on Magnetic Tape, and 5 1/4- and 3 1/2-Inch Magnetic Diskettes, for more information concerning magnetic media filing of Forms W–4.

SECTION 20. FILING FORMS W–2 (COPY A) WITH THE SOCIAL SECURITY ADMINISTRATION

Forms W–2, Wage and Tax Statements, must be filed directly with the Social Security Administration on magnetic media or paper. For information on magnetic media reporting of Form W–2, contact the Social Security Administration's Regional Magnetic Media Coordinators.

SECTION 21. INTERNAL REVENUE SERVICE CONTACT

Unless otherwise instructed, all questions regarding this revenue procedure

taxpayer's authorized representative that is not an Agent participating in the Form 941 ELF Program (including a suspended Agent) must have a valid power of attorney (usually a Form 2848, Power of Attorney and Declaration of Representative) that authorizes the representative to sign and file a paper Form 941 on behalf of a taxpayer.

.04 Each paper Form 941 must be signed by the taxpayer, the taxpayer's authorized representative, or a participating Agent to the extent permitted under section 11.02 of this revenue procedure.

SECTION 12. REVISION OF COMPUTER SPECIFICATIONS BY THE SERVICE

.01 If Publication 1855 is revised, the Service, if necessary, will advise all current Electronic Filers to submit test files prior to filing under the new specifications. Failure to submit a test file may later result in a Processing Interruption or an Error Rate exceeding 5 percent on returns filed electronically for which an Electronic Filer may receive a notice of suspension. See section 14 of this revenue procedure concerning the reasons for suspension of electronic filing privileges.

.02 If an Electronic Filer is unable to comply with the changes in specifications, the Electronic Filer must contact the ELF Help Desk for further instructions. See section 21 of this revenue procedure.

SECTION 13. ADVERTISING STANDARDS

.01 An Electronic Filer must:

(1) comply with the advertising and solicitation provisions of 31 C.F.R. Part 10 (Treasury Department Circular No. 230). This circular prohibits the use or participation in the use of any form of public communication containing a false, fraudulent, misleading, deceptive, unduly influencing, coercive, or unfair statement or claim. In addition, advertising must not imply a special relationship with the Service, Financial Management Service ("FMS"), or the Treasury Department;

(2) adhere to all relevant federal, state, and local consumer protection laws;

(3) not use the Service's name, "Internal Revenue Service" or "IRS", within a firm's name;

(4) not use improper or misleading advertising in relation to the Form 941 ELF Program;

(5) not carry the Service, FMS, or other Treasury Seals on its advertising material;

(6) clearly state the names of all cooperating parties if advertising for a cooperative electronic return filing project (public/private sector);

(7) pre-record any radio or television advertisement and keep a copy of this advertisement for a period of at least 36 months from the date of the last transmission or use; and

(8) retain a copy of any actual direct mailing or fax communications, along with a list or other description of persons to whom the communication was mailed, faxed, or otherwise distributed for a period of at least 36 months from the date of the last mailing, fax, or distribution.

.02 Acceptance to participate in the Form 941 ELF Program does not imply endorsement by the Service, FMS, or the Treasury Department of the software or quality of services provided.

SECTION 14. REASONS FOR SUSPENSION

.01 The Service reserves the right to suspend an Electronic Filer from the Form 941 ELF Program for the following reasons (this list is not all-inclusive):

(1) submitting tax returns for which the Service did not receive Authorizations;

(2) repeatedly submitting tax returns that have an Error Rate exceeding 5 percent or that cause a Processing Interruption;

(3) submitting tax returns that have an Error Rate exceeding 5 percent or that cause a Processing Interruption after failing to submit the test file required by section 12 of this revenue procedure;

(4) failing to comply with the responsibilities of an Electronic Filer set forth in section 10 of this revenue procedure;

(5) failing to abide by the advertising standards in section 13 of this revenue procedure; or

(6) significant complaints about an Electronic Filer's performance in the Form 941 ELF Program.

.02 If the Electronic Filing Coordinator ("ELF Coordinator") informs an Electronic Filer that a certain action is a reason for suspension and the action continues, the service center director may send the Electronic Filer a notice proposing suspension of the Electronic Filer. However, a notice proposing suspension may be sent without a warning if the Electronic Filer's action indicates an intentional disregard of rules. A notice proposing suspension will describe the reason(s) for the proposed suspension, and indicate the length of the suspension and the conditions that need to be met before the suspension will terminate.

.03 An Electronic Filer that is an Agent has an obligation to notify taxpayers filing through the Agent if and when that Agent is suspended from filing under the Form 941 ELF Program as provided in section 16.02(4) of this revenue procedure. The Service reserves the right to extend the period of suspension of any Agent that fails to comply with this requirement.

SECTION 15. ADMINISTRATIVE REVIEW PROCESS FOR PROPOSED SUSPENSION

.01 An Electronic Filer that receives a notice proposing suspension may request an administrative review prior to the proposed suspension taking effect.

.02 The request for an administrative review must be in writing and contain detailed reasons, with supporting documentation, for withdrawal of the proposed suspension.

.03 The written request for an administrative review and a copy of the notice proposing suspension must be delivered to the ELF Coordinator within 30 calendar days of the date on the notice proposing suspension. The ELF Coordinator will forward the written request to the National Program Analyst for Electronic Filing of Business Returns ("National Coordinator") if the service center director continues to believe that suspension is warranted.

.04 After consideration of the written request for an administrative review, the National Coordinator will either issue a suspension letter or notify the Electronic Filer in writing that the proposed suspension is withdrawn.

.05 If an Electronic Filer receives a suspension letter, the ELF Coordinator's sub-

error(s) and retransmit the return(s) on the same calendar day. If the Electronic Filer chooses not to have the previously rejected return retransmitted, or if the return still cannot be accepted for processing, a paper Form 941 (or a Form 941 on magnetic tape if the Electronic Filer meets the requirements of Rev. Proc. 96–18) must be filed by the later of: (1) the due date of the return; or (2) within five calendar days of the rejection or notice that the return cannot be retransmitted, with an explanation of why the return is being filed after the due date. For the penalty for failure to file a timely return, see section 18 of this revenue procedure.

SECTION 9. ADJUSTMENTS TO FORM 941

Forms 941 filed under the Form 941 ELF Program must not contain adjustments other than adjustments resulting from rounding fractions of cents or from third-party sick pay for which an employer is not responsible. Returns with other adjustments must be filed on magnetic tape or on paper.

SECTION 10. RESPONSIBILITIES OF AN ELECTRONIC FILER

.01 To ensure that complete returns are accurately and efficiently filed, an Electronic Filer must comply with Publication 1855.

.02 The Electronic Filer that is an Agent must retain the following material for 4 years after the due date of the return, unless otherwise notified by the Service:

(1) a complete copy of the electronically filed Form 941;

(2) a copy of the Service's acknowledgement of receipt of the return; and

(3) a copy of each Authorization.

.03 An Electronic Filer that is an Agent must:

(1) provide the taxpayer with a copy of the taxpayer's electronically filed Form 941. This information may be provided on a replica of an official form or on an unofficial form. However, data entries on an unofficial form must refer to the line numbers on an official form;

(2) advise the taxpayer to retain a copy of the return and any supporting material;

(3) inform the taxpayer of the service center that processes the taxpayer's returns;

(4) advise the taxpayer that an amended return, if needed, must be filed as a paper return and mailed to the service center identified in accordance with section 10.03(3) of this revenue procedure. See section 9 of this revenue procedure for adjustments to Forms 941; and

(5) provide the taxpayer, upon request, with the date the return was transmitted to the Service and the date the Service acknowledged receipt of the taxpayer's return.

.04 An Electronic Filer must comply with the following userid/password and PIN requirements:

(1) each authorized employee of the Electronic Filer must submit a signed receipt acknowledging receipt of the userid/password, and accepting the associated responsibilities. See Exhibit 3 in the APPENDIX of this revenue procedure for a sample userid/password receipt;

(2) the Authorized Signatory for the Electronic Filer must submit a signed receipt acknowledging possession, and accepting responsibility for proper use, of the PIN for signing and filing tax returns (or for software development testing) in the Form 941 ELF Program. See Exhibit 3 in the APPENDIX of this revenue procedure for a sample PIN receipt;

(3) the Electronic Filer is responsible for ensuring that the PIN remains the confidential information of the Electronic Filer's Authorized Signatory. If the Electronic Filer suspects that the confidentiality of the PIN and/or userid/password has been compromised, the Electronic Filer must contact the ELF Help Desk within 24 hours for instructions on how to proceed. See section 21 of this revenue procedure for Service contact information;

(4) if the Authorized Signatory for an Electronic Filer changes, the Electronic Filer must notify the Service of the name and title of the new Authorized Signatory for the electronically filed Form 941 and apply for a new PIN no later than 15 days before the filing of another return. After this notification, the Service will deactivate the current PIN and issue a new PIN to the new Authorized Signatory. The new Authorized Signatory must submit a PIN receipt as specified in section 10.04(2) of this revenue procedure in order to activate the PIN; and

(5) the Authorized Signatory for the Electronic Filer must manually enter the PIN signature for each transmission of electronically filed Forms 941.

.05 An Electronic Filer that is a Software Developer must:

(1) promptly correct any software error that may cause, or causes, an electronic return to be rejected;

(2) promptly distribute any such software correction;

(3) ensure that any software package that will be used to transmit returns from multiple Electronic Filers that are Agents has the capability of combining these returns into one Service transmission file; and

(4) not incorporate into its software a Service assigned PIN.

SECTION 11. ALTERNATIVE FILING PROCEDURES

.01 Procedures for the filing of Form 941 on magnetic tape are in Rev. Proc. 96-18 and the specifications are in Publication 1264.

.02 An Electronic Filer that is an Agent may use a Form 941 ELF Program Authorization to file a paper Form 941 under the Form 941 ELF Program under the following circumstances:

(1) the late receipt of payroll information from a taxpayer that would jeopardize the timely submission of the taxpayer's return;

(2) the amendment of returns filed under the Form 941 ELF Program;

(3) the rejection of an electronic transmission that would jeopardize the timely submission of the taxpayer's return;

(4) an authorization by the Service for an Electronic Filer to file paper Forms 941 instead of electronically filed Forms 941; or

(5) the suspension of an Agent from the Form 941 ELF Program as provided in section 16.02(3) of this revenue procedure.

.03 An Agent may prepare a paper Form 941 for the taxpayer's signature. A

must contact the ELF Help Desk after receiving the Validated Agent's List.

.03 An Applicant must transmit an initial test electronic transmission of Form 941 ("test file") by the test file due dates preceding the corresponding quarter due dates, as follows:

Initial Test File Due Date	*For Quarter Ending*
April 10	March 31
July 10	June 30
October 10	September 30
January 10	December 31

To transmit subsequent test files, contact the ELF Help Desk. Transmission of a test file does not constitute the filing of a tax return. See Publication 1855 for specific testing procedures.

.04 After evaluating the test file, the Service will notify an Applicant in writing of approval or denial of electronic filing privileges. An approval remains in effect unless the Electronic Filer:

(1) that is an Agent fails to comply with the Authorization requirements of sections 5.03(6) and 5.05 of this revenue procedure;

(2) that is a Software Developer fails to comply with the requirements of section 10.05 of this revenue procedure; or

(3) is suspended from the Form 941 ELF Program. See section 16 of this revenue procedure for the effect of a suspension.

.05 The acceptance by the Service of a Software Developer as an Electronic Filer:

(1) establishes only that the test electronic transmission(s) are formatted properly and may be processed by the Service;

(2) is not an endorsement by the Service of the software or the quality of services provided by the Software Developer; and

(3) does not entitle the Software Developer to electronically file Forms 941 unless the Software Developer is also accepted in the Form 941 ELF Program as an Agent.

.06 If an Application is approved, the Service will send the Electronic Filer the following two documents:

(1) a notification of approval that will contain the userid/password, and information and procedures regarding signing onto the system for filing electronic Forms 941; and

(2) a PIN that may be used only by the Electronic Filer's Authorized Signatory named in the Application.

.07 Upon receipt of each document referenced in section 6.06 of this revenue procedure, the Electronic Filer must return the following documents to the Service:

(1) an acknowledgement signed by each employee recipient of the userid/password indicating possession of, and responsibility for, the userid/password; and

(2) an acknowledgement signed by the Electronic Filer's Authorized Signatory indicating possession of, and responsibility for, the proper use of the PIN for signing tax returns (pursuant to § 301.6061–1) filed in the Form 941 ELF Program.

See Exhibit 3 in the APPENDIX of this revenue procedure for a sample userid/password and PIN receipt.

.08 The Service will activate the userid/password and the PIN upon receiving the Electronic Filer's acknowledgements of the receipt of the two documents referenced in section 6.06 of this revenue procedure.

.09 If an Applicant's test file fails to meet the evaluation criteria, the Applicant must, within 15 days of the Service's notification of the failure, transmit a new test file or contact the ELF Help Desk to make other arrangements.

.10 If an Applicant that is an Agent is denied, or does not receive, approval for participating in the Form 941 ELF Program before the end of the tax quarter for which the Forms 941 will be filed, the Applicant should file the returns on paper Forms 941 (or on magnetic tape if the Applicant meets the requirements of Rev. Proc. 96–18).

.11 If an Applicant is denied acceptance into the Form 941 ELF Program, the Applicant may reapply for a subsequent tax quarter by resubmitting an Application and test file in accordance with sections 5 and 6 of this revenue procedure.

SECTION 7. ADDING AND DELETING TAXPAYERS BY A REPORTING AGENT

.01 After an Electronic Filer that is an Agent is notified that the application for electronic filing of Forms 941 has been approved, the Agent may want to add and delete taxpayers from the Form 941 ELF Program.

.02 To add taxpayers, the Agent must submit the added names and EINs (Add List) and an Authorization, in accordance with sections 5.03(6) and 5.05 of this revenue procedure, for each taxpayer added to the Form 941 ELF Program. The Service must validate the Add List and return it to the Agent before the Agent can electronically file returns for these taxpayers. The Service will generally validate and mail the Add List to the Agent within 10 business days of receiving the Add List.

.03 To delete taxpayers, the Agent must submit a list of those taxpayers to be deleted (Delete List) and, if known, a short statement indicating which taxpayers will not remain in business.

SECTION 8. ELECTRONIC FILING OF FORM 941

.01 An Electronic Filer that is an Agent must ensure that an electronic Form 941 is filed on or before the due date of the return. The due dates prescribed for filing paper Forms 941 with the Service also apply to returns filed under the Form 941 ELF Program. Forms 941 are due on or before the last day of the first calendar month following the period for which the return is made. However, a return for which all tax deposits were made when due for the quarter may be filed by the 10th day of the month following the due date. In no case may one electronic transmission include returns with more than one due date.

.02 An electronically filed Form 941 is not considered filed until it has been acknowledged as accepted for processing by the Service. If an electronically filed Form 941 is transmitted on or before the due date, the return will be deemed timely filed. If an electronically filed Form 941 is initially transmitted on or shortly before the return due date and is ultimately rejected, but the Electronic Filer complies with section 8.03 of this revenue procedure, the return will be deemed timely filed.

.03 An electronic transmission that causes a Processing Interruption or that has an Error Rate exceeding 5 percent may not be accepted, and the Electronic Filer will be asked to resubmit the return(s). If the electronic transmission is acknowledged as rejected by the Service, the Electronic Filer should correct the

rate Authorization must be submitted for each taxpayer on the Agent's List. The Agent's List must contain each taxpayer's employer identification number ("EIN").

.10 *User identification/password.* The user identification/password ("userid/password") consists of an identification number (userid) issued by the Service and a confidential set of characters (password) that, when used in conjunction with each other, permit an Electronic Filer access to the Form 941 ELF Program.

.11 *Validated Reporting Agent's List.* A Validated Reporting Agent's List ("Validated Agent's List") is the source of the EIN and name control to be used as an identification of each taxpayer by an Electronic Filer that is an Agent. A Validated Agent's List is a list of taxpayers and their EINs prepared by an Agent that is confirmed and assigned name controls by the Service. Once the Service returns a Validated Agent's List, the Agent must use it to fill in certain required fields (for example, the name control field) of the electronic transmission. See Publication 1855.

SECTION 5. APPLICATION FOR THE FORM 941 ELF PROGRAM

.01 A prospective Electronic Filer ("Applicant") must first submit a Letter of Application ("Application") to participate in the Form 941 ELF Program.

.02 All Applications must contain the following:

(1) the name, address, and EIN of the Applicant;

(2) the name, title, and telephone number of the person to contact regarding the Application;

(3) the first tax period for which the Applicant plans to file Forms 941 electronically or to have Form 941 software available to the public;

(4) a representation that the Applicant will comply with section 10 of this revenue procedure regarding responsibilities of an Electronic Filer;

(5) a listing of any suspension from any of the Service's magnetic tape or electronic filing programs;

(6) the name and title of the Authorized Signatory; and

(7) the signature of the Applicant's Authorized Signatory for electronically filing Forms 941 or for software development testing.

.03 An Application of an Agent must also contain the following:

(1) the estimated volume of returns the Applicant plans to file under the Form 941 ELF Program;

(2) the brand name of the software translation package and the EDI version to be used;

(3) a statement that the Applicant will keep a copy of all the Authorizations on file at the Applicant's principal place of business for examination by the Service upon request;

(4) a representation that the Applicant will comply with section 3.03 of this revenue procedure regarding the types of returns accepted under the Form 941 ELF Program;

(5) an Agent's List containing the names of 10 or more taxpayers (except as provided in the grandfather rule in section 23.02 of this revenue procedure); and

(6) except as provided in section 5.05 of this revenue procedure, an Authorization made on Form 8655 with a revision date of October 1995 or later (or its equivalent) for each taxpayer included on the Agent's List. See Rev. Proc. 96-17, as modified by section 22.02 of this revenue procedure, for general instructions on preparing Form 8655.

See Exhibit 1 in the APPENDIX of this revenue procedure for a sample Application to Participate in the Form 941 ELF Program as an Agent.

.04 An Application of a Software Developer must also contain the following:

(1) the brand name of the software translation package, or the development name if no brand name exists, and the EDI version to be used; and

(2) whether the software is standalone or interfaces with a named payroll package.

See Exhibit 2 in the APPENDIX of this revenue procedure for a sample Application to Participate in the Form 941 ELF Program as a Software Developer.

.05 A revised Authorization is not required to replace an Authorization made on Form 8655 with a revision date before October 1995 (or its equivalent) that was previously submitted to the Service by an Agent, provided that Authorization places no restriction on the medium for filing Form 941, and the Agent:

(1) advises its client that its Forms 941 may be filed electronically, and provides the client with the option of rejecting electronic filing as the medium for filing its Forms 941. An Agent may use the most efficient and timely method of clearly providing this notification to a client. A client's rejection of electronic filing for its Forms 941 must be submitted in writing to the Agent; and

(2) immediately removes any client from its electronic filing client base that rejects having its Forms 941 filed electronically.

.06 To allow sufficient time for the approval process, the Applicant should submit its Application by the Application due dates preceding the quarter ending dates, as follows:

Application Due Date	*For Quarter Ending*
December 15 (prior year)	March 31
March 15	June 30
June 15	September 30
September 15	December 31

.07 The Application must be submitted to the Service at the address provided in section 21 of this revenue procedure.

.08 An Application *may not* include a request to file Forms 941, 940, and 945 on magnetic tape or make FTD payments and submit FTD information to the Service on magnetic tape or electronically. An Applicant interested in participating in these programs should submit an Application in accordance with the following revenue procedures: Rev. Proc. 96–18 (magnetic tape filing of Forms 941, 940, and 945); Rev. Proc. 97–33 (electronic transmission of FTDs); and Rev. Proc. 89–48 (magnetic tape filing of FTD information).

SECTION 6. ACCEPTANCE IN THE FORM 941 ELF PROGRAM

.01 In the case of an Applicant that is an Agent, the Applicant will receive a Validated Agent's List within 45 days of the Service receiving the Agent's Application. Failure to use the names and EINs provided on the Validated Agent's List may delay processing.

.02 An Applicant must contact the ELF Help Desk, at the number listed in section 21 of this revenue procedure (unless instructed to use a different number), to notify the Service that the Applicant is ready to begin the testing process. In the case of an Applicant that is an Agent, the Agent

return, statement, or other document required to be made under any provision of the internal revenue laws or regulations. The Service has prescribed in the electronic filing instructions to Form 941 that an electronically filed Form 941 is signed by the entry of the Electronic Filer's Personal Identification Number ("PIN").

.06 Section 31.6071(a)–1 generally provides that each return required to be made under § 31.6011(a)–1 for taxes imposed by the Federal Insurance Contributions Act, or required to be made under § 31.6011(a)–4 for withheld income taxes, must be filed on or before the last day of the first calendar month following the period for which it is made. However, under § 31.6071(a)–1 a return may be filed on or before the 10th day of the second calendar month following such period if timely deposits under § 6302(c) and the regulations thereunder have been made in full payment of such taxes due for the period.

.07 Procedures for the magnetic filing of Form 941 are in Rev. Proc. 96–18, 1996–1 C.B. 637, and the specifications are in Publication 1264.

.08 The submission of federal tax deposit ("FTD") information on magnetic tape is addressed in Rev. Proc. 89–48, 1989–2 C.B. 599. For taxpayers that are required to make FTDs by electronic funds transfer pursuant to § 6302(h), the submission of the FTD information along with the transfer of funds is addressed in Rev. Proc. 97–33, 1997–30 I.R.B. 10.

.09 This revenue procedure updates Rev. Proc. 96–19. The updates include changes in the 941 ELF Program, clarifications of prior Form 941 ELF Program statements, and additional guidance derived from other Service documents that relate to the Form 941 ELF Program. Some of the updates are:

(1) the signature provisions for an electronically filed Form 941 have been modified, amplified, and clarified to require use of a PIN instead of filing a Form 4996, Electronic/Magnetic Media Filing Transmittal for Wage and Withholding Tax Returns (sections 2.05, 4.05, 5.02, 6.06, 8.02, 10.02, 10.03, and 10.04);

(2) the definition of an Electronic Filer:

(a) is prospectively limited to Reporting Agents whose applications (received after the effective date of this revenue procedure) include an Agent's List containing 10 or more taxpayers (sections 4.02, 5.03, and 23.02); and

(b) has been expanded to include Software Developers (sections 4.02, 5.02, 5.04, 6.04, 6.05, and 10.05); and

(3) a Reporting Agent is not required to replace a previously submitted Authorization under certain circumstances (section 5.05).

SECTION 3. SCOPE

.01 The Form 941 ELF Program accepts electronically filed Forms 941 in Electronic Data Interchange ("EDI") format developed by the American National Standards Institute that meets the requirements of this revenue procedure and Publication 1855.

.02 An Electronic Filer in the Form 941 ELF Program must use asynchronous communications protocols to transmit electronic returns. See Publication 1855 for further information regarding communications and formatting requirements.

.03 The Form 941 ELF Program accepts timely current returns that are zero balance, refund, or limited balance due returns. For the current limitations on balance due returns, refer to Publication 1855. For the due dates of returns under the Form 941 ELF Program, see section 8.01 of this revenue procedure. The Form 941 ELF Program will not accept the electronic filing of the following returns:

(1) amended returns;

(2) corrected returns;

(3) returns containing attachments; or

(4) untimely returns.

A violation of any of these restrictions will cause a Processing Interruption (as defined in section 4.06 of this revenue procedure).

SECTION 4. DEFINITIONS

.01 *Authorized Signatory.* The "Authorized Signatory" is the person who is authorized to use the PIN for returns filed by an Electronic Filer under the Form 941 ELF Program or during software development testing.

.02 *Electronic Filer.* After acceptance in the Form 941 ELF Program, as described in section 6 of this revenue procedure, a participant is referred to as an "Electronic Filer." An Electronic Filer may be:

(1) an Agent that files Forms 941 electronically; or

(2) a "Software Developer" that develops software for the purposes of (a) formatting returns according to the Service's electronic return specifications in Publication 1855; and/or (b) transmitting electronic returns directly to the Service. A Software Developer may also sell its software.

.03 *Electronic Filing Help Desk.* The Electronic Filing Help Desk ("ELF Help Desk") is responsible for the administration of the Form 941 ELF Program. See section 21 of this revenue procedure for the address and telephone number of the ELF Help Desk.

.04 *Error Rate.* The "Error Rate" is the percentage of the total volume of tax data records that are identified by the Service's computer program as containing errors (as defined in Publication 1855).

.05 *Personal Identification Number.* A Personal Identification Number ("PIN") is a number assigned by the Service to the Authorized Signatory of an Electronic Filer for purposes of signing an electronically filed Form 941.

.06 *Processing Interruption.* A "Processing Interruption" is an abnormal termination of a program run caused by the electronic data submitted by an Electronic Filer.

.07 *Reporting Agent.* A Reporting Agent ("Agent") is an accounting service, franchiser, bank, or other person that complies with Rev. Proc. 96–17, as modified by section 22.02 of this revenue procedure, and is authorized to prepare and electronically file a Form 941 for a taxpayer.

.08 *Reporting Agent Authorization.* A Reporting Agent Authorization ("Authorization") allows a taxpayer to designate an Agent. The Authorization may be submitted on Form 8655, or any other instrument that complies with Rev. Proc. 96–17, as modified by section 22.02 of this revenue procedure. An Authorization must be submitted for each taxpayer on the Reporting Agent's List.

.09 *Reporting Agent's List.* For purposes of the Form 941 ELF Program, a Reporting Agent's List ("Agent's List") identifies all taxpayers for whom an Agent will file Forms 941 electronically. A sepa-

.02 Where transportation involves two or more segments, at least one of which begins or ends at a rural airport and at least one of which does not, the 7.5 percent rate is applied to the rural portion of the transportation and the nonrural rate is applied to the nonrural portion. The rural portion is determined by calculating the number of great circle miles in those segments beginning or ending at rural airports and the total number of great circle miles in all segments of the transportation. The fraction formed by using the great circle miles of the rural portion as the numerator and the total great circle miles as the denominator is multiplied by the amount paid for the transportation. The result is the portion of the total amount paid that is subject to the 7.5 percent rate. The remaining portion of the total amount paid is subject to the nonrural rate. In addition, all segments not beginning or ending at rural airports are subject to the segment tax.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for amounts paid after September 30, 1997, for transportation beginning after September 30, 1997.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, Sections 3504, 6011, 6061, 6071; 31.3504–1, 31.6011(a)–7, 31.6061–1 , 301.6061–1, 31.6071(a)–1.)

Rev. Proc. 97–47

Table of Contents

SECTION 1. PURPOSE

This revenue procedure sets forth the requirements of the Form 941 ELF Program under which a taxpayer that is a Reporting Agent ("Agent" as defined in section 4.07 of this revenue procedure) may electronically file Form 941, Employer's Quarterly Federal Tax Return. The technical specifications for filing Form 941 electronically are published separately in Publication 1855, Technical Specifications Guide for the Electronic Filing System of Form 941, Employer's Quarterly Federal Tax Return. For further information, see Publication 1264, File Specicifications, Process Criteria, and Record Layouts for Magnetic Tape Filing of Form 941, Employer's Quarterly Federal Tax Return. This revenue procedure amplifies, clarifies, modifies, and supersedes Rev. Proc. 96–19, 1996–1 C.B. 644.

SECTION 2. BACKGROUND

.01 Section 6011(a) of the Internal Revenue Code provides that any person liable for any tax imposed by this title, or for the collection thereof, must make a return or statement according to the forms and regulations prescribed by the Secretary. Every person required to make a return or statement must include therein the information required by such forms or regulations.

.02 Section 31.6011(a)–4 of the Employment Tax Regulations provides in general that every person required to make a return of income tax withheld from wages pursuant to § 3402 must make a return for the first calendar quarter in which the person is required to deduct and withhold such tax and for each subsequent calendar quarter until the person has filed a final return. Except as otherwise provided, Form 941 is the form prescribed for making the return.

.03 Section 31.6011(a)–7 provides that each return, together with any prescribed copies or supporting data, must be filled in and disposed of in accordance with the forms, instructions, and regulations applicable thereto. The return may be made by an agent in the name of the person required to make the return if an acceptable power of attorney is filed with the Internal Revenue Service office with which such person is required to file returns and if such a return includes all taxes required to be reported by such person on such return. Form 8655, Reporting Agent Authorization for Magnetic Tape/Electronic Filers, is an acceptable power of attorney, if prepared in accordance with the requirements set forth in Rev. Proc. 96–17, 1996–1 C.B. 633, as modified by section 22.02 of this revenue procedure.

.04 Section 31.6061–1 provides that the return may be signed for the taxpayer by an agent that is fully authorized in accordance with § 31.6011(a)–7 to make such return. An Agent may sign the Form 941 on behalf of a taxpayer that has a valid Form 8655 on file with the Service.

.05 Section 301.6061–1 of the Regulations on Procedure and Administration provides that the Secretary may prescribe in forms, instructions, or other appropriate guidance the method for signing any

TNC	TIN CITY, ALASKA	TIN CITY AFS	UNITED STATES
TNK	TUNUNAK, ALASKA	TUNUNAK	UNITED STATES
TOG	TOGIAK, ALASKA	TOGIAK VILLAGE	UNITED STATES
TUP	TUPELO, MISSISSIPPI	C D LEMONS MUNICIPAL	UNITED STATES
TVF	THIEF RIVER FALLS, MINNESOTA	THIEF RIVER FALLS	UNITED STATES
TWA	TWIN HILLS, ALASKA	TWIN HILLS	UNITED STATES
TWF	TWIN FALLS, IDAHO	CITY COUNTY	UNITED STATES
TYR	TYLER, TEXAS	POUNDS FIELD	UNITED STATES
UGB	PILOT POINT, ALASKA	UGASHIK BAY	UNITED STATES
UGI	UGANIK, ALASKA	UGANIK	UNITED STATES
UIN	QUINCY, ILLINOIS	BALDWIN FIELD	UNITED STATES
UMT	UMIAT, ALASKA	UMIAT	UNITED STATES
UNK	UNALAKLEET, ALASKA	UNALAKLEET	UNITED STATES
UTO	UTOPIA, ALASKA	INDIAN MOUNTAIN AFS	UNITED STATES
UUK	KUPARUK, ALASKA	KUPARUK	UNITED STATES
UXR	MONUMENT VALLEY, UTAH	MONUMENT VALLEY	UNITED STATES
VAK	CHEVAK, ALASKA	CHEVAK	UNITED STATES
VCT	VICTORIA, TEXAS	COUNTY-FOSTER	UNITED STATES
VDZ	VALDEZ, ALASKA	VALDEZ MUNICIPAL	UNITED STATES
VEE	VENETIE, ALASKA	VENETIE	UNITED STATES
VEL	VERNAL, UTAH	VERNAL	UNITED STATES
VIS	VISALIA, CALIFORNIA	VISALIA MUNICIPAL	UNITED STATES
VZM	JENSENS STRIP, ALASKA	JENSENS STRIP	UNITED STATES
VZN	WILDMAN CREEK, ALASKA	WILDMAN CREEK	UNITED STATES
VZR	KATMAI BAY, ALASKA	KATMAI BAY	UNITED STATES
VZY	KATMAI LODGE, ALASKA	KATMAI LODGE	UNITED STATES
WAA	WALES, ALASKA	WALES	UNITED STATES
WBB	STEBBINS, ALASKA	STEBBINS	UNITED STATES
WBQ	BEAVER, ALASKA	BEAVER	UNITED STATES
WCR	CHANDALAR, ALASKA	CHANDALAR LAKE	UNITED STATES
WDG	ENID, OKLAHOMA	ENID WOODRING MUNI	UNITED STATES
WFK	FRENCHVILLE, MAINE	FRENCHVILLE	UNITED STATES
WKK	ALEKNAGIK, ALASKA	ALEKNAGIK	UNITED STATES
WLB	LABOUCHERE BAY, ALASKA	LABOUCHERE BAY	UNITED STATES
WLK	SELAWIK, ALASKA	SELAWIK	UNITED STATES
WMH	MOUNTAIN HOME, ARKANSAS	MOUNTAIN HOME MUNI	UNITED STATES
WMO	WHITE MOUNTAIN, ALASKA	WHITE MOUNTAIN	UNITED STATES
WRG	WRANGELL, ALASKA	WRANGELL SPB	UNITED STATES
WRL	WORLAND, WYOMING	WORLAND MUNICIPAL	UNITED STATES
WSN	SOUTH NAKNEK, ALASKA	SOUTH NAKNEK	UNITED STATES
WTK	NOATAK, ALASKA	NOATAK	UNITED STATES
WWP	WHALE PASS, ALASKA	WHALE PASS	UNITED STATES
WWT	NEWTOK, ALASKA	NEWTOK	UNITED STATES
WYS	WEST YELLOWSTONE, MONTANA	YELLOWSTONE	UNITED STATES
YAK	YAKUTAT, ALASKA	YAKUTAT	UNITED STATES
YKN	YANKTON, SOUTH DAKOTA	CHAN GURNEY MUNI	UNITED STATES
YUM	YUMA, ARIZONA	YUMA INTERNATIONAL	UNITED STATES
ZXF	ILLINOIS CREEK, ALASKA	ILLINOIS CREEK	UNITED STATES
ZXO	EL CAPITAN, ALASKA	EL CAPITAN PEAK	UNITED STATES

*Rev. Proc. 97–46, which was "dropped" on September 30, 1997, includes *Mitchell, South Dakota,* as one of the listed rural airports for calendar year 1997. That revenue procedure is **incorrect**. *Mitchell, South Dakota* **has been deleted** from the corrected version of Rev. Proc. 97–46, which appears in this Bulletin.

RIW	RIVERTON, WYOMING	RIVERTON MUNICIPAL	UNITED STATES
RKD	ROCKLAND, MAINE	KNOX COUNTY REGIONAL	UNITED STATES
RKS	ROCK SPRINGS, WYOMING	SWEETWATER COUNTY	UNITED STATES
RMP	RAMPART, ALASKA	RAMPART	UNITED STATES
ROW	ROSWELL, NEW MEXICO	ROSWELL INDUSTRIAL	UNITED STATES
RQI	NIXON FORK MINE, ALASKA	NIXON FORK MINE	UNITED STATES
RTN	RATON, NEW MEXICO	CREWS FIELD	UNITED STATES
RUI	RUIDOSO, NEW MEXICO	RUIDOSO MUNICIPAL	UNITED STATES
RUT	RUTLAND, VERMONT	RUTLAND STATE	UNITED STATES
RWB	ROWAN BAY, ALASKA	ROWAN BAY	UNITED STATES
SBY	SALISBURY, MARYLAND	WICOMICO COUNTY	UNITED STATES
SCC	DEADHORSE, ALASKA	DEADHORSE	UNITED STATES
SCM	SCAMMON BAY, ALASKA	SCAMMON BAY SPB	UNITED STATES
SDP	SAND POINT, ALASKA	SAND POINT MUNICIPAL	UNITED STATES
SDX	SEDONA, ARIZONA	SEDONA	UNITED STATES
SDY	SIDNEY, MONTANA	RICHARD MUNICIPAL	UNITED STATES
SGU	ST. GEORGE, UTAH	ST. GEORGE MUNICIPAL	UNITED STATES
SGY	SKAGWAY, ALASKA	SKAGWAY MUNICIPAL	UNITED STATES
SHD	STAUNTON, VIRGINIA	SHENANDOAH VALLEY	UNITED STATES
SHG	SHUNGNAK, ALASKA	SHUNGNAK	UNITED STATES
SHH	SHISHMAREF, ALASKA	SHISHMAREF	UNITED STATES
SHR	SHERIDAN, WYOMING	SHERIDAN COUNTY	UNITED STATES
SHX	SHAGELUK, ALASKA	SHAGELUK	UNITED STATES
SIT	SITKA, ALASKA	SITKA	UNITED STATES
SJT	SAN ANGELO, TEXAS	MATHIS FIELD	UNITED STATES
SKK	SHAKTOOLIK, ALASKA	SHAKTOOLIK	UNITED STATES
SLN	SALINA, KANSAS	SALINA MUNICIPAL	UNITED STATES
SLQ	SLEETMUTE, ALASKA	SLEETMUTE	UNITED STATES
SMK	ST. MICHAEL, ALASKA	ST. MICHAEL	UNITED STATES
SMU	SHEEP MOUNTAIN, ALASKA	SHEEP MOUNTAIN	UNITED STATES
SNP	ST. PAUL ISLAND, ALASKA	SAINT PAUL ISLAND	UNITED STATES
SOW	SHOW LOW, ARIZONA	SHOW LOW	UNITED STATES
SPS	WICHITA FALLS, TEXAS	SHEPPARD AFB	UNITED STATES
SPW	SPENCER, IOWA	SPENCER MUNICIPAL	UNITED STATES
SQI	STERLING/ROCK FALLS, ILLINOIS		UNITED STATES
SRV	STONY RIVER, ALASKA	STONY RIVER SKYPARK	UNITED STATES
STG	ST. GEORGE, ALASKA	ST. GEORGE ISLAND	UNITED STATES
SUN	SUN VALLEY, IDAHO	FRIEDMAN MEMORIAL	UNITED STATES
SVA	SAVOONGA, ALASKA	SAVOONGA	UNITED STATES
SVC	SILVER CITY, NEW MEXICO	GRANT COUNTY	UNITED STATES
SVS	STEVENS VILLAGE, ALASKA	STEVENS VILLAGE	UNITED STATES
SVW	SPARREVOHN, ALASKA	SPARREVOHN AFS	UNITED STATES
SWD	SEWARD, ALASKA		UNITED STATES
SXP	SHELDON POINT, ALASKA	SHELDON POINT SPB	UNITED STATES
SYA	SHEMYA ISLAND, ALASKA	SHEMYA AFB	UNITED STATES
SYB	SEAL BAY, ALASKA	SEAL BAY	UNITED STATES
SYD	SIDNEY, MONTANA		UNITED STATES
TAL	TANANA, ALASKA	RALPH M CALHOUN MEML	UNITED STATES
TBN	FT. LEONARD WOOD, MISSOURI	FORNEY AAF	UNITED STATES
TCL	TUSCALOOSA, ALABAMA	VAN DE GRAAF	UNITED STATES
TCT	TAKOTNA, ALASKA	TAKOTNA	UNITED STATES
TEH	TETLIN, ALASKA	TETLIN	UNITED STATES
TEX	TELLURIDE, COLORADO	TELLURIDE REGIONAL	UNITED STATES
TKI	TOKEEN, ALASKA	TOKEEN	UNITED STATES
TKJ	TOK, ALASKA	TOK	UNITED STATES
TLA	TELLER, ALASKA	TELLER	UNITED STATES
TLF	TELIDA, ALASKA	TELIDA	UNITED STATES
TLJ	TATALINE, ALASKA	TATALINA AFS	UNITED STATES

MVM	KAYENTA, ARIZONA	MONUMENT VALLEY	UNITED STATES
MVN	MT. VERNON, ILLINOIS		UNITED STATES
MWA	MARION, ILLINOIS	WILLIAMSON COUNTY	UNITED STATES
MWH	EPHRATA/MOSES LAKE, WASHINGTON		UNITED STATES
MXY	MCCARTHY, ALASKA	MCCARTHY	UNITED STATES
MYK	MAY CREEK, ALASKA		UNITED STATES
MYU	MEKORYUK, ALASKA		UNITED STATES
NIB	NIKOLAI, ALASKA	ELLIS FIELD	UNITED STATES
NLG	NELSON LAGOON, ALASKA	NIKOLAI	UNITED STATES
NME	NIGHTMUTE, ALASKA	NELSON LAGOON	UNITED STATES
NNK	NAKNEK, ALASKA	NIGHTMUTE	UNITED STATES
NNL	NONDALTON, ALASKA	NAKNEK	UNITED STATES
NUI	NUIQSUT, ALASKA	NONDALTON	UNITED STATES
NUL	NULATO, ALASKA	NUIQSUT	UNITED STATES
OBU	KOBUK, ALASKA	NULATO	UNITED STATES
OFK	NORFOLK, NEBRASKA	KOBUK	UNITED STATES
OGS	OGDENSBURG, NEW YORK		UNITED STATES
OLF	WOLF POINT, MONTANA	OGDENSBURG MUNICIPAL	UNITED STATES
OLH	OLD HARBOR, ALASKA	WOLF POINT INTL	UNITED STATES
OME	NOME, ALASKA	OLD HARBOR SPB	UNITED STATES
OOK	TOKSOOK, ALASKA	NOME	UNITED STATES
ORH	WORCESTER, MASSACHUSETTS	TOKSOOK BAY	UNITED STATES
ORI	PORT LIONS, ALASKA	WORCESTER MUNICIPAL	UNITED STATES
ORT	NORTHWAY, ALASKA	PORT LIONS SPB	UNITED STATES
ORV	NOORVIK, ALASKA	NORTHWAY	UNITED STATES
OTM	OTTUMWA, IOWA	ROBERT CURTIS MEML	UNITED STATES
OTZ	KOTZEBUE, ALASKA		UNITED STATES
PAH	PADUCAH, KENTUCKY	RALPH WIEN MEMORIAL	UNITED STATES
PCA	PORTAGE CREEK, ALASKA	BARKLEY REGIONAL	UNITED STATES
PCE	PAINTER CREEK, ALASKA	PORTAGE CREEK	UNITED STATES
PDB	PEDRO BAY, ALASKA	PAINTER CREEK	UNITED STATES
PFA	PAF WARREN, ALASKA	PEDRO BAY	UNITED STATES
PGA	PAGE, ARIZONA	PAF WARREN	UNITED STATES
PGV	GREENVILLE, NORTH CAROLINA	PAGE	UNITED STATES
PHO	POINT HOPE, ALASKA	PITT-GREENVILLE	UNITED STATES
PIP	PILOT POINT, ALASKA	POINT HOPE MUNICIPAL	UNITED STATES
PIR	PIERRE, SOUTH DAKOTA	PILOT POINT	UNITED STATES
PIZ	POINT LAY, ALASKA	PIERRE MUNICIPAL	UNITED STATES
PML	PORT MOLLER, ALASKA	POINT LAY DEW STN	UNITED STATES
PNC	PONCA CITY, OKLAHOMA	PORT MOLLER AFS	UNITED STATES
PNF	PETERSON'S POINT, ALASKA	PONCA CITY MUNICIPAL	UNITED STATES
PPC	PROSPECT CREEK, ALASKA	PETERSON'S POINT	UNITED STATES
PPV	PORT PROTECTION, ALASKA	PROSPECT CREEK	UNITED STATES
PQI	PRESQUE ISLE, MAINE	PORT PROTECTION	UNITED STATES
PQS	PILOT STATION, ALASKA	PRESQUE ISLE MUNI	UNITED STATES
PRC	PRESCOTT, ARIZONA	PILOT STATION	UNITED STATES
PSG	PETERSBURG, ALASKA	PRESCOTT MUN	UNITED STATES
PTA	PORT ALSWORTH, ALASKA	PETERSBURG MUNICIPAL	UNITED STATES
PTD	PORT ALEXANDER, ALASKA	PORT ALSWORTH	UNITED STATES
PTH	PORT HEIDEN, ALASKA	PORT ALEXANDER	UNITED STATES
PTL	PORT ARMSTRONG, ALASKA	PORT HEIDEN	UNITED STATES
PTU	PLATINUM, ALASKA	PORT ARMSTRONG	UNITED STATES
RBH	BROOKS LODGE, ALASKA	PLATINUM	UNITED STATES
RBY	RUBY, ALASKA	BROOKS LODGE	UNITED STATES
RDB	RED DOG, ALASKA	RUBY	UNITED STATES
RDD	REDDING, CALIFORNIA	RED DOG MINE	UNITED STATES
RDM	REDMOND, OREGON	REDDING MUNICIPAL	UNITED STATES
RDV	RED DEVIL, ALASKA	ROBERTS FIELD	UNITED STATES
		RED DEVIL	UNITED STATES

KKU	EKUK, ALASKA	EKUK	UNITED STATES
KLL	LEVELOCK, ALASKA	LEVELOCK	UNITED STATES
KLN	LARSEN BAY, ALASKA	LARSEN BAY SPB	UNITED STATES
KMO	MANOKOTAK, ALASKA	MANOKOTAK SPB	UNITED STATES
KMY	MOSER BAY, ALASKA	MOSER BAY	UNITED STATES
KNK	KAKHONAK, ALASKA	KAKHONAK	UNITED STATES
KNW	NEW STUYAHOK, ALASKA	NEW STUYAHOK	UNITED STATES
KOT	KOTLIK, ALASKA	KOTLIK	UNITED STATES
KOY	OLGA BAY, ALASKA	OLGA BAY SPB	UNITED STATES
KOZ	OUZINKIE, ALASKA	OUZINKIE SPB	UNITED STATES
KPB	POINT BAKER, ALASKA	POINT BAKER SPB	UNITED STATES
KPC	PORT CLARENCE, ALASKA	PORT CLARENCE CGS	UNITED STATES
KPK	PARKS, ALASKA	PARKS SPB	UNITED STATES
KPN	KIPNUK, ALASKA	KIPNUK SPB	UNITED STATES
KPR	PORT WILLIAMS, ALASKA	PORT WILLIAMS SPB	UNITED STATES
KPV	PERRYVILLE, ALASKA	PERRYVILLE SPB	UNITED STATES
KPY	PORT BAILEY, ALASKA	PORT BAILEY SPB	UNITED STATES
KQA	AKUTAN, ALASKA	AKUTAN	UNITED STATES
KSM	ST. MARY'S, ALASKA	SAINT MARYS	UNITED STATES
KTS	BREVIG MISSION, ALASKA	BREVIG MISSION	UNITED STATES
KVC	KING COVE, ALASKA	KING COVE	UNITED STATES
KVL	KIVALINA, ALASKA	KIVALINA	UNITED STATES
KWK	KWIGILLINGOK, ALASKA	KWIGILLINGOK	UNITED STATES
KWP	WEST POINT, ALASKA	WEST POINT VILLAGE	UNITED STATES
KYK	KARLUK, ALASKA	KARLUK	UNITED STATES
KYU	KOYUKUK, ALASKA	KOYUKUK	UNITED STATES
KZB	ZACHAR BAY, ALASKA	ZACHAR BAY SPB	UNITED STATES
LAA	LAMAR, COLORADO	LAMAR FIELD	UNITED STATES
LAR	LARAMIE, WYOMING	GENERAL BREES FIELD	UNITED STATES
LBF	NORTH PLATTE, NEBRASKA	LEE BIRD FIELD	UNITED STATES
LBL	LIBERAL, KANSAS	LIBERAL MUNICIPAL	UNITED STATES
LMA	MINCHUMINA, ALASKA	MINCHUMINA	UNITED STATES
LPW	LITTLE PORT WALTER, ALASKA	LITTLE PORT WALTER	UNITED STATES
LRD	LAREDO, TEXAS	LAREDO INTL	UNITED STATES
LUR	CAPE LISBURNE, ALASKA	CAPE LISBURNE AFS	UNITED STATES
LVD	LIME VILLAGE, ALASKA	LIME VILLAGE	UNITED STATES
LWS	LEWISTON, IDAHO	NEZ PERCE COUNTY	UNITED STATES
LWT	LEWISTOWN, MONTANA	LEWISTOWN MUNICIPAL	UNITED STATES
MBL	MANISTEE, MICHIGAN		UNITED STATES
MCE	MERCED, CALIFORNIA	MERCED MUNICIPAL	UNITED STATES
MCG	MCGRATH, ALASKA	MCGRATH	UNITED STATES
MCK	MC COOK, NEBRASKA	MC COOK MUNICIPAL	UNITED STATES
MCN	MACON, GEORGIA	LEWIS B WILSON	UNITED STATES
MDH	CARBONDALE, ILLINOIS	SOUTHERN ILLINOIS	UNITED STATES
MEI	MERIDIAN, MISSISSIPPI	KEY FIELD	UNITED STATES
MHK	MANHATTAN/JCT.CTY/FT.RILEY, KANSAS	MANHATTAN MUNICIPAL	UNITED STATES
MHM	MINCHUMINA, ALASKA	MINCHUMINA	UNITED STATES
MKT	MANKATO, MINNESOTA		UNITED STATES
MLC	MC ALESTER, OKLAHOMA	MC ALESTER MUNICIPAL	UNITED STATES
MLS	MILES CITY, MONTANA	MILES CITY MUNICIPAL	UNITED STATES
MLY	MANLEY HOT SPRINGS, ALASKA	MANLEY HOT SPRINGS	UNITED STATES
MMH	MAMMOTH LAKES, CALIFORNIA	MAMMOTH LAKES	UNITED STATES
MOT	MINOT, NORTH DAKOTA	MINOT INTERNATIONAL	UNITED STATES
MOU	MOUNTAIN VILLAGE, ALASKA	MOUNTAIN VILLAGE	UNITED STATES
MQT	MARQUETTE, MICHIGAN	MARQUETTE COUNTY	UNITED STATES
MSS	MASSENA, NEW YORK	RICHARDS FIELD	UNITED STATES
MTO	MATTOON, ILLINOIS		UNITED STATES
MUE	KAMUELA, HAWAII		UNITED STATES

GGW	GLASGOW, MONTANA	GLASGOW INTL	UNITED STATES
GKN	GULKANA, ALASKA	GULKANA	UNITED STATES
GLD	GOODLAND, KANSAS	RENNER FIELD	UNITED STATES
GLH	GREENVILLE, MISSISSIPPI	GREENVILLE MUNICIPAL	UNITED STATES
GLV	GOLOVIN, ALASKA	GOLOVIN	UNITED STATES
GMT	GRANITE MOUNTAIN, ALASKA	GRANITE MOUNTAIN	UNITED STATES
GNU	GOODNEWS BAY, ALASKA	GOODNEWS BAY	UNITED STATES
GRI	GRAND ISLAND, NEBRASKA	GRAND ISLAND AIR PK	UNITED STATES
GST	GUSTAVUS, ALASKA	GUSTAVUS	UNITED STATES
GTR	COLUMBUS, MISSISSIPPI	GOLDEN TRIANGLE REGL	UNITED STATES
GUP	GALLUP, NEW MEXICO	SENATOR CLARKE FIELD	UNITED STATES
HAY	HAYCOCK, ALASKA	HAYCOCK	UNITED STATES
HBH	HOBART BAY, ALASKA	HOBART BAY	UNITED STATES
HCR	HOLY CROSS, ALASKA	HOLY CROSS	UNITED STATES
HDN	STEAMBOAT SPRINGS, COLORADO	YAMPA VALLEY	UNITED STATES
HGZ	HOGATZA, ALASKA	HOGATZA	UNITED STATES
HII	LAKE HAVASU CITY, ARIZONA	LAKE HAVASU CTY MUNI	UNITED STATES
HKB	HEALY LAKE, ALASKA	HEALY LAKE	UNITED STATES
HOB	HOBBS, NEW MEXICO	LEA COUNTY	UNITED STATES
HON	HURON, SOUTH DAKOTA	W W HOWES MUNICIPAL	UNITED STATES
HOT	HOT SPRINGS, ARKANSAS		UNITED STATES
HPB	HOOPER BAY, ALASKA	HOOPER BAY	UNITED STATES
HRO	HARRISON, ARKANSAS	BOONE COUNTY	UNITED STATES
HSI	HASTINGS, NEBRASKA	HASTINGS MUNICIPAL	UNITED STATES
HSL	HUSLIA, ALASKA	HUSLIA	UNITED STATES
HUS	HUGHES, ALASKA	HUGHES MUNICIPAL	UNITED STATES
HVR	HAVRE, MONTANA	HAVRE CITY-COUNTY	UNITED STATES
HYS	HAYS, KANSAS	HAYS MUNICIPAL	UNITED STATES
IAN	KIANA, ALASKA	BOB BARKER MEMORIAL	UNITED STATES
ICY	ICY BAY, ALASKA	ICY BAY	UNITED STATES
IGG	IGIUGIG, ALASKA	IGIUGIG	UNITED STATES
IGM	KINGMAN, ARIZONA	KINGMAN MUNICIPAL	UNITED STATES
IKO	NIKOLSKI, ALASKA	NIKOLSKI AFS	UNITED STATES
ILI	ILIAMNA, ALASKA	ILIAMNA	UNITED STATES
IMT	IRON MOUNTAIN/KINGSFD, MICHIGAN	FORD	UNITED STATES
INL	INTERNATIONAL FALLS, MINNESOTA	FALLS INTERNATIONAL	UNITED STATES
IPL	EL CENTRO, CALIFORNIA	IMPERIAL COUNTY	UNITED STATES
IRC	CIRCLE, ALASKA	CIRCLE CITY	UNITED STATES
IRK	KIRKSVILLE, MISSOURI	KIRKSVILLE MUNICIPAL	UNITED STATES
ISL	ISABEL PASS, ALASKA	ISABEL PASS	UNITED STATES
ISN	WILLISTON, NORTH DAKOTA	SLOULIN FIELD INTL	UNITED STATES
IWD	IRONWOOD, MICHIGAN	GOGEBIC COUNTY	UNITED STATES
JBR	JONESBORO, ARKANSAS		UNITED STATES
JMS	JAMESTOWN, NORTH DAKOTA	JAMESTOWN MUNICIPAL	UNITED STATES
KAE	KAKE, ALASKA	KAKE	UNITED STATES
KAL	KALTAG, ALASKA	KALTAG	UNITED STATES
KBC	BIRCH CREEK, ALASKA	BIRCH CREEK	UNITED STATES
KCG	CHIGNIK FISHERIES, ALASKA	CHIGNIK FISHERIES	UNITED STATES
KCL	CHIGNIK LAGOON, ALASKA	CHIGNIK LAGOON	UNITED STATES
KCN	CHERNOFSKI, ALASKA	CHERNOFSKI HARBOR	UNITED STATES
KCQ	CHIGNIK, ALASKA	CHIGNIK	UNITED STATES
KEK	EKWOK, ALASKA	EKWOK	UNITED STATES
KFP	FALSE PASS, ALASKA	FALSE PASS	UNITED STATES
KGK	KOLIGANEK, ALASKA	NEW KOLIGANEK	UNITED STATES
KGX	GRAYLING, ALASKA	GRAYLING	UNITED STATES
KIB	IVANOFF BAY, ALASKA	IVANOF BAY SPB	UNITED STATES
KKA	KOYUK, ALASKA	KOYUK	UNITED STATES
KKB	KITOI BAY, ALASKA	KITOI BAY SPB	UNITED STATES

COU	COLUMBIA, MISSOURI	COLUMBIA REGIONAL	UNITED STATES
CPR	CASPER, WYOMING	CASPER	UNITED STATES
CSG	COLUMBUS, GEORGIA	METROPOLITAN AREA	UNITED STATES
CVN	CLOVIS, NEW MEXICO	CLOVIS MUNICIPAL	UNITED STATES
CVS	CLOVIS, NEW MEXICO	CANNON AFB	UNITED STATES
CXC	CHITINA, ALASKA	CHITINA	UNITED STATES
CXF	COLDFOOT, ALASKA	COLDFOOT	UNITED STATES
CYF	CHEFORNAK, ALASKA	CRYSTAL LAKE	UNITED STATES
CYM	CHATHAM, ALASKA		UNITED STATES
CYS	CHEYENNE, WYOMING	CHEYENNE MUNICIPAL	UNITED STATES
CYT	CAPE YAKATAGA, ALASKA	YAKATAGA INTERMEDIAT	UNITED STATES
CZF	CAPE ROMANZOF, ALASKA	CAPE ROMANZOF AFS	UNITED STATES
CZN	CHISANA, ALASKA	CHISANA FIELD	UNITED STATES
DDC	DODGE CITY, KANSAS	DODGE CITY MUNICIPAL	UNITED STATES
DGB	DANGER BAY, ALASKA	DANGER BAY	UNITED STATES
DHN	DOTHAN, ALABAMA	DOTHAN	UNITED STATES
DIK	DICKINSON, NORTH DAKOTA	DICKINSON	UNITED STATES
DIO	DIOMEDE ISLAND, ALASKA	LITTLE DIOMEDE	UNITED STATES
DLG	DILLINGHAM, ALASKA	DILLINGHAM MUNI	UNITED STATES
DRG	DEERING, ALASKA	DEERING	UNITED STATES
DRO	DURANGO, COLORADO	LA PLATA	UNITED STATES
DRT	DEL RIO, TEXAS	DEL RIO INTL	UNITED STATES
DUJ	DU BOIS, PENNSYLVANIA	JEFFERSON COUNTY	UNITED STATES
DUT	DUTCH HARBOR, ALASKA	EMERGENCY FIELD	UNITED STATES
DVL	DEVILS LAKE, NORTH DAKOTA	DEVILS LAKE MUNI	UNITED STATES
DYS	ABILENE, TEXAS	DYESS AFB	UNITED STATES
EAA	EAGLE, ALASKA	EAGLE MUNICIPAL	UNITED STATES
EAR	KEARNEY, NEBRASKA	KEARNEY MUNI	UNITED STATES
EAT	WENATCHEE, WASHINGTON	PANGBORN FIELD	UNITED STATES
EDA	EDNA BAY, ALASKA	EDNA BAY	UNITED STATES
EEN	KEENE, NEW HAMPSHIRE		UNITED STATES
EGX	EGEGIK, ALASKA	EGEGIK	UNITED STATES
EHM	CAPE NEWENHAM, ALASKA	CAPE NEWENHAM AFS	UNITED STATES
ELD	EL DORADO/CAMDEN, ARKANSAS	GOODWIN FIELD	UNITED STATES
ELI	ELIM, ALASKA	ELIM	UNITED STATES
ELY	ELY, NEVADA	YELLAND	UNITED STATES
EMK	EMMONAK, ALASKA	EMMONAK	UNITED STATES
ENV	WENDOVER, UTAH	WENDOVER	UNITED STATES
ESC	ESCANABA, MICHIGAN	DELTA COUNTY	UNITED STATES
ESF	ALEXANDRIA, LOUISIANA	ESLER FIELD	UNITED STATES
FFM	FERGUS FALLS, MINNESOTA	FERGUS FALLS MUNI	UNITED STATES
FKL	OIL CITY/FRANKLIN, PENNSYLVANIA		UNITED STATES
FLT	FLAT, ALASKA	FLAT	UNITED STATES
FMC	FIVE MILE CAMP, ALASKA	FIVE MILE	UNITED STATES
FMN	FARMINGTON, NEW MEXICO	FARMINGTON MUNICIPAL	UNITED STATES
FNR	FUNTER BAY, ALASKA		UNITED STATES
FOD	FT. DODGE, IOWA	FORT DODGE MUNICIPAL	UNITED STATES
FOE	TOPEKA, KANSAS	FORBES AFB	UNITED STATES
FRM	FAIRMONT, MINNESOTA	FAIRMONT MUNICIPAL	UNITED STATES
FYU	FT. YUKON, ALASKA	FORT YUKON MUNICIPAL	UNITED STATES
GAL	GALENA, ALASKA	GALENA	UNITED STATES
GAM	GAMBELL, ALASKA	GAMBELL MUNICIPAL	UNITED STATES
GBD	GREAT BEND, KANSAS	GREAT BEND MUNICIPAL	UNITED STATES
GBH	GALBRAITH LAKE, ALASKA	GALBRAITH LAKE	UNITED STATES
GCC	GILLETTE, WYOMING	CAMPBELL COUNTY	UNITED STATES
GCK	GARDEN CITY, KANSAS	GARDEN CITY MUNI	UNITED STATES
GDV	GLENDIVE, MONTANA	DAWSON COMMUNITY	UNITED STATES
GFB	TOGIAK FISH, ALASKA	TOGIAK FISH	UNITED STATES

ANB	ANNISTON, ALABAMA	ANNISTON COUNTY	UNITED STATES
ANI	ANIAK, ALASKA	ANIAK	UNITED STATES
ANV	ANVIK, ALASKA	ANVIK	UNITED STATES
AOO	ALTOONA, PENNSYLVANIA	BLAIR COUNTY	UNITED STATES
AOS	AMOOK BAY, ALASKA	AMOOK	UNITED STATES
APN	ALPENA, MICHIGAN	ALPENA COUNTY REGL	UNITED STATES
ARC	ARCTIC VILLAGE, ALASKA	ARCTIC VILLAGE	UNITED STATES
ART	WATERTOWN, NEW YORK	WATERTOWN MUNICIPAL	UNITED STATES
ATK	ATQASUK, ALASKA	ATQASUK	UNITED STATES
ATY	WATERTOWN, SOUTH DAKOTA	WATERTOWN MUNICIPAL	UNITED STATES
AUG	AUGUSTA, MAINE	AUGUSTA STATE	UNITED STATES
AUK	ALAKANUK, ALASKA	ALAKANUK	UNITED STATES
BAR	BAKER ISLAND, ALASKA	BAKER AAF	UNITED STATES
BCE	BRYCE CANYON, UTAH	BRYCE CANYON	UNITED STATES
BFF	SCOTTSBLUFF, NEBRASKA	SCOTTS BLUFF COUNTY	UNITED STATES
BHB	BAR HARBOR, MAINE	BAR HARBOR	UNITED STATES
BIC	BIG CREEK, ALASKA	BIG CREEK	UNITED STATES
BIG	BIG DELTA, ALASKA	BIG DELTA INTERMED	UNITED STATES
BJI	BEMIDJI, MINNESOTA	BEMIDJI-BELTRAMI CO.	UNITED STATES
BKC	BUCKLAND, ALASKA	BUCKLAND	UNITED STATES
BKW	BECKLEY, WEST VIRGINIA	RALEIGH COUNTY MEML	UNITED STATES
BKX	BROOKINGS, SOUTH DAKOTA		UNITED STATES
BLF	PRINCETON/BLUEFIELD, WV	MERCER COUNTY	UNITED STATES
BNF	BARANOF, ALASKA	WARM SPRING BAY SPB	UNITED STATES
BRD	BRAINERD, MINNESOTA	CROW WING COUNTY	UNITED STATES
BRW	BARROW, ALASKA	BARROW WBAS	UNITED STATES
BSZ	BARTLETTS, ALASKA	BARTLETTS	UNITED STATES
BTI	BARTER ISLAND, ALASKA	BARTER ISLAND	UNITED STATES
BTT	BETTLES, ALASKA	BETTLES	UNITED STATES
BVD	BEAVER INLET, ALASKA	BEAVER INLET SEWPORT	UNITED STATES
BWD	BROWNWOOD, TEXAS	BROWNWOOD MUNICIPAL	UNITED STATES
BYA	BOUNDARY, ALASKA	BOUNDARY	UNITED STATES
CBE	CUMBERLAND, MARYLAND	WILEY FORD	UNITED STATES
CDB	COLD BAY, ALASKA	COLD BAY	UNITED STATES
CDC	CEDAR CITY, UTAH	CEDAR CITY MUNICIPAL	UNITED STATES
CDL	CANDLE, ALASKA	CANDLE	UNITED STATES
CDR	CHADRON, NEBRASKA	CHADRON MUNICIPAL	UNITED STATES
CDV	CORDOVA, ALASKA	MILE 13 FIELD	UNITED STATES
CEC	CRESCENT CITY, CALIFORNIA	JACK MC NAMARA FIELD	UNITED STATES
CEM	CENTRAL, ALASKA	CENTRAL	UNITED STATES
CEZ	CORTEZ, COLORADO	MONTEZUMA COUNTY	UNITED STATES
CFA	COFFEE POINT, ALASKA	COFFEE POINT	UNITED STATES
CGI	CAPE GIRARDEAU, MISSOURI	CAPE GIRARDEAU MUNI	UNITED STATES
CHP	CIRCLE HOT SPRINGS, ALASKA	CIRCLE HOT SPRINGS	UNITED STATES
CHU	CHUATHBALUK, ALASKA	CHUATHBALUK	UNITED STATES
CIC	CHICO, CALIFORNIA	CHICO MUNI	UNITED STATES
CIK	CHALKYITSIK, ALASKA	CHALKYITSIK	UNITED STATES
CIL	COUNCIL, ALASKA	MELSING CREEK	UNITED STATES
CIU	SAULT STE MARIE, MICHIGAN	CHIPPEWA COUNTY	UNITED STATES
CJI	CRAFTON ISLAND, ALASKA	CRAFTON ISLAND SPB	UNITED STATES
CKB	CLARKSBURG, WEST VIRGINIA	BENEDUM	UNITED STATES
CKD	CROOKED CREEK, ALASKA	CROOKED CREEK	UNITED STATES
CKX	CHICKEN, ALASKA	CHICKEN	UNITED STATES
CLP	CLARKS POINT, ALASKA	CLARKS POINT	UNITED STATES
CMX	HANCOCK/HOUGHTON, MICHIGAN	HOUGHTON COUNTY MEML	UNITED STATES
CNM	CARLSBAD, NEW MEXICO	CAVERN CITY AIR TERM	UNITED STATES
CNY	MOAB, UTAH	CANYONLANDS FIELD	UNITED STATES
COD	LOVELL/CODY, WYOMING	YELLOWSTONE REGIONAL	UNITED STATES

YNK	NOOTKA SOUND, B.C.	NOOTKA SOUND	CANADA
YPL	PICKLE LAKE, ONTARIO	PICKLE LAKE	CANADA
YQI	YARMOUTH, NOVA SCOTIA	YARMOUTH	CANADA
YQK	KENORA, ONTARIO	KENORA	CANADA
YQL	LETHBRIDGE, ALBERTA	LETHBRIDGE	CANADA
YQQ	COMOX, B.C.	COMOX	CANADA
YQV	YORKTON, SASK.	YORKTON	CANADA
YRL	RED LAKE, ONTARIO	RED LAKE	CANADA
YSB	SUDBURY, ONTARIO	SUDBURY	CANADA
YSC	SHERBROOKE, QUEBEC	SHEREBROOKE	CANADA
YSJ	ST. JOHN, N.B.	SAINT JOHN	CANADA
YSP	MARATHON, ONTARIO	MARATHON	CANADA
YSZ	SQUIRREL COVE, B.C.	SQUIRREL COVE	CANADA
YTA	PEMBROKE ONTARIO	PEMBROKE	CANADA
YTJ	TERRACE BAY, ONTARIO	TERRACE BAY	CANADA
YTP	TOFINO, B.C.	TOFINO SPB	CANADA
YTS	TIMMINS, ONTARIO	TIMMINS	CANADA
YVB	BONAVENTURE, QUEBEC	BONAVENTURE	CANADA
YWL	WILLIAMS LAKE, B.C.	WILLIAMS LAKE	CANADA
YWR	WHITE RIVER, ONTARIO	WHITE RIVER	CANADA
YXC	CRANBROOK, B.C.	CRANBROOK	CANADA
YXH	MEDICINE HAT, ALBERTA	MEDICINE HAT	CANADA
YXL	SIOUX LOOKOUT, ONTARIO	SIOUX LOOKOUT	CANADA
YXR	EARLTON, ONTARIO	EARLTON	CANADA
YXZ	WAWA, ONTARIO	WAWA	CANADA
YYB	NORTH BAY, ONTARIO	NORTH BAY	CANADA
YYG	CHARLOTTETOWN, P.E.I.	CHARLOTTETOWN	CANADA
YYU	KAPUSKASING, ONTARIO	KAPUSKASING	CANADA
YYY	MONT JOLI, QUEBEC	MONT JOLI	CANADA
YZT	PORT HARDY, B.C.	PORT HARDY	CANADA
YZV	SEVEN ISLANDS, QUEBEC	SEPT-ILES	CANADA
BHL	BAHIA ANGELES		MEXICO
CVM	CIUDAD VICTORIA, TAMAULIPAS		MEXICO
PDS	PIEDRAS NEGRAS, COAHUILA		MEXICO
SFH	SAN FELIPE		MEXICO
SNQ	SAN QUINTIN		MEXICO
ABI	ABILENE, TEXAS	ABILENE MUNICIPAL	UNITED STATES
ABL	AMBLER, ALASKA	AMBLER RIVER	UNITED STATES
ABR	ABERDEEN, SOUTH DAKOTA	ABERDEEN REGIONAL	UNITED STATES
ABY	ALBANY, GEORGIA	DOUGHERTY COUNTY	UNITED STATES
ACT	WACO, TEXAS	WACO MUNICIPAL	UNITED STATES
ACV	EUREKA/ARCATA, CALIFORNIA	ARCATA	UNITED STATES
ADK	ADAK ISLAND, ALASKA	ADAK ISLAND NS	UNITED STATES
ADQ	KODIAK, ALASKA	METROPOLITAN AREA	UNITED STATES
AET	ALLAKAKET, ALASKA	ALLAKAKET	UNITED STATES
AEX	ALEXANDRIA, LOUISIANA	ENGLAND AFB	UNITED STATES
AFK	ANDREAFSKI, ALASKA	ANDREAFSKI	UNITED STATES
AIA	ALLIANCE, NEBRASKA	ALLIANCE MUNICIPAL	UNITED STATES
AIN	WAINWRIGHT, ALASKA	WAINWRIGHT	UNITED STATES
AKB	ATKA, ALASKA	ATKA	UNITED STATES
AKK	AKHIOK, ALASKA	AKHIOK SPB	UNITED STATES
AKN	KING SALMON, ALASKA	KING SALMON	UNITED STATES
AKO	AKRON, COLORADO	WASHINGTON COUNTY	UNITED STATES
AKP	ANAKTUVIK PASS, ALASKA	ANAKTUVUK PASS	UNITED STATES
ALE	ALPINE, TEXAS	ALPINE CASPARIS MUNI	UNITED STATES
ALM	ALAMOGORDO, NEW MEXICO	ALAMOGORDO MUNICIPAL	UNITED STATES
ALS	ALAMOSA, COLORADO	ALAMOSA MUNICIPAL	UNITED STATES
ALZ	ALITAK, ALASKA	ALITAK SPB	UNITED STATES

tends and modifies the tax imposed by § 4261 on amounts paid for the transportation of persons by air. The new rules relating to domestic air transportation apply to amounts paid after September 30, 1997, for transportation beginning after that date. The Act generally provides a tax rate of 7.5 percent of the amount paid for taxable transportation. However, the rate is 9 percent for transportation beginning after September 30, 1997, and before October 1, 1998, and 8 percent for transportation beginning after September 30, 1998, and before October 1, 1999. The 7.5 percent rate is effective for transportation beginning after September 30, 1999.

In addition, the Act subjects each domestic segment of taxable transportation to a segment tax. The initial tax rate is $1.00 per domestic segment for segments beginning after September 30, 1997, and before October 1, 1998. The segment tax increases to a fully phased in rate of $3.00 per domestic segment for segments beginning during calendar year 2002. After calendar year 2002, the $3.00 segment tax will be indexed for inflation.

Transportation segments beginning or ending at a rural airport are not subject to the temporary 9 percent and 8 percent rates and are exempt from the segment tax. Thus, transportation segments beginning or ending at a rural airport are subject only to a 7.5 percent rate on the amount paid for the transportation segments.

An airport is a rural airport, as defined in § 4261(e)(1)(B), for a calendar year if -

(i) fewer than 100,000 commercial passengers departed by air during the second preceding calendar year from that airport, and

(ii) the airport is either (A) not located within 75 miles of another airport from which 100,000 or more commercial passengers departed during the second preceding calendar year, or (B) receiving essential air service subsidies as of August 5, 1997.

SECTION 3. SCOPE

This revenue procedure lists, based on information supplied by the Office of Airline Information at the Department of Transportation, airports that will be treated as rural airports for calendar year 1997. A subsequent revenue procedure will provide a similar list of rural airports for calendar year 1998. For calendar year 1997, the list in this revenue procedure may be relied upon unless and until modified or superseded by a subsequent revenue procedure. In addition, any airport not listed in this revenue procedure is, nevertheless, a rural airport if it meets the requirements of § 4261(e)(1)(B) set forth above.

SECTION 4. PROCEDURE

.01 The following airports will be treated as rural airports for calendar year 1997:

CODE	LOCATION*	AIRPORT NAME	COUNTRY
YAC	CAT LAKE, ONTARIO	CAT LAKE	CANADA
YAG	FORT FRANCES, ONTARIO	FORT FRANCES MUNI	CANADA
YAM	SAULT STE. MARIE, ONTARIO	SAULT STE MARIE	CANADA
YAZ	TOFINO, B.C.	TOFINO	CANADA
YBC	BAIE COMEAU, QUEBEC	BAIE COMEAU	CANADA
YBG	SAGUENAY, QUEBEC	BAGOTVILLE	CANADA
YBL	CAMPBELL RIVER, B.C.	CAMPBELL RIVER	CANADA
YBR	BRAN WN, MANITOBA	BRANDON	CANADA
YBV	BERENS RIVER MANITOBA	BERENS RIVER	CANADA
YCF	CORTES BAY, B.C.	CORTES BAY	CANADA
YCG	CASTLEGAR/NELSON/TRAIL,B.C.	CASTLEGAR	CANADA
YCL	CHARLO, NEW BRUNSWICK	CHARLO	CANADA
YDN	DAUPHIN, MANITOBA	DAUPHIN	CANADA
YDS	DESOLATION SOUND, B.C.	DESOLATION SOUND	CANADA
YEL	ELLIOT LAKE, ONTARIO	ELLIOT LAKE MUNI	CANADA
YFC	FREDERICTON, NEW BRUNSWICK	FREDERICTON	CANADA
YGE	GORGE HARBOR, B.C.	GORGE HARBOR	CANADA
YGK	KINGSTON, ONTARIO	KINGSTON	CANADA
YGN	GREENWAY SOUND, B.C.	GREENWAY SOUND	CANADA
YGP	GASPE, QUEBEC	GASPE	CANADA
YGQ	GERALDTON, ONTARIO	GERALDTON	CANADA
YHD	DRYDEN, ONTARIO	DRYDEN MUNICIPAL	CANADA
YHH	CAMPBELL RIVER, B.C.	HARBOR SPB	CANADA
YHN	HORNEPAYNE, ONTARIO	HORNEPAYNE	CANADA
YIB	ATIKOKAN, ONTARIO	ATIKOKAN MUNICIPAL	CANADA
YIG	BIG BAY MARINA, B.C.	BIG BAY MARINA	CANADA
YKX	KIRKLAND LAKE, ONTARIO	KIRKLAND LAKE	CANADA
YLD	CHAPLEAU, ONTARIO	CHAPLEAU	CANADA
YML	MURRAY BAY, QUEBEC	CHARLEVOIX	CANADA
YMP	PORT MCNEIL, B.C.	PORT MCNEIL	CANADA

ness purpose (and, for gifts and entertainment, business relationship of the recipient or persons entertained) for each expenditure or use. Section 1.274–5T(b).

.07 Section 1.274–5T(f)(4)(i) requires an employee substantiating expenses (or making an "adequate accounting" of expenses) to the employer to submit to the employer records that satisfy the "adequate records" requirements of § 1.274–5T(c)(2). However, § 1.274–5T(f)(4)(ii) provides that the Commissioner may prescribe rules under which an employee may make an adequate accounting to the employer by submitting an account book, diary, log, etc., alone, without submitting documentary evidence.

SECTION 3. SCOPE

This revenue procedure provides rules pursuant to § 1.274–5T(f)(4)(ii) under which an employee of a federal government agency may make an adequate accounting to the employer to substantiate the employee's expenses for travel, entertainment, gifts, or listed property, by submitting an account book, diary, log, statement of expense, trip sheet, or similar record, without submitting documentary evidence.

SECTION 4. DEFINITIONS

.01 *Documentary evidence.* The term "documentary evidence" means receipts, paid bills, or similar evidence (whether on paper or in electronic form) sufficient to support an expenditure (as provided in § 1.274–5T(c)(2)(iii)).

.02 *Employee.* The term "employee" has the same meaning as in 5 U.S.C. § 5701(2). The term "employee" also includes members of the uniformed services (as defined in 37 U.S.C. § 101(3)) and members of the Foreign Service (as defined in 22 U.S.C. § 3903).

.03 *Employer.* The term "employer" means a federal government agency (within the meaning of section 4.06 of this revenue procedure) that reimburses its employees under a reimbursement arrangement for their expenses for travel, entertainment, gifts, or listed property.

.04 *Expenses or expenditures.* The terms "expenses" or "expenditures" mean expenses under § 274(d) for travel (including meals and lodging away from home), entertainment, gifts, or listed property, incurred by an employee in connection with the performance of services as an employee.

.05 *Expense voucher.* The term "expense voucher" means an account book, diary, log, statement of expense, trip sheet, or similar record (within the meaning of § 1.274–5T(c)(2)(ii), and whether on paper or in electronic form).

.06 *Federal government agency.* The term "federal government agency" has the same meaning as "agency" in 5 U.S.C. § 5701(1).

.07 *Reimbursement.* The term "reimbursement" includes advances, reimbursements, or allowances for expenses.

SECTION 5. APPLICATION

.01 *In general* An employee of a federal government agency may make an adequate accounting to the employer to substantiate the employee's expenses (under §§ 1.274–5T(f)(2) and (4)(ii)) without submitting documentary evidence, provided the employer makes the reimbursement pursuant to a written policy that includes all the procedures set forth in section 5.02 of this revenue procedure. An adequate accounting made pursuant to these procedures satisfies the substantiation requirements applicable to accountable plans under § 1.62–2(c)(2). However, an employer must comply with the other requirements of § 1.62–2 in order to treat reimbursements as paid under an accountable plan.

.02 *Required procedures*

(1) The types and amounts of expenses paid or incurred by the employee, or to be paid or incurred by the employee, must be approved by an appropriate official of the employer (who is not the employee incurring the expenses), either in advance of, or after, the employee pays or incurs the expenses.

(2) Within a reasonable time after paying or incurring the expenses, the employee must submit to the employer an expense voucher sufficient to establish the elements of amount, time, place, and business purpose (and, for gifts and entertainment, business relationship of the recipient or persons entertained) for each expenditure or use.

(3) Except as provided in Rev. Proc. 96–63, 1996–2 C.B. 420, or Rev. Proc. 96–64, 1996–2 C.B. 427, or any successors, the employee must obtain and retain for a period of four years after submitting the expense voucher, documentary evidence for (a) expenditures of $75 or more, and (b) all expenditures for lodging, and produce the documentary evidence when requested by the employer or the Service. The employer must timely inform an employee receiving reimbursements of these requirements.

(4) The employer must conduct periodic audits of a representative sample of the expense vouchers submitted (including related documentary evidence), selected on a statistically sound basis. Compliance with the applicable requirements of the General Accounting Office is sufficient.

(5) The employer must either (a) collect from an employee any amount discovered on audit or otherwise to have been reimbursed in excess of the amount supported by the documentary evidence required under section 5.02(3) of this revenue procedure, or (b) treat such excess as paid under a nonaccountable plan.

(6) The employer's policy and procedures (including audit procedures) for reimbursing employees for expenses must be subject to review by an independent government authority (such as its Inspector General or the General Accounting Office).

SECTION 6. EFFECTIVE DATE

This revenue procedure is effective October 1, 1997.

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26 CFR 601.102: Classification of taxes collected by the Internal Revenue Service. (Also Part I, §4261.)

Rev. Proc. 97–46

SECTION 1. PURPOSE

This revenue procedure provides a list of "rural airports" as that term is defined in § 4261(e)(1)(B) of the Internal Revenue Code, for purposes of computing the tax on air transportation. The revenue procedure also provides guidance on how to calculate the tax in certain circumstances.

SECTION 2. BACKGROUND

Section 1031 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, (the Act) ex-

tions of the trade or business cease, or substantially all the assets of the trade or business are transferred to another taxpayer in a taxable or non-taxable transfer. For this purpose, "substantially all" has the same meaning as in section 3.01 of Rev. Proc. 77–37, 1977–2 C.B. 568. No acceleration of the settlement amount is required under this section 7.02 when a C corporation elects to be treated as an S corporation, or an S corporation terminates its S election and is then treated as a C corporation. However, acceleration of the settlement amount is required if a sole proprietor incorporates and immediately elects to be treated as an S corporation.

.03 A taxpayer that makes one or more payments under this revenue procedure may not change from the LIFO inventory method pursuant to Rev. Proc. 97–37, 1997–33 I.R.B. 18, for a taxable year beginning before the date that the entire settlement amount is paid in accordance with this revenue procedure. A taxpayer requesting to change from the LIFO method for a taxable year beginning before the date that the entire settlement amount is paid, must file a Form 3115 in accordance with Rev. Proc. 97–27. The Commissioner will not grant consent to change from the LIFO method unless the taxpayer agrees to accelerate any remaining payments of the settlement amount.

SECTION 8. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 97–37 is modified.

SECTION 9. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1559.

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.

The collection of information in this revenue procedure is in section 5 of this revenue procedure. This information is required to ensure that the settlement amount required to be paid under this revenue procedure is accurately computed and timely paid. The likely respondents are businesses engaged in the retail sale of new automobiles or trucks.

The estimated total annual reporting burden is 100,000 hours.

The estimated annual burden per respondent will vary from 10 hours to 30 hours, depending on individual circumstances, with an estimated average of 20 hours. The estimated number of respondents is 5,000.

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 return information are confidential, as required by 26 U.S.C. 6103.

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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 I, §§ 62, 162, 274; 1.62-2, 1.162–17, 1.274–5T, 1.274(d)–1.)

Rev. Proc. 97–45

SECTION 1. PURPOSE

This revenue procedure provides optional rules under which an employee of a federal government agency who is reimbursed for ordinary and necessary business expenses relating to travel, entertainment, gifts, or listed property (such as an employee's automobile) may make an adequate accounting to the employer to substantiate those expenses (under §§ 1.274–5T(f)(2) and (4)(ii) of the temporary Income Tax Regulations) by submitting an account book, diary, log, etc., alone, without submitting documentary evidence such as receipts. These rules generally apply to employees of the executive and judicial branches, and certain employees of the legislative branch, of the federal government.

SECTION 2. BACKGROUND

.01 Section 162(a) of the Internal Revenue Code allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (including amounts expended for meals and lodging) while away from home in pursuit of a trade or business.

.02 Section 1.62–2(c)(2) provides that reimbursements by an employer to an employee for business expenses paid or incurred by the employee are paid under an "accountable plan" if the reimbursement arrangement meets the requirements of business purpose, substantiation, and returning amounts in excess of expenses. Amounts failing to meet these requirements are treated as paid under a nonaccountable plan. Section 1.62–2(c)(3).

.03 Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W–2, and are exempt from the withholding and payment of employment taxes. Section 1.62–2(c)(4). Conversely, amounts treated as paid under a nonaccountable plan are included in the employee's gross income, must be reported as wages or other compensation on the employee's Form W–2, and are subject to the withholding and payment of employment taxes. Section 1.62–2(c)(5).

.04 An employee may satisfy the substantiation requirement of a § 1.62–2(c)(2) accountable plan by substantiating the expenses to the employer in accordance with § 274(d) and the regulations thereunder. Section 1.62–2(e)(2).

.05 Section 274(d) disallows a deduction under § 162 for any travel (including meals and lodging), entertainment, gift, or listed property expense, unless the taxpayer substantiates the elements of the expense by adequate records or by sufficient evidence.

.06 Under § 1.274–5T(c)(2), a taxpayer must maintain two types of records to satisfy the "adequate records" requirement: (1) a summary of expenses (account book, diary, log, statement of expense, trip sheets, or similar record) made at or near the time the expenses are incurred (as provided in § 1.274–5T(c)(2)(ii)), and (2) documentary evidence (such as receipts, paid bills, or similar evidence as provided in § 1.274–5T(c)(2)(iii)). Section 1.274–5T(c)(2)(iii) generally requires that a taxpayer have documentary evidence to substantiate (A) any expenditure for lodging, and (B) any other expenditure of $75 or more ($25 or more for expenses paid or incurred before October 1, 1995). Together, these records must establish the elements of amount, time, place, and busi-

due on or before May 31, 1998, in the case of inventory related to the purchase, sale, and service of automobiles or light-duty trucks. Except as provided in section 5.03(2) or (3) of this revenue procedure, the first installment and the memorandum described in section 5.04 of this revenue procedure are due on or before January 31, 1999, in the case of inventory related to the purchase, sale, and service of medium- or heavy-duty trucks. The remaining installments and memoranda are due on or before January 31 of the two succeeding calendar years. Payments, together with the original memorandum, must be sent to the Internal Revenue Service, Cincinnati Service Center, 201 W. River Center Blvd., Stop 31, Unit 21, Covington, KY 41019. A copy of each memorandum must be sent to the national office addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington, DC 20044 (or, in the case of a private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224).

(2) *Taxpayers under examination, before appeals, or before a federal court.* If any federal income tax return of a taxpayer is under examination, before an appeals office, or before a federal court on October 14, 1997, the first installment of the settlement amount and the memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of automobiles and light-duty trucks are due on or before December 1, 1997. Such a taxpayer must notify the examining agent(s), appeals officer, or the counsel for the government, whichever is applicable, in writing on or before December 15, 1997, that it has applied for relief under this revenue procedure. If any federal income tax return of a taxpayer is under examination, before an appeals office, or before a federal court on September 8, 1998, the first installment of the settlement amount and the memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of medium- and heavy-duty trucks are due on or before December 1, 1998. Such a taxpayer must notify the examining agent(s), appeals officer, or the counsel for the government, whichever is applicable, in writing on or before December 15, 1998, that it has applied for relief under this revenue procedure. For these purposes, the terms "under examination," "before an appeals office," and "before a federal court" have the same meaning as provided in Rev. Proc. 97–27, 1997–21 I.R.B. 10. Evidence that the first installment has been paid and a copy of the memorandum described in section 5.04 of this revenue procedure must be provided as part of this written notification.

(3) *Option to pay settlement amount in one installment.* A taxpayer may elect to pay the entire settlement amount in one installment. If a taxpayer makes this election, the entire settlement amount and the original memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of automobiles and light-duty trucks are due on or before May 31, 1998, or, if any federal income tax return of such taxpayer is under examination, before an appeals office, or before a federal court, on or before December 1, 1997. The entire settlement amount and the original memorandum described in section 5.04 of this revenue procedure with respect to inventory related to the purchase, sale, and service of medium- and heavy-duty trucks are due on or before January 31, 1999, or, if any federal income tax return of such taxpayer is under examination, before an appeals office, or before a federal court, on or before December 1, 1998.

.04 *Accompanying Memorandum.* Each installment payment must be accompanied by a memorandum providing the following information:

(1) the taxpayer's name, address, and EIN number;

(2) the amount of the taxpayer's LIFO reserve calculated under section 5.02(2) of this revenue procedure;

(3) the total settlement amount calculated under section 5.02(2) of this revenue procedure;

(4) the amount of the installment being paid;

(5) a statement identifying the payment as the first, second, or third installment (or a statement that the taxpayer elects to pay the entire settlement amount in a single installment); and

(6) a statement that the taxpayer agrees to all of the terms of this revenue procedure.

Each memorandum must be signed under penalties of perjury by an individual with authority to bind the taxpayer in such matters. The following language must be either typed or legibly printed at the top of the first page of each memorandum: "PAYMENT OF SETTLEMENT AMOUNT UNDER REV. PROC. 97–44."

SECTION 6. DEFINITIONS

.01 *Violation year.* A violation year is any taxable year for which a taxpayer violated the LIFO conformity requirement under the facts described in section 3 of this revenue procedure. However, solely for purposes of this revenue procedure, a taxable year will not be treated as a violation year if it ended on or before October 14, 1997, and the taxpayer replaced the twelfth monthly income statement for that year with a "thirteenth period income statement" that:

(1) covered the same period as the twelfth monthly income statement;

(2) reflected the LIFO inventory method; and

(3) was provided, before the first monthly income statement of the following year, to each creditor that received the twelfth monthly income statement.

.02 *Look-back period.* For purposes of this revenue procedure, the "look-back period" consists of the taxpayer's six most recent taxable years ended on or before October 14, 1997.

SECTION 7. ADDITIONAL TERMS OF RELIEF

.01 A taxpayer that fails to pay each installment of the settlement amount timely, or to submit the memorandum timely, has not satisfied the requirements of this revenue procedure. Accordingly, the relief provided under section 4 of this revenue procedure is not available.

.02 A taxpayer that ceases to engage in the trade or business of purchase, sale, and service of automobiles or trucks or terminates its existence must pay the remaining balance of the settlement amount within 45 days of the cessation or termination. A taxpayer is treated as ceasing to engage in a trade or business if the opera-

be used, for the purpose of a report or statement covering that taxable year to shareholders, partners, other proprietors, or beneficiaries, or for credit purposes.

.03 Section 472(e) provides that a taxpayer electing to use the LIFO inventory method must continue to use the LIFO inventory method unless the taxpayer: (1) obtains the consent of the Commissioner to change to a different method; or (2) is required by the Commissioner to change to a different method because the taxpayer has used some inventory method other than LIFO to ascertain the income, profit, or loss of any subsequent taxable year in a report or statement covering that taxable year (a) to shareholders, partners, other proprietors, or beneficiaries, or (b) for credit purposes.

.04 Section 1.472–2(e)(1) of the Income Tax Regulations provides that a taxpayer electing to use the LIFO inventory method must establish to the satisfaction of the Commissioner that the taxpayer, in ascertaining the income, profit, or loss of the taxable year for which the LIFO inventory method is first used, or for any subsequent taxable year, for credit purposes or for purposes of reports to shareholders, partners, other proprietors, or beneficiaries, has not used any inventory method other than LIFO.

.05 Rev. Rul. 97–42 holds that a franchised automobile dealer that elected the LIFO inventory method violates the LIFO conformity requirement by providing to a credit subsidiary of its franchisor (an automobile manufacturer) an income statement covering a taxable year that fails to reflect the LIFO inventory method in the computation of net income.

.06 Rev. Proc. 79–23, 1979–1 C.B. 564, provides that a violation of the LIFO conformity requirement warrants termination of a taxpayer's LIFO election.

SECTION 3. SCOPE

This revenue procedure applies to any taxpayer engaged in the purchase, sale, and service of automobiles or light-, medium-, or heavy-duty trucks that violated the LIFO conformity requirement by providing, for credit purposes, an income statement prepared in a format required by the franchisor or on a pre-printed form supplied by the franchisor (an automobile or truck manufacturer), covering any taxable year ended on or before October 14, 1997, that fails to reflect the LIFO inventory method in the computation of net income, regardless of whether the taxpayer is currently under examination, before an appeals office, or before a federal court. For this purpose, the term "taxpayer" has the same meaning as the term "person" defined in § 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in § 7701(a)(14)). The term "taxpayer" includes a corporation that is included in an affiliated group of corporations as defined in § 1504.

SECTION 4. RELIEF

.01 A taxpayer within the scope of this revenue procedure that satisfies all the requirements for relief set forth herein is hereby granted the following relief: the district director will not terminate the LIFO election of the taxpayer because of a LIFO conformity violation described in section 3 of this revenue procedure.

.02 The relief granted under this revenue procedure extends only to LIFO conformity violations described in section 3 of this revenue procedure that occurred on or before October 14, 1997. Accordingly, the district director may, upon examination, terminate a taxpayer's LIFO election for:

(1) other LIFO conformity violations, including those described in section 3 of this revenue procedure that occur after October 14, 1997; or

(2) any other action that may warrant termination of a taxpayer's LIFO election.

.03 The district director may, upon examination, verify the accuracy of the taxpayer's settlement amount calculation and otherwise determine whether the taxpayer has fully satisfied the requirements of this revenue procedure. The district director may terminate a taxpayer's LIFO election for any violation year ended within the look-back period if the taxpayer failed to fully satisfy the requirements of this revenue procedure.

.04 Nothing in this revenue procedure will prohibit the district director from making adjustments to a taxpayer's LIFO inventory method of accounting.

SECTION 5. REQUIREMENTS FOR RELIEF

.01 A taxpayer within the scope of this revenue procedure for which any violation year ended within the look-back period is entitled to relief only if the taxpayer: (1) pays the settlement amount at the time and in the manner set forth in section 5.03 of this revenue procedure; (2) submits the accompanying memorandum at the time and in the manner set forth in sections 5.03 and 5.04 of this revenue procedure; and (3) satisfies the additional requirements set forth in section 7 of this revenue procedure. A taxpayer within the scope of this revenue procedure that does not have a violation year that ends in the look-back period is automatically granted relief and is not required to satisfy any of the requirements of this revenue procedure.

.02 *Settlement Amount.* (1) *In general.* A taxpayer applying for relief under this revenue procedure must pay a "settlement amount," which is intended to approximate the after-tax, time value of money benefit that the taxpayer will derive from continuing to use the LIFO inventory method for a period of years. The settlement amount is not treated as interest under § 163(a) and may not be capitalized or deducted under any provision of the Code. Moreover, the settlement amount is not refundable or creditable against any federal tax liability of the taxpayer.

(2) *Calculating the settlement amount.* The settlement amount equals 4.7% of the difference between the LIFO carrying value and the non-LIFO carrying value (for example, the value using the actual invoice cost or the first-in, first-out method) of the taxpayer's inventory (the "LIFO reserve") on the last day of the taxpayer's last taxable year ended on or before October 14, 1997. For this purpose, the taxpayer's inventory includes only inventory related to the purchase, sale, and service of automobiles and light-, medium-, and heavy-duty trucks. A taxpayer determines the LIFO reserve on the last day of its last taxable year ended on or before October 14, 1997, using the method of accounting that it used on its original federal income tax return for that taxable year.

.03 *Time and Manner of Payment.* (1) *In general.* The settlement amount must be paid in three equal installments. Except as provided in section 5.03(2) or (3) of this revenue procedure, the first installment and the memorandum described in section 5.04 of this revenue procedure are

purpose of Rev. Proc. 97–27, 1997–21 I.R.B. 10, section 3.08(3).

.07 The taxpayer must properly complete and execute a Form 3115. A legend must be typed on the top of the first page of the Form 3115 that identifies the applicable parts of section 4 of this revenue procedure (other than section 4.04 and section 4.07). The legend should read substantially as follows: "Filed under section[s] 4.** [and 4.**] of Rev. Proc. 97–43."

(1) Form 3115 requires an explanation of the legal basis of the proposed change in method of accounting. That explanation must state specifically which election(s) the taxpayer made under § 1.475(c)–1. *See also* Rev. Rul. 97–39, Holding 17 (discussing the need for multiple elections).

(2) The taxpayer must attach to the Form 3115 a statement describing all identifications, if any, that are or were effective for the purposes of § 475(b)(2) of securities acquired prior to the date of executing the Form 3115 (or the date of filing if filed more than 30 days after executing). For identifications that are not subject to Holding 15 of Rev. Rul. 97–39, the statement must describe the procedures or systems used to make each identification, the date on which the identifications were made, and the content and location of the identifications in the taxpayer's books and records. *See* Rev. Rul. 97–39, Holding 14 (discussing when an identification under § 475(b)(2) is timely made). If the taxpayer holds, or held, transition securities, which are subject to identification under Holding 15 of Rev. Rul. 97–39, the statement must describe the basis for concluding that the securities were or were not described in § 475(b)(1)(A), (B), or (C), including the date, content, and location of documents in the taxpayer's books and records that support such conclusions. If there were no identifications, or if none of the taxpayer's securities were transition securities, then the statement should convey this information.

SEC. 5. CONSENT

.01 If a taxpayer described in section 3 of this revenue procedure complies with the requirements set forth in section 4, then the Commissioner hereby grants consent for the taxpayer to change its method of accounting for securities to reflect the application of § 475(a).

.02 Pending further guidance, in the case of any taxpayer granted automatic consent to change an accounting method by this revenue procedure, § 475(a) applies only to changes in value of securities occurring after the start of the year of change, and any built-in gain or loss as of the beginning of the year of change must be taken into account under rules similar to § 1.475(a)–3(b)(2).

SEC. 6. EFFECTIVE DATE

This revenue procedure is effective September 10, 1997, the date this revenue procedure was made available to the public.

SEC. 7. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1558.

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

The collections of information in this revenue procedure are in sections 2.02, 2.03, 2.04, and 4.07(2). This information is required by the Service in order to facilitate monitoring taxpayers changing accounting methods resulting from making the elections provided by § 1.475(c)–1(a)(3)(iii), –1(b)(4), or –1(c)(1)(ii). The information collected will be used if a taxpayer making the change is audited. The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The collection of information contained in sections 2.02, 2.03, and 2.04 were reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1496.

The estimated total annual reporting burden described in section 4.07(2) is 100,000 hours.

The estimated annual burden per respondent varies from .25 hours to 50 hours, depending on individual circumstances, with an estimated average of 5 hours. The estimated number of respondents is 20,000.

The estimated annual frequency of responses is once in the existence of each respondent.

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.

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26 CFR 1.472–2: Requirements incident to adoption and use of LIFO inventory method. (Also Part I, § 472; § 1.472-1.)

Rev. Proc. 97–44[1]

SECTION 1. PURPOSE

This revenue procedure provides relief for automobile and truck dealers that elected the last-in, first-out (LIFO) inventory method and violated the LIFO conformity requirement of § 472(c) or (e)(2) of the Internal Revenue Code by providing, for credit purposes, an income statement prepared in a format required by the franchisor or on a pre-printed form supplied by the franchisor (an automobile or truck manufacturer), covering any taxable year ended on or before October 14, 1997, that fails to reflect the LIFO inventory method. *See, e.g.*, Rev. Rul. 97–42, 1997–41 I.R.B. 4 (*Situation 3*). Automobile and truck dealers that comply with this revenue procedure will not be required to change from the LIFO inventory method to another inventory method as a result of such LIFO conformity violation.

SECTION 2. BACKGROUND

.01 Section 472(a) authorizes a taxpayer to use the LIFO inventory method in accordance with regulations prescribed by the Secretary.

.02 Section 472(c) provides that a taxpayer may not elect to use the LIFO inventory method unless it establishes to the satisfaction of the Commissioner that it used no method other than the LIFO method in inventorying goods to ascertain the income, profit, or loss of the first taxable year for which the LIFO method is to

[1] This revenue procedure contains the modifications made by Rev. Proc. 98–46, 1998–36 I.R.B. 21. These modifications clarify that the relief provided in this revenue procedure is available to automobile and light-, medium-, and heavy-duty truck dealers.

not to be governed by the negligible sales exemption. This is done on a timely filed original federal income tax return (or, in limited cases, on an amended return). Section 1.475(c)–1(c)(1)(ii); *see also* Rev. Rul. 97–39, Holding 12.

.05 In general, making one of these elections results in the taxpayer being required to change its method of accounting to reflect the application of § 475(a). *But see* Rev. Rul. 97-39, Holding 17 (discussing circumstances in which more than one election must be made for § 475(a) to apply). A taxpayer must obtain the consent of the Commissioner to change an accounting method. Section 446(e).

.06 A taxpayer that accounts for securities under § 475(a) may change that method only with the consent of the Commissioner. Section 446(e). *See* Rev. Rul. 97–39, Holding 20; *see also* Rev. Proc. 97–27, 1997–21 I.R.B. 10, or its successor on how to request consent to change.

SEC. 3. SCOPE

This revenue procedure applies to taxpayers required to change methods of accounting as a result of elections under § 1.475(c)–1(a)(3)(iii), –1(b)(4), or –1(c)(1)(ii) (including taxpayers that made those elections prior to September 10, 1997).

SEC. 4. PROCEDURE

.01 If a taxpayer elects to be governed by the intragroup-customer election and the election results in the taxpayer being required to change its method of accounting, then the taxpayer must attach both the statement described in § 1.475(c)–1(a)(3)(iii)(B) and the additional documents required by section 4.07 of this revenue procedure to the taxpayer's timely filed original federal income tax return for the first year subject to the election. If that return is filed on or before October 31, 1997, however, the additional documents may be filed at a later date in accordance with section 4.04. In addition, a copy of those documents must be filed as required by section 4.05 and, if applicable, section 4.06.

.02 If a taxpayer elects not to be governed by the customer paper exemption and the election results in the taxpayer being required to change its method of accounting, then the taxpayer must attach both the statement described in § 1.475(c)–1(b)(4)(i) and the additional documents required by section 4.07 of this revenue procedure to a timely filed federal income tax return or to an amended return, as appropriate under § 1.475(c)–1(b)(4)(i)(A) or (B) or Holding 13 of Rev. Rul. 97-39. If that return is filed on or before October 31, 1997, however, the additional documents may be filed at a later date in accordance with section 4.04. In addition, a copy of those documents must be filed as required by section 4.05 and, if applicable, section 4.06.

.03 If a taxpayer elects not to be governed by the negligible sales exemption and the election results in the taxpayer being required to change its method of accounting, then the taxpayer must attach the documents required by section 4.07 of this revenue procedure to the timely filed original federal income tax return described in § 1.475(c)–1(c)(1)(ii) or the amended return described in Rev. Rul. 97–39, Holding 12 (discussing when the election not to be governed by the negligible sales exemption may be made by filing an amended return). If that return is filed on or before October 31, 1997, however, the additional documents may be filed at a later date in accordance with section 4.04. In addition, a copy of those documents must be filed as required by section 4.05 and, if applicable, section 4.06.

.04 A taxpayer that files the return described in section 4.01, 4.02, or 4.03 of this revenue procedure on or before October 31, 1997, need not attach the documents required by section 4.07 to that return if the taxpayer instead attaches these documents to the first federal income tax return or amended return filed by the taxpayer after October 31, 1997, that is for a taxable year subject to the election.

.05 The taxpayer must file a copy of the documents required by section 4.07 of this revenue procedure with the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington, DC 20044 (or, in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224). This filing must occur on or before the later of October 31, 1997, and the time the taxpayer files the return described in section 4.01, 4.02, or 4.03. The documents must contain the name and telephone number of the examining agent, appeals office, or counsel of record for the government, if any, described in section 4.06.

.06 If a taxpayer files an amended return on which the taxpayer elects not to be governed by the customer paper exemption or the negligible sales exemption and, at the time of filing, the taxable year to which the amended return applies or any subsequent taxable year is before the Service or before a federal court, then the taxpayer must provide a copy of the documents required by section 4.07 of this revenue procedure to the persons provided below.

(1) If a taxable year in question is before the Service, a copy of the documents required by section 4.07 of this revenue procedure must be provided to the taxpayer's examining agent or, instead, if the taxable year has been assigned to an appeals office, to such appeals office. The taxpayer must provide the copy by the later of October 31, 1997, and the day that is 30 days after the date the taxable year in question first came before the Service. For purposes of this section, a taxable year shall be considered before the Service from the time the taxpayer (or any member of a consolidated group of which taxpayer was a member during the taxable year) has been contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of its federal income tax return for that year until the receipt of a no-change letter for that year, the execution of a waiver of restrictions on assessment and collection of deficiency in tax and acceptance of overassessment, the expiration of the period for filing a petition with the Tax Court for that year, or the filing of a petition with the Tax Court.

(2) If a taxable year in question is before a federal court, a copy of the documents required by section 4.07 of this revenue procedure must be provided to counsel of record for the government. The taxpayer must provide the copy by the later of October 31, 1997, and the day which is 30 days after the date the taxable year in question first came before a federal court. For purposes of this section, a taxable year will be considered before a federal court if the treatment of any item (whether or not involving a method of accounting) for such taxable year would be considered before a federal court for the

ply with § 1450(c)(1) before the first day of the first plan year beginning on or after January 1, 1998 (or, in the case of a contract purchased under a § 403(b) plan that is a governmental plan, the later of (i) the first day of the first plan year beginning on or after January 1, 2000, or (ii) the last day of the first plan year beginning on or after the 1999 legislative date), provided the retroactive amendment and operational compliance requirements of § 1465 are satisfied with respect to the contract.

SECTION 13. EFFECTIVE DATE

This revenue procedure is effective August 18, 1997.

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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 I, § 42; 1.42–14.)

Rev. Proc. 97–42

SECTION 1. PURPOSE

This revenue procedure publishes the amounts of unused housing credit carryovers allocated to qualified states under § 42(h)(3)(D) of the Internal Revenue Code for calendar year 1997.

SECTION 2. BACKGROUND

Rev. Proc. 92–31, 1992–1 C.B. 775, provides guidance to state housing credit agencies of qualified states on the procedure for requesting an allocation of unused housing credit carryovers under § 42(h)(3)(D). Section 4.06 of Rev. Proc. 92–31 provides that the Internal Revenue Service will publish in the Internal Revenue Bulletin the amount of unused housing credit carryovers allocated to qualified states for a calendar year from a national pool of unused credit authority (the National Pool). This revenue procedure publishes these amounts for calendar year 1997.

SECTION 3. PROCEDURE

The unused housing credit carryover amount allocated from the National Pool by the Secretary to each qualified state for calendar year 1997 is as follows:

Qualified State	*Amount Allocated*
Alabama	$ 77,659
Alaska	11,032
California	579,360
Colorado	69,480
Connecticut	59,503
Delaware	13,176
Florida	261,710
Georgia	133,636
Idaho	21,609
Illinois	215,311
Indiana	106,156
Iowa	51,833
Kansas	46,744
Maryland	92,180
Massachusetts	110,718
Michigan	174,364
Minnesota	84,656
Mississippi	49,361
Missouri	97,396
Nebraska	30,024
Nevada	29,133
New Hampshire	21,119
New Jersey	145,176
New York	330,500
North Carolina	133,090
Ohio	203,061
Oregon	58,230
Pennsylvania	219,109
Rhode Island	17,993
South Carolina	67,227
South Dakota	13,304
Texas	347,638
Utah	36,349
Vermont	10,705
Virginia	121,313
Washington	100,558

SECTION 4. EFFECTIVE DATE

This revenue procedure is effective for allocations of housing credit dollar amounts attributable to the National Pool component of a qualified state's housing credit ceiling for calendar year 1997.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446, 475; 1.446–1, 1.475(c)–1.)

Rev. Proc. 97–43

SEC. 1. PURPOSE

This revenue procedure tells taxpayers how to request consent to change methods of accounting to comply with elections out of certain exemptions from dealer status for purposes of § 475 of the Internal Revenue Code. *See* § 1.475(c)–1(a)(3) of the Income Tax Regulations (concerning taxpayers buying securities from or selling securities to members of the same consolidated group); § 1.475(c)–1(b) (concerning sellers of nonfinancial goods and services); and § 1.475(c)–1(c) (concerning taxpayers that engage in no more than negligible sales of securities).

SEC. 2. BACKGROUND

.01 Under § 475(a), dealers in securities must use a mark-to-market accounting method for securities other than certain securities timely identified as exempt under § 475(b)(2). Section 475(c)(1) defines dealer in securities for purposes of § 475.

.02 One component of the definition of dealer in securities in § 475(c)(1) is entering into transactions in securities with customers. Members of the same consolidated group are ordinarily not each other's customers for purposes of § 475(c)(1). Section 1.475(c)–1(a)(3)(ii). A consolidated group may, however, elect to treat its members as potential customers of one another for purposes of § 475(c)(1) (the intragroup-customer election). Unless the Commissioner otherwise prescribes, the election is made by filing a specified statement with a timely filed consolidated federal income tax return. Section 1.475(c)–1(a)(3)(iii)(B).

.03 A taxpayer is ordinarily exempt from treatment as a dealer in securities if the taxpayer would not be a dealer in securities but for its purchases and sales of debt instruments that are customer paper as defined in § 1.475(c)–1(b)(2) with respect to the taxpayer or another member of its consolidated group (the customer paper exemption). Section 1.475 (c)–1(b)(1). Taxpayers may elect not to be governed by the customer paper exemption. Section 1.475(c)–1(b)(4). Unless the Commissioner otherwise prescribes, the election generally is made by filing a specified statement with a timely filed federal income tax return (or, in limited cases, an amended return). Section 1.475(c)–1(b)(4)(i); *see also* Rev. Rul. 97–39, page 00, this Bulletin, Holding 13.

.04 A taxpayer's purchases of securities from customers do not make the taxpayer a dealer in securities if the taxpayer engages in no more than negligible sales of securities as defined in § 1.475(c)–1(c)(2) (the negligible sales exemption). Section 1.475(c)–1(c)(1)(i). Taxpayers may elect

quired must be amended in connection with the plan termination to comply with the changes as of their effective date with respect to the plan. For this purpose, any amendment that is adopted after the date of plan termination in order to receive a favorable determination letter will be considered as adopted in connection with the plan termination. In addition, annuity contracts distributed from such terminated plans also must meet all the applicable requirements of SBJPA and GATT. In the case of changes in the qualification requirements to which § 1465 of SBJPA applies, the operational compliance requirement of § 1465 must also be satisfied. (See Notice 87–57, 1987–2 C.B. 368, and Announcement 88–8, 1988–4 I.R.B. 32, which enunciated the same principles with respect to plans that terminated before the amendment date described in § 1140 of TRA '86.)

SECTION 10. PLANS WITH EXTENDED RELIANCE

As described above, the sponsor of a plan that is entitled to extended reliance on a favorable TRA '86 letter may rely on that letter until the earlier of the last day of the last plan year commencing prior to January 1, 1999, or the date established for plan amendment by any legislation that is effective after the date of the plan's letter. A plan with extended reliance must be amended by the last day of the first plan year beginning on or after January 1, 1999, to the extent necessary to comply with regulations or administrative guidance of general applicability that has been issued since the date of the plan's favorable TRA '86 letter. These amendments must be made effective no later than the first day of the first plan year beginning on or after January 1, 1999, and no earlier than the first day of the plan year in which the amendments are adopted. (But see Rev. Rul. 94–76, 1994–2 C.B. 46, and Rev. Rul. 96–48, 1996–40 I.R.B. 7.) Also see section 11, below, regarding preapproved plans.

SECTION 11. DETERMINATION AND OPINION LETTER PROGRAMS

.01 Effective with the date of enactment of SBJPA or GATT, as applicable, and until further notice is given, determination, opinion, notification, and advisory letters, other than determination letters issued for terminating plans, will not include consideration by the Service of any amendments to the qualification requirements made by SBJPA or GATT, with the following two exceptions. First, determination letters will include consideration of the changes made to § 401(a)(26) by § 1432 of SBJPA, which limited the applicability of § 401(a)(26) to defined benefit plans and made certain other changes. See Announcement 97–2, 1997–2, I.R.B. 62. Second, determinations of leased employee status under § 414(n) will reflect the "primary direction or control" test under § 414(n)(2)(C), as amended by § 1454 of SBJPA, that replaces the former "historically performed" test.

.02 Until further notice is given, plans (including master or prototype, regional prototype, and volume submitter plans), other than terminating plans, that include provisions that reflect the SBJPA or GATT amendments to the qualification requirements will not be subject to adverse letters by reason of the inclusion of the provisions. This will not preclude the issuance of adverse letters for other reasons, such as an impermissible elimination or reduction of § 411(d)(6) protected benefits resulting from the adoption of amendments for SBJPA or GATT. However, favorable letters issued for plans, other than terminating plans, may not be relied upon with respect to whether the plans satisfy the qualification requirements as amended by SBJPA or GATT.

.03 The Service will begin reviewing both preapproved plans and individually designed plans for compliance with the qualification requirements as amended by SBJPA and GATT as soon as possible after the issuance of additional guidance pertaining to the requirements of SBJPA. Prior to that time, the Service intends to publish procedures relating to the issuance of determination, opinion, notification and advisory letters for plans that take into account the requirements of SBJPA and GATT. The procedures are also expected to include rules pertaining to the required time for sponsors to amend preapproved plans for SBJPA and GATT and actions that may be required of adopters of these plans.

PART III. TIME FOR AMENDING SECTION 403(B) PLANS

SECTION 12. SECTION 403(B) PLANS

.01 SBJPA also made certain changes that may require the amendment of tax-sheltered annuity plans described in § 403(b) or annuity contracts purchased under these plans. The provisions of § 1465 of SBJPA apply with respect to any plan or annuity contract that is required to be amended by any provision of subtitle D of SBJPA. Section 1465 thus applies not only to qualified plans but also to § 403(b) plans and annuity contracts purchased under these plans. Therefore, if a provision of subtitle D of SBJPA requires an amendment to a § 403(b) plan or an annuity contract purchased under the plan, the amendment will not be required to be made before the time described in § 1465 of SBJPA, provided the retroactive amendment and operational compliance requirements of § 1465 are satisfied. For this purpose, the time described in § 1465 with respect to a § 403(b) plan that is a governmental plan will be treated as not expiring before the last day of the first plan year beginning on or after the 1999 legislative date, that is, the 90th day after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously.

.02 For example, § 1450(c)(1) of SBJPA amended § 403(b)(1)(E) to provide that each contract purchased under a § 403(b) plan salary reduction agreement must provide that elective deferrals made under the contract may not exceed the annual limit on elective deferrals under § 402(g)(1). Prior to this amendment, the § 403(b) plan, not each contract, was required to provide this limitation. Section 1450(c)(2) provides that this amendment applies to years beginning after December 31, 1995, except a contract will not be required to meet any change in any requirement by reason of the amendment before the 90th day after enactment of SBJPA (that is, November 18, 1996). Because § 1465 applies to any annuity contract purchased under a § 403(b) plan, such a contract is not required to be amended to com-

retroactive amendments must reflect the choices that the plan sponsor has already made in the operation of the plan (for example, the definition of highly compensated employee).

3 Section 1.401(b)–1T(d)(1)(v) permits a remedial amendment of a disqualifying provision that is integral to a qualification requirement changed by SBJPA (including § 414(u) and USERRA) to be made retroactively effective only to the first day on which the plan was operated in accordance with the provision as amended.

.07 Earlier plan amendment may be required by law or regulation or by revenue ruling, notice or other guidance published in the Internal Revenue Bulletin. In these cases plan sponsors may not rely on the remedial amendment period as a basis for making an amendment retroactively effective. The following are examples where the remedial amendment period may not be relied on as a basis for making an amendment retroactively effective.

1 Except as provided in Rev. Proc. 97–9, 1997–2 I.R.B. 55, a plan sponsor may not retroactively amend a § 401(k) plan to adopt the alternative ("SIMPLE") method of satisfying the § 401(k) and § 401(m) nondiscrimination tests added by § 1422 of SBJPA.

2 As provided in § 417(e)(3)(B), the present value of a distribution from a pre-GATT plan that is made prior to the first plan year beginning after December 31, 1999, and before a plan amendment applying the GATT changes to § 417(e)(3) to the plan has been adopted and made effective generally must be determined under the plan's pre-GATT terms.

.08 Any amendment that would result in an elimination or reduction of § 411(d)(6) protected benefits may not be made retroactively effective unless specifically permitted by law or regulation or by revenue ruling, notice, or other guidance published in the Internal Revenue Bulletin.

.09 Section 1431(b)(1) of SBJPA eliminated the family aggregation requirements of § 414(q)(6), effective for years beginning after December 31, 1996. Section 1431(b)(2) of SBJPA also eliminated the family aggregation requirement that formerly applied under § 401(a)(17)(A), effective for years beginning after December 31, 1996. A plan's family aggregation provisions generally would be disqualifying provisions under § 401(b) because they would be integrally related to a qualification requirement of the Code that has been changed by SBJPA, effective before 1999. In certain limited circumstances, the continued application of the family aggregation rules in the operation of a plan could result in the loss of qualified status. The plan's family aggregation provisions also would then be disqualifying provisions because they would cause disqualification as a result of SBJPA changes to the qualification requirements effective before 1999. Regardless of whether a plan's family aggregation provisions are disqualifying provisions because they are integrally related to SBJPA qualification changes or because they would cause plan disqualification, a plan amendment eliminating the provisions will not violate the requirements of § 411(d)(6) provided the amendment is effective no earlier than the first day on which the plan was operated in accordance with the amendment, and in no event earlier than the first day of the first plan year beginning after December 31, 1996.

SECTION 7. TIME FOR ADOPTING CERTAIN AMENDMENTS RELATING TO SECTION 415

For purposes of § 767(d)(3)(B) of GATT, the date provided by the Secretary for adopting plan amendments reflecting the changes to § 415(b)(2)(E) is the last day of the plan's remedial amendment period under section 6.04. Moreover, as discussed in section 3.04, § 1449(d) of SBJPA provides that an amendment applying specified GATT changes that was adopted or effective before August 20, 1996, will be disregarded in applying § 767(d)(3)(A) of GATT, as modified by § 1449(a) of SBJPA, if that amendment is repealed by another plan amendment that is adopted no later than August 20, 1997. Pursuant to this revenue procedure, a plan amendment applying the amendments made by § 767 of GATT which was adopted or made effective on or before August 20, 1996, also shall not be taken into account in applying § 767(d)(3)(A) of GATT as amended by § 1449(a) of SBJPA, if the amendment is repealed by another plan amendment that is adopted on or before the last day of the plan's remedial amendment period under section 6.04. This relief will not fail to be available merely because a plan is not operated in accordance with the repealing amendment prior to the date specified in future guidance. The Service intends to issue additional guidance concerning the GATT and SBJPA changes to the limitations under § 415(b) in the near future.

SECTION 8. MINIMUM FUNDING REQUIREMENTS

Section 412 provides minimum funding standards applicable to pension plans that are or were qualified plans under § 401. Section 1.412(c)(3)–1 provides rules concerning the reasonable funding methods for defined benefit pension plans. Section 1.412(c)(3)–1(d)(1)(i) provides that, except as provided by the Commissioner, a reasonable funding method does not anticipate changes in plan benefits that become effective, whether or not retroactively, in a future plan year or that become effective during a plan year but after the first day thereof. Section 412(c)(12), which was added by GATT, provides that the funding method of a collectively bargained plan described in § 413(a) (other than a multiemployer plan) must anticipate benefit increases scheduled to take effect during the term of the collective bargaining agreement applicable to the plan. Therefore, except to the extent required by § 412(c)(12) or as otherwise provided by the Commissioner, in determining the minimum funding standards for a defined benefit plan under § 412, amendments that become effective, whether or not retroactively, in a future plan year may not be anticipated, even though the amendments are made before the end of any applicable remedial amendment period. Contributions to a defined benefit plan will be deductible subject to the limitations of § 404, with the § 412 minimum funding standards determined without anticipating such future amendments.

SECTION 9. TERMINATING PLANS

A plan (including a master or prototype, regional prototype, or volume submitter plan) that is terminated after the effective date of changes in the qualification requirements made by SBJPA or GATT but before the date that plan amendments would otherwise be re-

SECTION 6. DESIGNATION OF CERTAIN PLAN PROVISIONS RELATING TO SBJPA, GATT AND USERRA CHANGES AS DISQUALIFYING PROVISIONS

.01 Pursuant to the Commissioner's authority under § 1.401(b)–1T(b)(3), a plan provision is hereby designated as a disqualifying provision under § 1.401(b)–1(b) if the plan provision causes a plan to fail to satisfy the qualification requirements of the Code because of changes made to those requirements by SBJPA or GATT that are effective before the first day of the first plan year beginning on or after January 1, 1999.

.02 A plan provision is also hereby designated as a disqualifying provision if the plan provision is integral to a qualification requirement changed by SBJPA, but only to the extent the change in the qualification requirement is effective before the first day of the first plan year beginning on or after January 1, 1999, and the plan provision as amended is effective prior to the end of the remedial amendment period as described in section 6.04, below. For purposes of this paragraph, the changes in the qualification requirements made by SBJPA include § 414(u) and USERRA. In accordance with § 1.401(b)–1T(d)(1)(v), an amendment of a disqualifying provision described in this paragraph may be made retroactively effective only to the first day on which the plan was operated in accordance with the provision. For example, Announcement 97–24, 1997–11 I.R.B. 24, and Announcement 97–70, 1997–29 I.R.B. 14, provide that an employer may offer certain employees an option to defer commencement of benefits under its qualified plan provided the employer amends the plan retroactively to conform the plan to its pre-amendment operation regarding the option to defer. These announcements also state that future guidance will provide the date by which such a retroactive amendment must be adopted. The retroactive amendment described in Announcements 97–24 and 97–70 is an amendment to a plan provision that is integral to a qualification requirement changed by SBJPA and must therefore be adopted by the end of the remedial amendment period as described below. Generally, plan provisions reflecting the family aggregation rules as in effect prior to 1997 would also be integrally related to SBJPA qualification changes. See section 6.09.

.03 A plan provision that causes a plan to fail to satisfy § 401(a) because of a change made by SBJPA or GATT to the qualification requirements that is effective on or after the first day of the first plan year beginning on or after January 1, 1999, is not a disqualifying provision under section 6.01. A plan provision that is integral to a qualification requirement changed by SBJPA is not a disqualifying provision under section 6.02 if the change in the qualification requirement is effective on or after the first day of the first plan year beginning on or after January 1, 1999, or if the plan provision as amended is not effective prior to the end of the remedial amendment period as described in section 6.04, below. Thus, for example, § 401(b) and the regulations thereunder would not apply to permit the adoption of the § 401(k) and § 401(m) safe harbors described in § 1433(a) and (b) of SBJPA on a retroactive basis, because the provisions of § 1433(a) and (b) are effective for plan years beginning after December 31, 1998. A plan provision that is integral to the limitation under § 415(e), which was repealed by § 1452(a) of SBJPA effective for limitation years beginning after December 31, 1999, also is not a disqualifying provision under section 6.02.

.04 Pursuant to the Commissioner's authority under § 1.401(b)–1(f), with respect to plans other than governmental plans, the remedial amendment period for disqualifying provisions described in sections 6.01 and 6.02 is hereby extended to the last day of the first plan year beginning on or after January 1, 1999. Thus, for example, a single employer calendar year nongovernmental plan that does not satisfy the requirements of § 401(a) because of a disqualifying provision described in section 6.01 or 6.02 may be retroactively amended to meet those requirements by December 31, 1999. For governmental plans, the remedial amendment period for disqualifying provisions described in sections 6.01 and 6.02 is extended to the later of (i) the first day of the first plan year beginning on or after January 1, 2000, or (ii) the last day of the first plan year beginning on or after the "1999 legislative date" (that is, the 90th day after the opening of the first legislative session beginning on or after January 1, 1999, of the governing body with authority to amend the plan, if that body does not meet continuously).

.05 In addition, the remedial amendment period with respect to all disqualifying provisions of new plans adopted or effective after December 7, 1994, and all disqualifying provisions of existing plans arising from a plan amendment adopted after December 7, 1994, that causes the plan to fail to satisfy the requirements of § 401(a) as of the date the amendment is adopted or effective (whichever is earlier), will not expire earlier than the last day of the first plan year beginning on or after January 1, 1999. For a governmental plan, this period will not expire before the later of (i) the first day of the first plan year beginning on or after January 1, 2000, or (ii) the last day of the first plan year beginning on or after the 1999 legislative date.

.06 Although plan amendments are not required before the end of the remedial amendment period, plan sponsors must operate their plans in compliance with the provisions of SBJPA or GATT prior to the time plan amendments are required to the extent earlier operational compliance is required by law or regulation or by revenue ruling, notice or other guidance published in the Internal Revenue Bulletin. In these cases, any retroactive amendments will have to reflect the choices the plan sponsor has already made in the operation of the plan. The following are examples where earlier operational compliance is required.

1 Section 1465 of SBJPA generally requires plans to be operated in compliance with any provision of SBJPA that is effective before the first day of the first plan year beginning on or after January 1, 1998 (or January 1, 2000, in the case of a governmental plan), as of such provision's effective date.

2 Section 401(m)(6)(A) requires correction of excess aggregate contributions to § 401(m) plans to be accomplished within 12 months of the end of the plan year in which the contributions were made. Thus, to this extent, for example, a sponsor of a § 401(m) plan will have to operate the plan in a manner that satisfies § 401(a) as amended by SBJPA and any

cordance with the GATT changes to § 415(b)(2)(E) as of the first limitation year beginning after December 31, 1994, even though, under § 767(d)(3)(B) of GATT, plan amendments applying these changes to the plan would not be required until such date as the Secretary provides.

.04 Section 1449 of SBJPA amended § 767(d)(3)(A) of GATT, however, to permit plan sponsors to delay the implementation of the GATT changes to § 415(b)(2). Section 1449 provides that a pre-GATT plan is not required to apply the GATT changes to § 415(b)(2)(E) with respect to benefits accrued before the earlier of (i) the later of the date a plan amendment applying the changes is adopted or effective or (ii) the first day of the first limitation year beginning after December 31, 1999. Further, § 1449(d) of SBJPA provides that an amendment applying specified GATT changes that was adopted or effective before August 20, 1996, will be disregarded in applying § 767(d)(3)(A) of GATT, as modified by § 1449(a) of SBJPA, if that amendment is repealed by another plan amendment that is adopted no later than August 20, 1997.

SECTION 4. THE REMEDIAL AMENDMENT PERIOD UNDER SECTION 401(B)

.01 Section 401(b) provides a remedial amendment period during which a plan may be amended retroactively, under certain circumstances, to comply with the Code's qualification requirements. Temporary and proposed amendments to the regulations under § 401(b) were published in the Federal Register on August 1, 1997. Section 1.401(b)–1(f) of the regulations grants the Commissioner the discretion to extend the remedial amendment period. Absent such an extension, however, the remedial amendment period is generally determined as described below.

.02 Section 1.401(b)–1 provides that a plan that fails to satisfy the requirements of § 401(a) solely as a result of a disqualifying provision defined under § 1.401(b)–1(b) need not be amended to comply with those requirements until the last day of the remedial amendment period with respect to the disqualifying provision, provided the amendment is made retroactively effective to the beginning of the remedial amendment period. Under § 1.401(b)–1T(b)(3), a disqualifying provision includes a plan provision designated, at the Commissioner's discretion, as a disqualifying provision that either (i) results in the failure of the plan to satisfy the qualification requirements of the Code by reason of a change in those requirements; or (ii) is integral to a qualification requirement of the Code that has been changed. For this purpose, § 1.401(b)–1T(c)(1) provides that a disqualifying provision includes the absence from a plan of a provision required by or, if applicable, integral to the applicable change in the qualification requirements of the Code, if the plan was in effect on the date the change in those requirements became effective with respect to the plan.

.03 For a disqualifying provision described in § 1.401(b)–1T(b)(3), the remedial amendment period generally begins with the date on which the change becomes effective with respect to the plan or, in the case of a provision that is integral to a qualification requirement that has been changed, the first day on which the plan was operated in accordance with the provision as amended. The remedial amendment period for a disqualifying provision described in §1.401(b)–1T(b)-(3) generally ends with the later of (1) the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the remedial amendment period begins or (2) the last day of the plan year that includes the date on which the remedial amendment period begins. A plan maintained by more than one employer need not be amended until the last day of the tenth month following the last day of the plan year in which the remedial amendment period begins.

.04 Section 1.401(b)–1 also provides that in the case of a new plan which contains (or fails to contain) a provision that causes the plan to fail to satisfy the requirements of § 401(a) as of the date the plan is put into effect, the plan need not be amended to comply with those requirements until the later of the due date including extensions for filing the employer's tax return for the taxable year in which the plan is put into effect or the last day of the plan year in which the plan is put into effect. A new plan maintained by more than one employer need not be amended until the last day of the tenth month following the last day of the plan year in which falls the date the plan is put into effect.

.05 Section 1.401(b)–1 also provides that in the case of an amendment to an existing plan which causes the plan to fail to satisfy the requirements of § 401(a) as of the date the amendment is adopted or effective (whichever is earlier), the plan need not be amended to correct the amendment until the later of the due date for filing the employer's tax return (including extensions) for the taxable year in which the amendment is adopted or effective (whichever is later) or the last day of the plan year in which the amendment is adopted or effective (whichever is later). In the case of an amendment to an existing plan maintained by more than one employer, the plan need not be amended until the last day of the tenth month following the last day of the plan year in which the amendment is adopted or effective (whichever is later).

SECTION 5. EXTENDED RELIANCE

.01 Under Rev. Proc. 89–9, 1989–1 C.B. 780, Rev. Proc. 89–13, 1989–1 C.B. 801 (both as modified by Rev. Proc. 93–9, 1993–1 C.B. 474), Rev. Proc. 93–39, 1993–2 C.B. 513, Announcement 94–85, 1994–26 I.R.B. 23, and Rev. Proc. 95–12, 1995–1 C.B. 508, plans that were submitted to the Service within certain deadlines for determination, opinion, or notification letters under the Tax Reform Act of 1986, Pub. L. 99–514 (TRA '86), and received favorable letters are entitled to extended reliance. During the extended reliance period, a plan is generally not required to operationally comply with or be amended for regulations or administrative guidance of general applicability issued after the date of the plan's letter which interpret the qualification requirements in effect when the letter was issued. The extended reliance period continues until the earlier of the last day of the last plan year commencing prior to January 1, 1999, or the date established for plan amendment by any legislation that is effective after the date of the plan's letter.

PART II. TIME FOR AMENDING QUALIFIED PLANS FOR SBJPA, GATT, AND USERRA

hour. The estimated number of respondents is 200.

The estimated annual frequency of responses is one.

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.

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26 CFR 601.601: Rules and regulations.
(Also, Part I, §§ 401, 403; 1.401(b)–1.)

Rev. Proc. 97–41

SECTION 1. PURPOSE

.01 This revenue procedure provides guidance to sponsors of pension, profit-sharing and stock bonus plans qualified under § 401(a) or 403(a) of the Internal Revenue Code (qualified plans) and tax-sheltered annuity plans described in § 403(b) (§ 403(b) plans) with respect to the date by which they must adopt amendments to comply with changes in the law made by the Small Business Job Protection Act of 1996, Pub. L. 104–188 (SBJPA), the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT), and the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103–353 (USERRA). This revenue procedure provides that:

1 In general, there is a single deadline for adopting SBJPA, GATT and USERRA amendments to qualified plans.

2 The deadline for adopting SBJPA, GATT and USERRA amendments is the same as the date by which certain plans that have extended reliance on Tax Reform Act of 1986 (TRA '86) determination letters must be amended.

3 Plan sponsors are allowed, for qualification purposes, to anticipate in plan operation certain plan amendments that they intend to adopt as a result of changes in the qualification requirements.

.02 Specifically, under this revenue procedure:

1 Qualified plans have a remedial amendment period under § 401(b) with respect to certain amendments for SBJPA, GATT or USERRA through the last day of the first plan year beginning on or after January 1, 1999. Thus, these amendments will not have to be adopted before the last day of a plan's 1999 plan year.

2 The deadline for adopting plan amendments to reflect certain limitations under § 415(b), as amended by GATT and SBJPA, is also the last day of the first plan year beginning on or after January 1, 1999. In addition, relief is provided so that a plan amendment described in § 1449(d)(2) of SBJPA repealing an earlier plan amendment that implemented certain amendments made by GATT to § 415(b) need not be adopted before the last day of the first plan year beginning on or after January 1, 1999.

3 Plan sponsors are advised of the Service's intention to publish procedures for obtaining determination letters that include consideration of the changes to the qualification requirements made by SBJPA and GATT as soon as possible after necessary guidance is issued.

4 Amendments for SBJPA to § 403(b) plans, or to annuity contracts purchased under § 403(b) plans, are not required to be adopted before the first day of the first plan year beginning on or after January 1, 1998.

PART I. BACKGROUND

SECTION 2. SBJPA

.01 SBJPA changed several of the requirements of the Code that apply to pension, profit-sharing and stock bonus plans qualified under § 401(a) or 403(a). While a number of these changes are effective in plan years beginning after December 31, 1996, others are not effective until later years.

.02 Section 1465 of SBJPA generally provides an extended period for amending plans and annuity contracts as required by SBJPA. Under § 1465, if any provision of subtitle D (Pension Simplification) of SBJPA requires an amendment to any plan or annuity contract, the amendment is not required to be made before the first day of the first plan year beginning on or after January 1, 1998, provided (1) the amendment is made effective retroactively to the date on which the provision of SBJPA became effective with respect to the plan or contract and (2) the plan or contract is operated in accordance with the requirements of the provision as of its effective date. For a governmental plan (as defined in § 414(d) of the Code), the year "2000" is substituted for the year "1998" in § 1465. Section 1465 applies to plans and contracts in existence on or after the date of enactment of SBJPA, August 20, 1996.

.03 In Rev. Proc. 96–49, 1996–43 I.R.B. 74, the Service stated that plan amendments to reflect the provisions of USERRA and § 414(u), which was added by § 1704(n) in subtitle G (Technical Corrections) of SBJPA, are not required to be made before the date plan amendments are required to be made under § 1465 of SBJPA.

SECTION 3. GATT

.01 GATT, which was enacted December 8, 1994, also changed several of the Code's qualification requirements. These included the rules relating to the determination of certain benefits under §§ 411(a)-(11)(B), 415(b)(2)(E) and 417(e)(3).

.02 The changes to §§ 411(a)(11)(B) and 417(e)(3), relating to the determination of the present value of certain plan distributions, were generally effective for plan years beginning after December 31, 1994. However, § 767(a)(2) of GATT provided a transition rule with respect to the determination under §§ 411(a)(11)(B) and 417(e)(3) of the present value of distributions from plans that were adopted and in effect as of December 7, 1994 ("pre-GATT plans"). In general, under this transition rule, the present value of a distribution from a pre-GATT plan that is made before the earlier of (i) the first plan year beginning after December 31, 1999, or (ii) the later of the adoption or effective date of a plan amendment applying the GATT changes to §§ 411(a)-(11)(B) and 417(e)(3) to the plan is to be determined under the plan's pre-GATT terms. Thus, for pre-GATT plans, amendments applying the GATT changes to §§ 411(a)-(11)(B) and 417(e)(3) to the plan cannot be adopted retroactively. As a result, these plans are not permitted to operate in accordance with these changes prior to the adoption of plan amendments.

.03 Under section 767(d) of GATT, the changes to § 415(b)(2)(E), relating to required adjustments to certain benefits for limitation purposes, were effective for limitation years beginning after December 31, 1994. In addition, § 767(d) of GATT required plans to be operated in ac-

of 12 hours. The estimated number of respondents and/or recordkeepers is 350.

The estimated annual frequency of responses is on occasion.

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.

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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 I, § 1362; 1.1362–6.)

Rev. Proc. 97–40

SECTION 1. PURPOSE

This revenue procedure provides guidance under § 1362(b)(5) of the Internal Revenue Code for requesting relief for late S corporation elections that are filed within 6 months of the due date of the election.

SECTION 2. BACKGROUND

Section 1361(a)(1) defines an "S corporation," with respect to any taxable year, as a small business corporation for which an S election is in effect for that year.

Section 1362(a)(1) provides that, except in a situation described in § 1362(g), a small business corporation may elect to be treated as an S corporation.

Section 1362(b)(1) provides that the corporation may make an election to be treated as an S corporation (A) at any time during the preceding taxable year, or (B) at any time during the taxable year and on or before the 15th day of the 3rd month of the taxable year. Under § 1362(b)(3), if an S corporation election is made for a taxable year after the 15th day of the 3rd month of that taxable year and on or before the 15th day of the 3rd month of the following taxable year, then the S corporation election is treated as made for the following taxable year.

Section 1362(b)(5) provides that if (A) an election under § 1362(a) is made for any taxable year (determined without regard to § 1362(b)(3)) after the date prescribed by § 1362(b) for making the election for the taxable year or no election is made for any taxable year, and (B) the Secretary determines that there was reasonable cause for the failure to timely make the election, the Secretary may treat the election as timely made for the taxable year (and § 1362(b)(3) shall not apply).

SECTION 3. SCOPE

This revenue procedure provides a special procedure to request relief for a late S corporation election. This revenue procedure applies only to a corporation (1) that has not filed a timely S corporation election under § 1362(a)(1), and (2) for which an S corporation election is filed within 6 months of the original due date for the election. This revenue procedure does not provide relief for late shareholder elections including a qualified subchapter S trust (QSST) election or electing small business trust (ESBT) election. This special procedure is in lieu of the letter ruling procedure that is used to obtain relief for a late S corporation election under § 1362(b)(5). Accordingly, user fees do not apply to corrective action under this revenue procedure. A corporation that is not eligible for relief under this revenue procedure, or is denied relief, may request relief by applying for a private letter ruling. The procedural requirements for requesting a private letter ruling are described in Rev. Proc. 97–1, 1997–1 I.R.B. 11 (or its successor).

SECTION 4. RELIEF FOR LATE S CORPORATION ELECTIONS UNDER THIS REVENUE PROCEDURE

.01 *Eligibility for Relief.* A corporation is eligible for relief if it meets the following requirements:

(1) The corporation fails to qualify as an S corporation solely because the Form 2553 (Election by a Small Business Corporation) was not filed timely pursuant to § 1362(b)(1); and

(2) The due date for the tax return (excluding extensions) for the first year the corporation intended to be an S corporation has not passed.

.02 *Procedural Requirements for Relief.* Within 6 months of the original due date for the S corporation election, the corporation must file with the applicable service center a completed Form 2553, signed by an officer of the corporation authorized to sign and all persons who were shareholders (or deemed to have been shareholders) at any time during the period that began on the first day of the taxable year for which the election is to be effective and ends on the day the election is made. The Form 2553 must state at the top of the document "FILED PURSUANT TO REV. PROC. 97–40." Attached to the Form 2553 must be a statement explaining the reason for the failure to file a timely S corporation election.

.03 *Relief for Late S Corporation Elections.* Upon receipt of a completed application requesting relief under this revenue procedure, the Internal Revenue Service will determine if there was reasonable cause for the failure to file a timely S corporation election and will notify the corporation of the result of the reasonable cause determination.

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for all applications for relief satisfying the requirements of section 4 of this revenue procedure, including those applications now being considered by the Service.

SECTION 6. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1548.

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

The collection of information in this revenue procedure is in Section 4.02. This information is required to be submitted to the applicable service center in order to obtain relief for late S corporation elections. This information will be used to determine if the reasonable cause requirement in § 1362(b)(5) has been met. The collection of information is required to obtain a benefit. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting burden is 200 hours.

The estimated annual burden per respondent varies from .5 hours to 1.5 hours, depending on individual circumstances, with an estimated average of 1

computation period is the portion of total discount that corresponds to the portion of principal recovered during the period. For this purpose, Recognized Discount is the product of the sum of Starting Discount plus Current Discount times a fraction the denominator of which is the sum of Starting Principal plus Current Principal and the numerator of which is the excess of the denominator over Ending Principal. This can be restated as:

$R = (D_{Start} + D_{Current}) \times ([P_{Start} + P_{Current} - P_{End}] / [P_{Start} + P_{Current}])$

where —

P_{Start}	=	Starting Principal
D_{Start}	=	Starting Discount
$P_{Current}$	=	Current Principal
$D_{Current}$	=	Current Discount
P_{End}	=	Ending Principal
R	=	Recognized Discount

.06 The unrecognized discount at the end of the period (Ending Discount) is the excess of the sum of Starting Discount plus Current Discount over Recognized Discount. This amount must be used as Starting Discount for the next period. This can be restated as:

$D_{End} = D_{Start} + D_{Current} - R$

where —

D_{End} = Ending Discount

.07 Ending Principal for the current period must be used as Starting Principal for the following period.

.08 The discount recognized as gain during a taxable year is the sum of the Recognized Discount for all computation periods comprising the year.

.09 For each period, the amounts referred to above must be recorded and separately retained as part of the taxpayer's tax books and records. *See* § 6001 and the regulations thereunder. These records must be maintained as separate tax records and not merely as a set of adjustments to book figures. These records must affirmatively demonstrate the period-to-period consistency required by sections 5.06 and 5.07 of this revenue procedure.

SECTION 6. EXAMPLE

.01 *T* properly adopts the method described in section 5 of this revenue procedure for all the loans that it acquires that are described in Category (1) in section 4.02 of this revenue procedure.

.02 For *T*'s first month in operation, it acquired at origination loans in Category (1) with an aggregate stated principal amount of $10,000,000 at the time of acquisition. The sum of the discount with which these loans were acquired is $400,000. At the end of the month, $9,000,000 was the outstanding stated principal amount on the Category (1) loans still held by *T*. Thus, the discount recognized during the month is $40,000. That figure is derived as follows:

$R = (D_{Start} + D_{Current}) \times ([P_{Start} + P_{Current} - P_{End}] / [P_{Start} + P_{Current}])$

$= (\$0 + \$400,000) \times ([\$0 + \$10,000,000 - \$9,000,000] / [\$0 + \$10,000,000])$

$= (\$400,000) \times (\$1,000,000 / \$10,000,000)$

$= \$400,000 \times 0.1$

$= \$40,000$

The amount of unrecognized discount at the end of the month is $360,000. This figure is derived as follows:

$D_{End} = D_{Start} + D_{Current} - R$

$= \$0 + \$400,000 - \$40,000$

$= \$360,000$

.03 In the second month of operation, T acquired at origination $23,000,000 in Category (1) loans with a total of $760,000 in discount at the time of acquisition. At the end of the month, $28,000,000 was the outstanding stated principal amount on Category (1) loans still held by T. Thus, the discount recognized during the second month is $140,000. This figure is derived as follows:

$R = (D_{Start} + D_{Current}) \times ([P_{Start} + P_{Current} - P_{End}] / [P_{Start} + P_{Current}])$

$= (\$360,000 + \$760,000) \times (\$9,000,000 + \$23,000,000 - \$28,000,000) / (\$9,000,000 + \$23,000,000)$

$= \$1,120,000 \times (\$4,000,000 / \$32,000,000)$

$= \$1,120,000 \times 0.125$

$= \$140,000$

The amount of unrecognized discount at the end of the month is $980,000 of discount. This figure is derived as follows:

$D_{End} = D_{Start} + D_{Current} - R$

$= \$360,000 + \$760,000 - \$140,000$

$= \$980,000$

SECTION 7. INTERACTION WITH § 475

If a loan is subject to both the mark-to-market rules under § 475 and the principal-reduction method, see Notice 96–23, 1996–1 C.B. 374.

SECTION 8. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:FI&P, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 9. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 94–29, 1994–1 C.B. 616, is modified, and as modified, is superseded. However, see the transition rules in section 13.02 of Rev. Proc. 97–37.

SECTION 10. EFFECTIVE DATE

This revenue procedure is effective on August 18, 1997.

SECTION 11. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551.

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.

The collections of information in this revenue procedure are in sections 4 and 5. This information is necessary and will be used to determine whether the taxpayer properly has adopted the principal-reduction method of accounting. The collections of information are required for the taxpayer to use the principal-reduction method of accounting. The likely respondents are business or other for-profit institutions.

The estimated total annual reporting and/or recordkeeping burden is 3,650 hours.

The estimated annual burden per respondent/record keeper varies from 12 hours to 14 hours depending on individual circumstances, with an estimated average

SECTION 4. USE OF THE PRINCIPAL-REDUCTION METHOD

.01 *Permissibility.*

(1) *In general.* The principal-reduction method of accounting (described in section 5 of this revenue procedure) is a permissible method for use by taxpayers to account for de minimis OID (discount) on one or more categories of loans described in section 4.02 or 4.03 of this revenue procedure. If the principal-reduction method is used to account for any loans in a category of loans, the method must be used for the entire category of loans. As is more fully described in section 5 of this revenue procedure, if the method is used for more than one category, separate data for each category must be kept, and the computations must be made separately for each category.

(2) *Adopting principal-reduction method.* If a taxpayer does not already have a method of accounting for discount on one or more categories of loans, the taxpayer may adopt the principal-reduction method for discount on all or any of those categories of loans by using it on a federal income tax return. The taxpayer must attach to this return a statement identifying the categories of loans to which the new method will apply and describing any "additional categories" permitted under section 4.03 of this revenue procedure.

(3) *Changes to principal-reduction method.* A taxpayer wanting to change to the principal-reduction method must follow the provisions of Rev. Proc. 97–37.

.02 *Standard categories of loans.* The standard categories of loans are:

Category (1). Loans that are secured by 1- to 4-family residential real property and are not home equity lines of credit or construction loans.

Category (2). Construction loans with original terms not greater than three years.

Category (3). Loans that are secured by real property, are not contained in category (1) or (2), and are not home equity lines of credit.

Category (4). Loans that are consumer loans with original terms not greater than seven years, are not secured by real property, and are not revolving credit loans.

.03 *Additional categories of loans.* The principal-reduction method also may be used for discount on loans that are described in section 3 of this revenue procedure but are not in one of the standard categories described in section 4.02 of this revenue procedure. This use is permissible, however, only if the taxpayer defines one or more additional categories of loans that are sufficiently homogeneous so that use of the principal-reduction method for those additional categories clearly reflects the taxpayer's income. In particular, each additional category must consist solely of loans of comparable duration. For this purpose, duration means the weighted average time to expected payments of principal (including expected prepayments of principal). The weighted average is computed using the present value at issue of the expected payments and prepayments.

SECTION 5. PRINCIPAL-REDUCTION METHOD OF ACCOUNTING

Under the principal-reduction method of accounting for discount —

.01 As of the date each loan in a category is acquired, the taxpayer's basis in the loan is deemed to be the loan's stated principal amount. All the gain represented by the discount on the loan is recognized solely under the principal-reduction method described in this revenue procedure.

.02 The required computations must be made monthly. Thus, the computation period referred to in this revenue procedure is the month (or that portion of a month that falls within a short taxable year).

.03 At the start of each computation period, the taxpayer must record and retain the following information for each category of loans for which the taxpayer is using the principal-reduction method:

(1) Unpaid stated principal as of the end of the prior period of all loans in the category that were held at the end of the prior period (Starting Principal); and

(2) Unrecognized discount as of the end of the prior period (Starting Discount).

For the initial computation period, Starting Principal and Starting Discount are zero.

.04 During each computation period, the taxpayer must record and retain the following information for each category of loans for which the taxpayer is using the principal-reduction method:

(1) The stated principal amount at the time of acquisition of all loans in the category that were acquired at origination by the taxpayer at any time during the period, whether or not they are still held by the taxpayer at the end of the period (Current Principal). This amount includes loans in the category that are acquired as refinancings of, or in exchange for, loans previously held by the taxpayer. Thus, if a loan (whether or not in the category) is modified and the modification results under § 1001 in a deemed sale or exchange of the old loan for a new one that is in the category, the stated principal amount of the new loan is included in Current Principal.

(2) The aggregate discount (including discount attributable to points) at the time of acquisition on all loans described in section 5.04(1) of this revenue procedure (Current Discount).

(3) The unpaid stated principal amount of all loans in the category that are still held by the taxpayer at the end of the period (Ending Principal). Thus, Ending Principal does not include the stated principal amount of loans disposed of in refinancings or exchanges during the period. Ending Principal does not include rights (such as mortgage servicing rights) that are retained on the sale of a loan, except to the extent that those rights represent a participation interest in the stated principal amount of the original loan. Ending Principal does not include the stated principal amount of any loan to the extent charged off by the taxpayer during the period. Except as provided in the following sentence, if the taxpayer has foreclosed on the property securing a loan, neither the unpaid stated principal on the loan nor any remaining deficiency on the loan is counted as part of Ending Principal. If property securing a loan is acquired in a transaction governed by former § 595 and the property has not been disposed of before the end of the period, Ending Principal includes the unpaid stated principal of the loan immediately before the transaction in which the property was acquired.

.05 The discount taken into account as gain (Recognized Discount) during each

APPENDIX
(Table)

Applicable Interest Rate	Term of Service Agreement in Years					
	1	2	3	4	5	6
1.0%	1.0000	0.5025	0.3367	0.2537	0.2040	0.1708
2.0%	1.0000	0.5050	0.3400	0.2575	0.2080	0.1750
3.0%	1.0000	0.5074	0.3432	0.2612	0.2120	0.1792
4.0%	1.0000	0.5098	0.3465	0.2649	0.2160	0.1834
5.0%	1.0000	0.5122	0.3497	0.2686	0.2200	0.1876
6.0%	1.0000	0.5146	0.3529	0.2723	0.2240	0.1919
7.0%	1.0000	0.5169	0.3561	0.2759	0.2279	0.1961
8.0%	1.0000	0.5192	0.3593	0.2796	0.2319	0.2003
9.0%	1.0000	0.5215	0.3624	0.2832	0.2359	0.2045
10.0%	1.0000	0.5238	0.3656	0.2868	0.2398	0.2087
11.0%	1.0000	0.5261	0.3687	0.2904	0.2438	0.2130
12.0%	1.0000	0.5283	0.3717	0.2940	0.2477	0.2172
13.0%	1.0000	0.5305	0.3748	0.2975	0.2516	0.2214
14.0%	1.0000	0.5327	0.3778	0.3011	0.2555	0.2256
15.0%	1.0000	0.5349	0.3808	0.3046	0.2594	0.2298

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 1273; 1.1273–1, 1.1273–2.)

Rev. Proc. 97–39

SECTION 1. PURPOSE

.01 This revenue procedure allows a taxpayer to use the principal-reduction method of accounting — an aggregate method of accounting for de minimis original issue discount on certain loans originated by the taxpayer. The principal-reduction method is based on the rule that, if a taxpayer holds a debt instrument with de minimis original issue discount, the taxpayer must include that discount in income as stated principal payments are made. *See* § 1.1273–1(d)(5) of the Income Tax Regulations. A taxpayer may change to or adopt the principal-reduction method. The procedures for a taxpayer to change to the principal-reduction method are provided in Rev. Proc. 97–37, page 18, which provides simplified and uniform procedures to obtain automatic consent to make this and other changes in methods of accounting. This revenue procedure modifies and supersedes Rev. Proc. 94–29, 1994–1 C.B. 616.

.02 The principal-reduction method described in this revenue procedure is the same method of accounting that was described in Rev. Proc. 94–29. Accordingly, a taxpayer that properly changed to or adopted this method pursuant to Rev. Proc. 94–29 is not required to change its method of accounting to comply with this revenue procedure.

SECTION 2. BACKGROUND

.01 A debt instrument (loan) is issued with original issue discount (OID) if the loan's issue price is less than its stated redemption price at maturity. See § 1273(a)(1) of the Internal Revenue Code. In some cases, although a loan is issued with OID, the amount of OID is treated as zero. *See* § 1273(a)(3) and § 1.1273–1(d) (concerning de minimis OID).

.02 Points treated as paid when a loan is originated generally reduce the issue price of the loan. *See* § 1.1273–2(g) (concerning the effect of certain cash payments on the issue price of a loan). Thus, all points charged on a loan create or increase OID on the loan. As used in this revenue procedure, the term "points" refers only to amounts charged for the use or forbearance of money.

.03 Section 1.1272–3 allows a holder of a debt instrument to elect to use a constant yield method to account for all interest that accrues on the instrument. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium. A holder may make the election only for a debt instrument acquired on or after April 4, 1994. Section 1.1272–3(d) provides rules for the time and manner of making the election under § 1.1272–3.

.04 Section 6001 and the regulations thereunder require taxpayers to keep permanent books of account or records to establish the amount of gross income for a taxable year.

SECTION 3. SCOPE

The principal-reduction method (described in section 5 of this revenue procedure) applies only to loans that—

(1) are acquired by the taxpayer at origination,

(2) do not have OID or, because the OID is de minimis under § 1.1273–1(d), are treated as not having OID,

(3) are not issued at a premium,

(4) are not subject to the election under § 1.1272–3, and

(5) produce ordinary gain or loss when sold or exchanged by the taxpayer.

behalf of a limited liability company, a trustee on behalf of a trust, or an individual taxpayer on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, the statement submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. See section 6.02(4) of Rev. Proc. 97–37.

.04 *Annual reporting requirement.* Upon election of the service warranty income method of accounting, a taxpayer must satisfy an annual reporting requirement. For each taxable year after election of the service warranty income method, the taxpayer must attach a statement to its timely filed original federal income tax return setting forth:

(1) a description of the service warranty contracts sold during the taxable year;

(2) the aggregate amount of the qualified advance payment amounts received for each class of service warranty contracts sold during the taxable year; and

(3) the future value factors that are to be applied to the aggregate qualified advance payment amounts for each class of service warranty contracts sold during the taxable year.

SECTION 7. EFFECT OF AND REVOCATION OF ELECTION

The election of the service warranty income method under this revenue procedure constitutes a change to or adoption of a method of accounting. Because the service warranty income method constitutes a method of accounting, an electing taxpayer must use that method for all its qualified advance payment amounts on service warranty contracts described in section 4.01 of this revenue procedure. The election of the service warranty income method may only be revoked with the consent of the Commissioner. Thus, to request revocation of an election under this revenue procedure, a taxpayer must apply to the Commissioner to change its method of accounting under the procedures prescribed in Rev. Proc. 97–27, 1997–21 I.R.B. 10.

SECTION 8. FAILURE TO COMPLY

Failure of the taxpayer (and, in the case of, for example, an S corporation or partnership, any of its shareholders or partners) to comply with all the requirements of this revenue procedure will constitute grounds for revocation of the service warranty income method election by the Commissioner and may result in revocation of the election by an examining agent beginning in the first open taxable year of noncompliance.

SECTION 9. APPLICABILITY OF REV. PROC. 97–37

The definitions in Rev. Proc. 97–37 apply for purposes of this revenue procedure, except to the extent provided otherwise in this revenue procedure.

SECTION 10. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 11. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 92–98, 1992–2 C.B. 512, is modified, and as modified, is superseded. However, see the transition rules in section 13.02 of Rev. Proc. 97–37.

SECTION 12. EFFECTIVE DATE

This revenue procedure is effective for any taxable year of a qualifying taxpayer ending on or after August 18, 1997.

SECTION 13. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551.

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.

The collections of information in this revenue procedure are in section 6. This information is necessary and will be used to determine whether the taxpayer is properly using the service warranty income method. The collections of information are required for the taxpayer to use the service warranty income method. The likely respondents are the following: individuals, business or other for-profit institutions, and small businesses or organizations.

The estimated total annual reporting burden is 5,000 hours.

The estimated annual burden per respondent varies from 2 hours to 3 hours, depending on individual circumstances, with an estimated average of 2.5 hours. The estimated number of respondents is 2,000.

The estimated annual frequency of responses is once.

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.

To calculate this amount, A must first determine the portion of the qualified advance payment amount and the portion of imputed income included in each annual equal payment amount. For 1997, the annual equal payment amount included in income, $1,439, is entirely from the qualified advance payment amount because no income is imputed to the taxpayer in the first taxable year. Thus, the $6,000 deferred qualified advance payment amount is reduced for A's inclusion of $1,439 in 1997 leaving $4,561 of deferred qualified advance payment amount remaining.

For 1998, A multiplies the applicable interest rate of 10% by the 1997 remaining qualified advance payment amount of $4,561. That product, $456, constitutes the imputed income portion of the 1998 annual equal payment amount of $1,439. The difference between $1,439 and $456 ($983) is the portion of the annual equal payment amount that constitutes the qualified advance payment amount. The $983 reduces the qualified advance payment amount remaining after 1997 to $3,578.

When A's business ceases in 1999, A must include in gross income the qualified advance payment amount remaining after 1998 and an appropriate imputed income amount. The appropriate imputed income amount is the product of the qualified advance payment amount remaining after 1998 and the applicable interest rate ($3,578 x 10%), which is $358. Thus, in 1999, A includes in gross income $3,936 ($3,578 + $358).

(2) *Example 2.* X, a calendar year accrual basis taxpayer, elects under this revenue procedure to use the service warranty income method of accounting for its qualified advance payment amounts on service warranty contracts. X sold 5 service warranty contracts on January 1, 1997, for $800 each. X also sold 5 service warranty contracts on December 31, 1997, for $800 each. All the service warranty contracts sold by X in 1997 carry a term of 5 years and run concurrently with the manufacturer's warranties. Further, X pays, within 60 days of the receipt of each advance payment, $600 per contract to an unrelated third party to insure (in an arrangement that constitutes insurance) its obligations under the service warranty contracts. The applicable interest rate, determined in accordance with section 5.04 of this revenue procedure, is 10 percent.

X aggregates all its qualified advance payment amounts on its 5-year service warranty contracts, thus determining that $6,000 of qualified advance payment amounts were received in 1997 with respect to the class of 5-year service warranty contracts. Applying the "10% and 5-year" factor of .2398 found in the table in the APPENDIX of this revenue procedure, X determines that it has annual equal payment amounts of $1,439 includible in gross income in 1997 through 2001 under the election provided in this revenue procedure. In addition, X must include in gross income in 1997 the $2,000 payment received for services that is not deferred as a qualified advance payment amount by this revenue procedure.

After making the initial determinations above, X experiences a short taxable year of 7 months beginning on January 1, 1999, and ending on July 31, 1999. After the 7-month short period, X's taxable year ends on July 31. When X experiences the 7-month short period, X must multiply the factor in the table in the APPENDIX of this revenue procedure by a fraction, the numerator of which is the number of the months in the short period, and the denominator of which is 12. This adjusted factor of .1399 (7/12 x .2398) is applied to the qualified advance payment amount of $6,000. The product, $839, is included in X's gross income for the short taxable year. Because X's contracts had a term of 5 years or 60 months (and are assumed under this revenue procedure to have begun at the beginning of the 1997 taxable year), there are 5 additional months in the taxable year ending July 31, 2002, for which a portion of the annual equal payment amount must be taken into account. Thus, X includes $600 (5/12 x .2398 x $6,000) in gross income. Gross income is reported by X in each taxable year as follows:

SECTION 6. CHANGING TO OR ADOPTING SERVICE WARRANTY INCOME METHOD

.01 *Automatic change.* A taxpayer wanting to change its method of accounting to the service warranty income method must follow the provisions of Rev. Proc. 97–37.

.02 *Adoption of method.* A qualifying taxpayer may adopt the service warranty income method in any taxable year ending on or after August 18, 1997 by attaching a statement to its timely filed original federal income tax return (including extensions) for the year of adoption.

.03 *Statement.* The statement referred to in section 6.02 of this revenue procedure should be identified at the top as follows: "ELECTION OF THE SERVICE WARRANTY INCOME METHOD UNDER REV. PROC. 97–38." The statement should set forth:

(1) a paragraph stating that the taxpayer is electing the service warranty income method for all advance payments (as defined in this revenue procedure) received in the current taxable year and to be received in subsequent taxable years;

(2) a paragraph stating that the taxpayer agrees to all the terms and conditions of this Rev. Proc. 97–38, and specifically stating that the taxpayer agrees to include in gross income all imputed income amounts necessary at the applicable interest rate determined in accordance with section 5.04 of this revenue procedure so that the net present value of gross income inclusions in taxable years to which qualified advance payment amounts are being deferred equals the amount of qualified advance payment amounts received in earlier taxable years;

(3) a description of the service warranty contracts sold during the taxable year the service warranty income method is elected;

(4) the aggregate amount of the qualified advance payment amounts received for each class (3-year contracts, 4-year contracts, etc.) of service warranty contracts sold during the taxable year of election;

(5) the future value factors that are to be applied to the aggregate qualified advance payment amounts for each class of service warranty contracts sold during the election year; and

(6) the signature by or on behalf of the taxpayer making the election by an individual with the authority to bind the taxpayer in such matters. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a state law partnership, a member-manager on

manner as if the taxpayer did not make an election under this revenue procedure.

(2) *Terminations.* If a contract terminates because of a mileage or usage limitation during or after the year in which the taxpayer sold the contract, the taxpayer must continue to include the annual equal payment amount obtained from the APPENDIX table in gross income for the original length of the terminated contract. See paragraph (b) of Example 1 in section 5.08 of this revenue procedure.

.07 *Short taxable years.* If a taxpayer using the table in the APPENDIX of this revenue procedure has a short taxable year during the term of its service warranty contract, the applicable table factor for the short period must be multiplied by a fraction, the numerator of which is the number of months in the short period, and the denominator of which is 12. After a short taxable year for which the table factor adjustment of the preceding sentence has been made, the taxpayer must continue to determine its gross income on a prior year's qualified advance payment amount using the applicable table factor for each 12-month taxable year (or that table factor multiplied by an appropriate fraction for any other short periods), until the number of months for which the qualified advance payment amount is taken into account (determined as if the qualified advance payment amount is first taken into account in the first month of the year in which the advance payment is received) is equal to the number of months in the original contract term (as determined under section 5.02 of this revenue procedure). If less than 12-months' inclusion remains for the final year, the applicable table factor for that year may be determined as if it were a short period containing the number of months remaining on the contract not yet taken into account. See Example 2 in section 5.08 of this revenue procedure.

.08 *Examples of the service warranty income method.*

(1) *Example 1.*

(a) A, a calendar year accrual basis taxpayer, elects under this revenue procedure to use the service warranty income method of accounting for its qualified advance payment amounts on service warranty contracts. A sold 5 service warranty contracts on January 1, 1997, for $800 each. A also sold 5 service warranty contracts on December 31, 1997, for $800 each. All the service warranty contracts sold by A in 1997 carry a term of 5 years and run concurrently with the manufacturer's warranties. Further, A pays, within 60 days of the receipt of each advance payment, $600 per contract to an unrelated third party to insure (in an arrangement that constitutes insurance) its obligations under the service warranty contracts. The applicable interest rate, determined in accordance with section 5.04 of this revenue procedure, is 10 percent.

A aggregates all its qualified advance payment amounts on its 5-year service warranty contracts, thus determining that $6,000 of qualified advance payment amounts were received in 1997 with respect to the class of 5-year service warranty contracts. Applying the "10% and 5-year" factor of .2398 found in the table in the APPENDIX of this revenue procedure, A determines that it must report gross income of $1,439 ($6,000 x .2398) in 1997 through 2001 under the election provided in this revenue procedure. In addition, A must include in gross income in 1997 the $2,000 payment received for services that is not deferred under this revenue procedure. Gross income is reported by A as follows:

Description of Item	1997	1998	7-month Short Yr.	Yr. End 7/31/00	Yr. End 7/31/01
Non-deferred Income	$2,000				
Deferred Income	1,439	$1,439	$ 839	$1,439	$1,439
Gross Income	$3,439	$1,439	$ 839	$1,439	$1,439

Description of Item	Yr. End 7/31/02
Non-deferred Income	
Deferred Income	$ 600
Gross Income	$ 600

Assuming that A is an S corporation with a single shareholder and that A reported no income other than that arising from the above service warranty transactions, the shareholder would report the following § 1367 adjustments to stock basis:

The stock basis adjustment for the deferred advance payment amount is determined by ratably spreading the stock basis adjustment over the term of the service warranty contract. Since the service warranty contract is treated as sold at the beginning of the taxable year, the stock basis adjustment each year would be $1,200 ($6,000/5). The aggregate imputed income of $1,195 ($239 x 5) on the $6,000 of aggregate qualified advance payment amounts for 1997 is not taken into account at any time by the shareholder in determining its basis in the A stock.

(b) If one of the service warranty contracts described in paragraph (a) terminates because of a mileage or usage limitation in 1999, there is no effect on the amounts that A must include in gross income each year. Under section 5.06 of this revenue procedure, A would continue to report the amounts of gross income set forth in section 5.08(1)(a) of this revenue procedure even if one or more of its service warranty contracts is terminated.

(c) If A's business ceases in 1999, A must include the $2,000 non-qualified advance payment amount in gross income in 1997 and the $1,439 annual equal payment amount in gross income in 1997 and 1998, as in section 5.08(1)(a) of this revenue procedure above. However, in 1999, A must accelerate and include in gross income the remaining advance payment amount plus an appropriate imputed income amount.

contract, a taxpayer first uses the column headed by the "Term of Service Agreement in Years." The taxpayer determines which column to use by ascertaining the length (the number of years) of its service warranty contract (limited to six years) without regard to whether there is a period for which there are no obligations under the contract. For example, if a service warranty contract begins in the third year after payment is received and ends in the fifth year after payment, the taxpayer uses the column headed "5." The taxpayer then finds the factor in the row headed by "The Applicable Interest Rate," which is defined in section 5.04 of this revenue procedure. If the applicable interest rate in this instance is 8 percent, the resulting factor would be .2319. This factor is multiplied by the qualified advance payment amount to determine the "annual equal payment amount" included in gross income each year for the number of years at the top of the column.

(3) A taxpayer may calculate the aggregate amount to be included in gross income each year by aggregating the qualified advance payment amounts with respect to contracts of the same class (that is, 2-year contracts, 3-year contracts, etc.). See section 5.08 of this revenue procedure for examples of the service warranty income method.

.03 *Special rule for when the taxpayer's trade or business ceases.* In the year in which the taxpayer's trade or business ceases (as defined in section 5.02(3) of Rev. Proc. 97–37), the remaining qualified advance payment amounts that have been deferred must be accelerated and included in gross income, along with appropriate imputed income amounts. These amounts must be determined using the applicable interest rates specified in section 5.04 of this revenue procedure and must be sufficient to ensure that the net present value of all amounts included in income over the period of deferral equals the qualified advance payment amounts that would have been reported and included in income upon receipt in the absence of an election under this revenue procedure. See the example in section 5.08(1)(c) of this revenue procedure. The Service will compute the amounts to be included in the year of cessation for any taxpayer that submits a request for a ruling pursuant to Rev. Proc. 97–1, 1997–1 I.R.B. 11 (or any successor). The Service waives the applicable user fee required under Rev. Proc. 97–1 for these requests.

.04 *Applicable interest rate.* The applicable interest rate to be applied to the qualified advance payment amount received for a particular contract in a particular taxable year under the service warranty income method is the applicable federal rate in effect for purposes of § 1274(d) (compounded annually) for the month with or within which the taxable year ends. For purposes of this revenue procedure, the applicable federal rate is rounded to the nearest full percent (or if a multiple of 1/2 of 1 percent, such rate shall be increased to the next highest full percent).

.05 *Effects of the imputed income.* Any income imputed on a qualified advance payment amount under this service warranty income method must not be taken into account for any purpose under the Internal Revenue Code other than the determination of a taxpayer's income. Thus, for example, the income imputed on a qualified advance payment amount may not increase the basis of any asset held by the taxpayer and may not be recovered as a deduction in any taxable year. Additionally, any income imputed on a qualified advance payment amount may not be taken into account, for example, in determining:

(1) the earnings and profits of any corporation under § 312;

(2) the adjustments to a shareholder's stock basis in an S corporation under § 1367;

(3) the adjustments to a partner's interest in a partnership under § 705; or

(4) the investment adjustments (or adjustments to an excess loss account) under § 1.1502–32 of the Income Tax Regulations with respect to the stock of any consolidated group member owned by another member of the group.

.06 *Special rules for customer cancellations of service warranty contracts and terminations of service warranty contracts because of mileage or usage limitations.*

(1) *Customer cancellations.* If a customer cancels a service warranty contract during the taxable year of sale and, in that year, receives a refund of amounts paid, the amount refunded is not included in the taxpayer's income for the year of the sale. If a customer cancels a service warranty contract after the year in which the taxpayer sold the contract, the taxpayer must continue to include the annual equal payment amount obtained from the APPENDIX table in gross income for the original length of the cancelled contract. Any amount refunded to the customer reduces income in the year paid. Imputed income amounts added to a qualified advance payment amount are not considered in (and have no effect on) the determination of this reduction of income. Thus, reductions for refunds upon customer cancellation of a multi-year service warranty contract are to be determined in the same

Description of Item	1997	1998	1999	2000	2001
Non-deferred Income	$2,000				
Deferred Income	1,439	$1,439	$1,439	$1,439	$1,439
Gross Income	$3,439	$1,439	$1,439	$1,439	$1,439

Description of Item	1997	1998	1999	2000	2001
Non-deferred Income	$2,000				
Deferred Income	1,200	$1,200	$1,200	$1,200	$1,200
Gross Income	$3,200	$1,200	$1,200	$1,200	$1,200

cluded in gross income in the taxable year of receipt. The Commissioner recognizes that this treatment has resulted in a significant and unique cash flow problem for certain accrual method taxpayers that sell multi-year service warranty contracts to customers in connection with the sale of motor vehicles or other durable consumer goods and immediately pay a third-party to insure their risks under the contracts.

.02 Accordingly, these taxpayers will be permitted to adopt or change to a special method of accounting for advance payments that would alleviate the cash flow problem arising in these situations but would generally conform economically to the tax treatment of advance payments under current law. In general, this method of accounting permits these taxpayers to recognize and include in gross income, generally over the period of their service warranty contracts, a series of equal payments, the present value of which equals the portion of the advance payment qualifying for deferral. This method of accounting is described in further detail in section 5 of this revenue procedure.

SECTION 3. DEFINITIONS

.01 The "service warranty income method" for advance payments is the method of accounting permitted by this revenue procedure and described in section 5 of this revenue procedure.

.02 The "qualified advance payment amount" is the portion of an advance payment received by a taxpayer under a multi-year service warranty contract that is paid by that taxpayer to an unrelated third party within 60 days after receipt for insurance costs associated with a policy insuring that taxpayer's obligations under the contract.

.03 The classification of goods as "durable consumer goods" for purposes of this revenue procedure depends on the common usage of the goods, rather than the purchaser's actual intended use of the goods. Thus, a taxpayer qualifying under this revenue procedure does not have to segregate, as non-qualifying advance payments, those payments under multi-year service warranty contracts entered into with a purchaser that will use the underlying durable consumer goods in its trade or business.

SECTION 4. SCOPE

.01 Except as provided in sections 4.03 and 4.04 of this revenue procedure, the use of the service warranty income method is available to any accrual method manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods with respect to qualified advance payment amounts received on service warranty contracts:

(1) that are fixed-term service arrangements with respect to a motor vehicle or other durable consumer good purchased by a customer;

(2) that are separately priced, such that customers have the option to purchase the service warranty contracts for an expressly stated amount separate from the price of the underlying motor vehicle or other durable consumer good;

(3) for which the service period begins in the taxable year the advance payment is received or upon expiration of a fixed-term manufacturer's warranty beginning in the taxable year the advance payment is received;

(4) for which the taxpayer purchases a policy that constitutes insurance for federal income tax purposes from an unrelated third party to insure its obligation under the service warranty contract; and

(5) for which the taxpayer makes payment to the unrelated third party insurer within 60 days after receipt of the advance payment for the entire amount of the insurance costs associated with the policy insuring its obligations under the service warranty contract.

.02 For purposes of section 4.01 of this revenue procedure, a service warranty contract will be treated as a fixed-term arrangement even if the contract provides for a reasonable mileage or other usage cap that is generally commensurate with average consumer mileage or usage over the term of the contract and which causes termination of the fixed-term arrangement when exceeded. Also for purposes of section 4.01 of this revenue procedure, a taxpayer has not made payment to an unrelated third party insurer if the taxpayer and the payee are related persons within the meaning of § 267(b) or 707(b)(1).

.03 A taxpayer is not within the scope of this revenue procedure unless the taxpayer either (1) has never previously received advance payments under service warranty contracts prior to the taxable year of an adoption under this revenue procedure, or (2) uses the proper method of accounting for advance payments under its service warranty contracts (*see Schlude v. Commissioner*, 372 U.S. 128 (1963), 1963–1 C.B. 99).

.04 A taxpayer also is not within the scope of this revenue procedure unless the taxpayer uses the proper method of accounting for amounts paid or incurred for insurance costs that cover the taxpayer's risks under service warranty contracts. *See* section 5.03 of the APPENDIX of Rev. Proc. 97–37 for a description of that proper method.

SECTION 5. DESCRIPTION OF THE SERVICE WARRANTY INCOME METHOD

.01 *In general.* Taxpayers with an advance payment within the scope of section 4 of this revenue procedure may elect to include a qualified advance payment amount, increased by an imputed income amount, in gross income on a level basis over the shorter of:

(1) the period beginning in the taxable year the advance payment is received and ending when the service warranty contract terminates; or

(2) a 6-taxable-year period beginning in the taxable year the advance payment is received.

This method of accounting permits these taxpayers to recognize and include in gross income, generally over the period of their service warranty contracts, a series of equal payments, the present value of which equals the qualified advance payment amounts received by the taxpayer. A taxpayer using the service warranty income method provided by section 5 of this revenue procedure must include in income, in the taxable year of receipt, the excess of aggregate advance payments received during a taxable year over aggregate qualified advance payment amounts for the taxable year.

.02 *Simplifying table.*

(1) An electing taxpayer must use the table in the APPENDIX of this revenue procedure to determine the amount of the gross income (attributable to a qualified advance payment amount) that must be reported annually under the service warranty income method.

(2) To use the table for a particular

of the year of change. *See* section 2.06 of this revenue procedure.

(b) The taxpayer must maintain books and records sufficient to satisfy the district director that old and new loans have been adequately segregated.

(3) *Additional requirements.* On a statement attached to the application, the taxpayer must:

(a) identify the categories of loans to which the new method will apply; and

(b) describe any "additional categories" permitted under section 4.03 of Rev. Proc. 97–39.

(4) *No audit protection.* A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Reserved.*

SECTION 13. SHORT-TERM OBLIGATIONS (§ 1281)

.01 *Interest income on short-term obligations.*

(1) *Description of change and scope.*

(a) This change applies to a taxpayer that wants to change its method of accounting to comply with § 1281 for interest income on short-term obligations. This change was formerly provided in Rev. Proc. 90–37, 1990–2 C.B. 361.

(b) Under § 1281, a holder of certain short-term obligations, including a bank as defined in § 581, must include in gross income any accrued interest income on such obligations, regardless of the holder's overall method of accounting. Section 1281 applies to all types of interest income, including acquisition discount, original issue discount (OID), and stated interest. *See* S. Rep. No. 99–313, 99th Cong., 2d Sess. 903 (1986), 1986–3 (Vol. 3) C.B. 903.

(c) Section 1283(a)(1) generally defines a short-term obligation as any bond, debenture, note, certificate, or other evidence of indebtedness that matures in one year or less from its issue date. A short-term loan, including a short-term loan made in the ordinary course of the taxpayer's business, is a short-term obligation.

(d) Under §§ 1281(a) and 1283(c), a holder of a short-term obligation subject to § 1281 must include in gross income an amount equal to the sum of the daily portions of the acquisition discount or OID, whichever is applicable, on the obligation for each day during the taxable year that the obligation is held by the holder. See § 1283(b), as modified by § 1283(c), to determine the daily portions of acquisition discount or OID. In addition, § 1281(a) requires the holder to include in gross income any stated interest that is payable on the short-term obligation (other than stated interest taken into account to determine the amount of the acquisition discount or OID) as it accrues.

(2) *Section 481(a) adjustment period.* A taxpayer must take the entire § 481(a) adjustment into account in computing taxable income for the year of change.

.02 *Stated interest on short-term loans of cash method banks in the Eighth Circuit.*

(1) *Description of change and scope.*

(a) This change applies to a cash method bank in the Eighth Circuit that wants to change its method of accounting from accruing stated interest on short-term loans made in the ordinary course of business to using the cash method for that interest. This change was formerly provided in Notice 95–57, 1995–2 C.B. 337.

(b) In *Security Bank Minnesota v. Commissioner,* 994 F.2d 432 (8th Cir. 1993), *aff'g* 98 T.C. 33 (1992), the U.S. Circuit Court of Appeals for the Eighth Circuit held that § 1281 does not require a cash method bank to include in gross income stated interest on short-term loans made in the ordinary course of business as that interest accrues. The Service disagrees with the interpretation of § 1281 in *Security Bank Minnesota* and intends to pursue this issue in other circuits. In light of *Security Bank Minnesota,* however, cash method banks in the Eighth Circuit will be granted permission to change to the cash method of accounting for stated interest on short-term loans made in the ordinary course of business. If this change was made on or before November 6, 1995, the Service will not seek to deny cash method banks in the Eighth Circuit the use of the cash method on the ground that there was an unauthorized change in method of accounting.

(2) *Section 481(a) adjustment period.* A taxpayer must take the entire § 481(a) adjustment into account in computing taxable income for the year of change.

(3) *No ruling protection.* If the Service is later successful in further litigation on this issue in other circuits, or there is a change in law, then cash method banks in the Eighth Circuit may be required to use an accrual method of accounting for any taxable year not barred by the statute of limitations.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 446; 1.446–1.)

Rev. Proc. 97–38

SECTION 1. PURPOSE

.01 This revenue procedure implements an administrative decision, made by the Commissioner in the exercise of discretion under section 446 of the Internal Revenue Code. Under this revenue procedure, accrual method manufacturers, wholesalers, and retailers of motor vehicles or other durable consumer goods may, in certain specified and limited circumstances, include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income generally over the life of the service warranty obligation. A taxpayer may change to or adopt the service warranty income method. The procedures for a taxpayer to change to the service warranty income method are provided in Rev. Proc. 97–37, page 18, which provides simplified and uniform procedures to obtain automatic consent to make this and other changes in methods of accounting. This revenue procedure modifies and supersedes Rev. Proc. 92–98, 1992–2 C.B. 512.

.02 The service warranty income method described in this revenue procedure is the same method of accounting that was described in Rev. Proc. 92–98. Accordingly, a taxpayer that properly changed to or adopted this method pursuant to Rev. Proc. 92–98 is not required to change its method of accounting to comply with this revenue procedure.

SECTION 2. BACKGROUND

.01 In general, payments received by an accrual method taxpayer for services to be performed in the future must be in-

the application is labeled as being filed under both sections 10.04 and 10.05 of this APPENDIX. *See* section 6.02(3) of this revenue procedure.

(2) *Manner of making the change.* This change is made using a cut-off method. See section 2.06 of this revenue procedure.

.05 *Determining current-year cost under the LIFO inventory method.*

(1) *Description of change and scope.* This change applies to a LIFO taxpayer that wants to change to a method of determining current year cost:

(a) by reference to the actual cost of the goods most recently purchased or produced;

(b) by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; or

(c) by application of an average unit cost equal to the aggregate actual cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced. *See* § 1.472–8(e)(2)(ii).

(2) *Manner of making the change.* This change is made using a cut-off method. *See* section 2.06 of this revenue procedure.

SECTION 11. BANK RESERVES FOR BAD DEBTS (§ 585)

.01 *Changing from the § 585 reserve method to the § 166 specific charge-off method.*

(1) *Description of change and scope.*

(a) *Applicability.* Except as provided in section 11.01(1)(b) of this APPENDIX, this change applies to a bank (as defined in § 581, including a bank for which a qualified subchapter S subsidiary (QSSS) election is filed) that wants to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method.

(b) *Inapplicability.* This change does not apply to:

(i) a large bank as defined in § 585(c)(2); or

(ii) any bank within the scope of Rev. Proc. 97–18, 1997–10 I.R.B. 53, which applies to banks making this change in method of accounting in 1997 to become eligible to elect S corporation status for 1997. A bank is not outside the scope of Rev. Proc. 97–18 solely because it is a qualified subchapter S subsidiary. In that event, the S corporation (the parent) should follow the application procedures required by Rev. Proc. 97–18 on behalf of the bank.

(2) *Certain scope limitations inapplicable.* A bank that changed from the § 593 reserve method under § 593(g) to the § 585 reserve method will not be prohibited under section 4.02(6) of this revenue procedure from changing its method of accounting for bad debts under section 11.01 of this APPENDIX solely because of the § 593(g) change. A bank for which a QSSS election is filed will not be prohibited under section 4.02(7) of this revenue procedure from changing its method of accounting for bad debts under section 11.01 of this APPENDIX solely because of the deemed liquidation of the bank arising from a QSSS election.

(3) *Section 481(a) adjustment.* Generally, the amount of the § 481(a) adjustment for a change in method of accounting under section 11.01 of this APPENDIX is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately before the year of change. However, the amount of the § 481(a) adjustment does not include the amount of a bank's pre–1988 reserves (as described in § 593(g)(2)(A)(ii), without taking into account § 593(g)(2)(B)) if the bank changed in a prior year from the § 593 reserve method to the § 585 reserve method and § 593(g) applied to that change. The deemed liquidation of a bank occurring solely because its parent makes a QSSS election does not accelerate the § 481(a) adjustment. In accordance with section 5.04(3)(c) of this revenue procedure, a bank that ceases to be a bank under § 581 must accelerate its § 481(a) adjustment.

(4) *Change from § 585 required when electing S corporation status.* A bank electing S corporation status (or a bank for which a QSSS election is filed) cannot use the § 585 reserve method. The filing by a bank of a Form 2553 (Election by a Small Business Corporation) or the filing by a bank's parent of a QSSS election with respect to the bank will constitute an agreement by the bank to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method effective as of the taxable year for which the S corporation election or QSSS election is effective (year of change) in accordance with all of the applicable provisions of this revenue procedure. The § 481(a) adjustment is recognized built-in gain under § 1374. *See* § 1.1374–4(d).

.02 *Reserved.*

SECTION 12. ORIGINAL ISSUE DISCOUNT (§ 1273)

.01 *De minimis original issue discount (OID).*

(1) *Description of change and scope.*

(a) *Applicability.* This change, which was formerly provided in Rev. Proc. 94–29, 1994–1 C.B. 616, applies to a taxpayer that wants to change to the principal-reduction method of accounting described in section 5 of Rev. Proc. 97–39, page 48. The principal-reduction method of accounting is an aggregate method of accounting for de minimis OID (discount) on certain loans originated by the taxpayer.

(b) *Scope limitations inapplicable.* A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(c) *Description.* The principal-reduction method of accounting is a permissible method for use by taxpayers to account for discount on one or more categories of loans described in section 4.02 or 4.03 of Rev. Proc. 97–39. If the principal-reduction method is used to account for any loans in a category of loans, the method must be used for the entire category of loans. The principal-reduction method applies only to loans described in section 3 of Rev. Proc. 97–39.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method and applies only to loans described in section 3 of Rev. Proc. 97–39 that were acquired on or after the first day

taxpayer's last taxable year as a C corporation as provided in § 1363(d)(2), unless the taxpayer is required to take the remaining balance of the § 481(a) adjustment into account in the last taxable year as a C corporation under another acceleration provision in section 5.02(3)(c) of this revenue procedure.

(4) *Additional requirements.* The taxpayer must complete the following statements and attach them to the application:

(a) "The new method of identifying inventory goods is the [insert method; that is, specific identification; FIFO; retail; etc.] method."

(b) "The new method of valuing inventory goods is [insert method; that is, cost; cost or market, whichever is lower; etc.]."

(c) "The new method conforms to the requirements of section 10.01(1)(b)(i) [insert either (A), (B), (C), or (D)] of the APPENDIX of Rev. Proc. 97–37 because [explain in detail how the new method conforms to the specific subdivision]."

.02 *Determining the cost of used vehicles purchased or taken as a trade-in.*

(1) *Description of change and scope.* This change applies to a LIFO taxpayer that wants to:

(a) determine the cost of used vehicles acquired by trade-in using the average wholesale price listed by an official used car guide on the date of the trade-in. *See* Rev. Rul. 67–107, 1967–1 C.B. 115. The official used car guide selected must be consistently used;

(b) determine the cost of used vehicles purchased for cash using the actual purchase price of the vehicle; or

(c) reconstruct the beginning-of-the-year cost of used vehicles purchased for cash using values computed by national auto auction companies based on vehicles purchased for cash. The national auto auction company selected must be consistently used.

(2) *Manner of making the change.* This change is made using a cut-off method and applies to used vehicles acquired during the year of change and all subsequent years. See section 2.06 of this revenue procedure.

.03 *Alternative LIFO inventory method for retail automobile dealers.*

(1) *Description of change and scope.*

(a) *Applicability.* This change, which was formerly provided in Rev. Proc. 92–79, 1992–2 C.B. 457, applies to a taxpayer engaged in the trade or business of retail sales of new automobiles or new light-duty trucks ("automobile dealer") that wants to change to the "Alternative LIFO Method" described in section 4 of Rev. Proc. 97–36, page 14, for its LIFO inventories of new automobiles and new light-duty trucks. Light-duty trucks are trucks with a gross vehicle weight of 14,000 pounds or less, which also are referred to as class 1, 2, or 3 trucks.

(b) *Inapplicability.* This change does not apply to an automobile dealer that uses the inventory price index computation (IPIC) method for goods other than new automobiles, new light-duty trucks, parts and accessories, used automobiles, and used trucks.

(2) *Manner of making the change.*

(a) *Cut-off method.* This change is made using a cut-off method. See section 2.06 of this revenue procedure and section 5.03(6) of Rev. Proc. 97–36.

(b) *IPIC method changes.* An automobile dealer that uses the IPIC method also must change from the IPIC method under section 10.03 of this APPENDIX to another acceptable method for its goods other than new automobiles and new light-duty trucks. For parts and accessories, the automobile dealer must change to the dollar-value, index method, with all parts and accessories within each separate trade or business in a separate LIFO pool. For used vehicles, the automobile dealer must change to the dollar-value, link-chain method, with all used automobiles within each separate trade or business in one LIFO pool and all used trucks within each separate trade or business in another separate LIFO pool.

(c) *Additional requirements.* An automobile dealer also must comply with the following:

(i) the conditions in section 5.03 of Rev. Proc. 97–36; and

(ii) for an automobile dealer changing from the IPIC method, the automobile dealer also must attach to the application a schedule setting forth the classes of goods for which the automobile dealer has elected to use the LIFO method and the accounting method changes being made under section 10.03 of this APPENDIX for each class of goods.

.04 *Inventory price index computation (IPIC) method under the LIFO inventory method.*

(1) *Description of change and scope.*

(a) This change applies to an eligible taxpayer that wants to change its LIFO inventory method to use the IPIC method for its entire LIFO inventory in accordance with all the provisions of § 1.472–8(e)(3) and Rev. Proc. 84–57, 1984–2 C. B. 496. The taxpayer must:

(i) in the case of the CPI Detailed Report, select an index from Table 3 (Consumer Price Index for All Urban Consumers (CPI–U): U.S. city average, detailed expenditure categories); and

(ii) in the case of the Producer Price Indexes, select an index from Table 6 (Producer price indexes and percent changes for commodity groupings and individual items).

(b) A taxpayer using the IPIC method must apply the inventory price index to its ending inventory valued at current-year cost, under the taxpayer's method of determining current-year cost. *See* § 1.472–8(e)(2)(ii). Furthermore, there must be a nexus between the taxpayer's method of determining current-year costs and the month to be used in selecting indexes. *See* § 1.472–8(e)(3)(iii)(C) and Rev. Rul. 89–29, 1989–1 C.B. 168. For example, if a taxpayer determines current-year cost by reference to the actual cost of goods purchased or produced during the taxable year in the order of acquisition (earliest acquisitions cost), then the inventory price index must be applied to the earliest acquisitions cost of ending inventory. In computing the inventory price index, such a taxpayer must select indexes from a month toward the beginning of its taxable year.

(c) A taxpayer may not change its method of pooling as part of a change made under section 10.04 of this APPENDIX, except to a method specifically authorized by § 1.472–8(e)(3)(iv) or section 3.04(1)(b) of Rev. Proc. 84–57. These special pooling rules do not apply to goods manufactured by the taxpayer. *See* § 1.472–8(b) for principles for establishing pools of manufacturers and processors.

(d) A taxpayer may change its method of determining current-year cost as part of a change made under section 10.04 of this APPENDIX by also following the provisions of section 10.05 of this APPENDIX. These changes may be made using a single application, provided

(2) *Recurring item exception.* As part of this change, a taxpayer that previously has not changed to or adopted the recurring item exception for FICA and FUTA taxes must change to the recurring item exception method for FICA and FUTA taxes as specified in § 461(h)(3).

(3) *Amounts taken into account.* Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain taxes must be included in inventory costs and may be recovered through cost of goods sold. See § 1.263A–1(e)(3)(ii)(L). A taxpayer may not rely on the provisions of section 8.04 of this APPENDIX to take a current year deduction.

SECTION 9. INVENTORIES (§ 471)

.01 *Cash discounts — Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for cash discounts (discounts granted for timely payment) when they approximate a fair interest rate, from a method of consistently including the price of the goods before discount in the cost of the goods and including in gross income any discounts taken (the "gross invoice method"), to a method of reducing the cost of the goods by the cash discounts and deducting as an expense any discounts not taken (the "net invoice method"), or vice versa. See Rev. Rul. 73–65, 1973–1 C.B. 216.

.02 *Reserved.*

SECTION 10. LAST-IN, FIRST-OUT (LIFO) INVENTORIES (§ 472)

.01 *Change from the LIFO inventory method.*

(1) *Description of change and scope.*

(a) *In general.* This change, which was formerly provided in Rev. Proc. 88–15, 1988–1 C.B. 683, applies to any taxpayer that wants to:

(i) change from the LIFO inventory method for all its LIFO inventory; and

(ii) change to the permitted method as determined in section 10.01(1)(b) of this APPENDIX.

(b) *Method to be used.*

(i) *Determining method to be used.* The inventory method to be used by a taxpayer is determined as follows:

(A) If the taxpayer has inventoriable goods not included in its LIFO inventory computations (non-LIFO inventory) and, for all the taxpayer's non-LIFO inventory, the taxpayer uses an inventory method that is a permitted method, then the taxpayer must use that same inventory method for its entire inventory.

(B) If the LIFO inventory method is used by the taxpayer with respect to all its inventoriable goods, then the taxpayer must use the same inventory method it used prior to the adoption of the LIFO inventory method, if that prior method is a permitted method.

(C) If the taxpayer has only LIFO inventory and the method used by the taxpayer prior to the adoption of the LIFO inventory method is not a permitted method, then the taxpayer must use a permitted method.

(D) If the taxpayer did not use an inventory method prior to the adoption of the LIFO inventory method and has no inventoriable goods other than its LIFO inventory, then the taxpayer must use a permitted method.

(ii) *Permitted method defined.* For purposes of section 10.01 of this APPENDIX, a permitted method is a method under which:

(A) the identification method is either the first-in, first-out (FIFO) inventory method or the specific identification inventory method; and

(B) the valuation method is cost; cost or market, whichever is lower; market (but only if the taxpayer is a dealer in securities, as defined in § 1.471–5); the "farm price method" or the "unit-livestock-price method" (but only if the taxpayer is a farmer permitted to use such methods); or the retail method, reduced to either approximate cost or approximate cost or market, whichever is lower (but only if the taxpayer is a retail merchant).

(iii) *Method not to be used.* The average cost method (sometimes also referred to as "the rolling average method") described in Rev. Rul. 71–234, 1971–1 C.B. 148, is not a permitted method.

(iv) *Determining permitted method.* Whether an inventory method is a permitted method is determined by the taxpayer's method of inventory identification and valuation, and not by which types and amounts of costs are capitalized under the taxpayer's method of computing inventory cost. *See* § 263A and the regulations thereunder, which govern the types and amounts of costs required to be included in inventory cost for taxpayers subject to those provisions.

(2) *Limitation on LIFO election.* The taxpayer may not re-elect the LIFO inventory method for a period of at least five taxable years beginning with the year of change, unless based on a showing of unusual and compelling circumstances, consent is specifically granted by the Commissioner to change the method of accounting at an earlier time. The request for consent to readopt the LIFO inventory method must comply with Rev. Proc. 97–27.

(3) *Effect of subchapter S election by corporation.*

(a) *S election effective for year of LIFO discontinuance.* If a C corporation elects to be treated as an S corporation for the taxable year in which it discontinues use of the LIFO inventory method, § 1363(d) requires an increase in the taxpayer's gross income for the LIFO recapture amount (as defined in § 1363(d)(3)) for the taxable year preceding the year of change (the taxpayer's last taxable year as a C corporation), and a corresponding adjustment to the basis of the taxpayer's inventory as of the end of the taxable year preceding the year of change. Any increase in income tax as a result of the inclusion of the LIFO recapture amount is payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation as provided in § 1363(d)(2). Any corresponding basis adjustment is taken into account in computing the § 481(a) adjustment (if any) that results upon the discontinuance of the LIFO method by the corporation.

(b) *S election effective for a year after LIFO discontinuance.* If a C corporation elects to be treated as an S corporation for a taxable year after the taxable year in which it discontinued use of the LIFO inventory method, the remaining balance of any positive § 481(a) adjustment must be included in its gross income in its last taxable year as a C corporation. If this inclusion results in an increase in tax for its last taxable year as a C corporation, this increase in tax is payable in four equal installments, beginning with the

wants to change its method of accounting to treat bonuses or self-insured medical benefits as follows:

(i) *Bonuses.* If the obligation to pay a bonus becomes fixed and certain by the end of the taxable year (see Rev. Rul. 61–27, 1961–2 C.B. 36), and the bonus is otherwise deductible, but the bonus is paid after the 15th day of the third calendar month after the end of that taxable year, to treat the bonus as deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the bonus is includible in the gross income of the employee; or

(ii) *Self-insured medical benefits.* If the obligation to pay an employee's medical expenses is neither insured nor paid from a welfare benefit fund within the meaning of § 419(e), to treat the liability as incurred in the taxable year in which the employee files the claim with the employer. *See United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), 1987–2 C.B. 134.

(b) *Inapplicability.* This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.01 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(2) *Amounts taken into account.* Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, direct labor costs must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(2)(i)(B). A taxpayer may not rely on the provisions of section 8.01 of this APPENDIX to take a current year deduction.

.02 *Timing of incurring liabilities for real property taxes.*

(1) *Description of change.* An accrual method taxpayer generally incurs a liability in the taxable year that all the 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)(ii). Under § 1.461–4(g)(6), if the liability of the taxpayer is to pay a tax, economic performance occurs as the tax is paid to the government authority that imposed the tax.

(2) *Scope.*

(a) *Applicability.* This change applies to an accrual method taxpayer that wants to change its method of accounting to:

(i) treat a liability for real property taxes as incurred in the taxable year in which the taxes are paid, under §§ 461 and 1.461–4(g)(6);

(ii) account for real property taxes under the recurring item exception to the economic performance rules under §§ 461(h)(3) and 1.461–5(b)(1); or

(iii) revoke an election under § 461(c) (ratable accrual election).

(b) *Inapplicability.* This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(3) *Amounts taken into account.* Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain real property taxes must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(3)(ii)(L). A taxpayer may not rely on the provisions of section 8.02 of this APPENDIX to take a current year deduction.

.03 *Timing of incurring liabilities under a workers' compensation act, tort, breach of contract, or violation of law.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to an accrual method taxpayer that wants to change its method of accounting for self-insured liabilities (including any amounts not covered by insurance, such as a "deductible" amount under an insurance policy) arising under any workers' compensation act or out of any tort, breach of contract, or violation of law, to treating the liability for the workers' compensation, tort, breach of contract, or violation of law as being incurred in the taxable year in which all the events have occurred which establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and payment is made to the person to which the liability is owed. *See* § 461 and § 1.461–4(g)(2).

(b) *Inapplicability.* This change does not apply:

(i) to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.03 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) if payment is made to a third party rather than to the person to which the liability is owed. See § 1.461–4(g)(1); or

(iii) if payment is made by a third party.

(2) *Amounts taken into account.* Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain employee benefit costs (including workers' compensation) must be included in inventory costs and may be recovered through costs of goods sold. *See* § 1.263A–1(e)(3)(ii)(D). A taxpayer may not rely on the provisions of section 8.03 of this APPENDIX to take a current year deduction.

.04 *Timing of incurring liabilities for payroll taxes.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to an accrual method employer that wants to change its method of accounting for FICA and FUTA taxes to a method consistent with the holding in Rev. Rul. 96–51, 1996–43 I.R.B. 5. Rev. Rul. 96–51 holds that, under the all events test of § 461, an accrual method employer may deduct in Year 1 its otherwise deductible FICA and FUTA taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met.

(b) *Inapplicability.* This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.04 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: "CHANGE TO THE SERVICE WARRANTY INCOME METHOD UNDER SECTION 5.02 OF THE APPENDIX OF REV. PROC. 97–37." The statement must set forth the information required under section 6.03 of Rev. Proc. 97–38, except that the statement under section 6.03(2) (that the taxpayer agrees to all of the terms and conditions of the revenue procedure) also should refer to Rev. Proc. 97–37.

(c) A taxpayer changing to the service warranty income method of accounting under section 5.02 of this APPENDIX must satisfy the annual reporting requirement set forth in section 6.04 of Rev. Proc. 97–38.

.03 *Multi-year insurance policies for multi-year service warranty contracts — Description of change and scope.*

(1) *Applicability.* Except as provided in section 5.03(2) of this APPENDIX, this change applies to a manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods that wants to change its method of accounting for insurance costs paid or incurred to insure its risks under multi-year service warranty contracts to the method described in section 5.03(3) of this APPENDIX. Multi-year service warranty contracts to which this change applies include only those separately priced contracts sold by a manufacturer, wholesaler, or retailer also selling the motor vehicles or other durable consumer goods (to the ultimate customer or to an intermediary) underlying the contracts. The classification of goods as "durable consumer goods" for purposes of this change depends on the common usage of the goods, rather than the purchaser's actual intended use of the goods. This change was formerly provided in Rev. Proc. 92–97, 1992–2 C.B. 510.

(2) *Inapplicability.* This change does not apply to a taxpayer that covers its risks under its multi-year service warranty contracts through arrangements not constituting insurance.

(3) *Description of method.* If a taxpayer purchases a multi-year service warranty insurance policy (in connection with its sale of multi-year service warranty contracts to customers) by paying a lump-sum premium in advance, the taxpayer must capitalize the amount paid or incurred and may only obtain deductions for that amount by prorating (or amortizing) it over the life of the insurance policy (whether the cash method or an accrual method of accounting is used to account for service warranty transactions).

SECTION 6. OBLIGATIONS ISSUED AT DISCOUNT (§ 454)

.01 *Series E or EE U.S. savings bonds.*

(1) *Description of change and scope.* This change applies to a cash method taxpayer that wants to change its method of accounting for interest income on Series E or EE U.S. savings bonds. However, this change only applies to a taxpayer that has previously made an election under § 454 to report as interest income the increase in redemption price on a bond occurring in a taxable year, and that now wants to report this income in the taxable year in which the bond is redeemed, disposed of, or finally matures, whichever is earliest. This change was formerly provided in Rev. Proc. 89–46, 1989–2 C.B. 597.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method and is effective for any increase in redemption price occurring after the beginning of the year of change for all Series E and EE U.S. savings bonds held by the taxpayer on or after the beginning of the year of change. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: "CHANGE IN METHOD OF ACCOUNTING UNDER SECTION 6.01 OF THE APPENDIX OF REV. PROC. 97–37." The statement must set forth:

(i) the Series E or EE U.S. savings bonds for which this change in accounting method is requested;

(ii) an agreement to report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest; and

(iii) an agreement to report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of any interest income previously reported in prior taxable years.

.02 *Reserved.*

SECTION 7. PREPAID SUBSCRIPTION INCOME (§ 455)

.01 *Prepaid subscription income.*

(1) *Description of change and scope.* This change applies to an accrual method taxpayer that wants to change its method of accounting for prepaid subscription income to the method described in § 455 and the regulations thereunder, including an eligible taxpayer that wants to make the "within 12 months" election under § 1.455–2. This change was formerly provided, in part, in Rev. Proc. 84–76, 1984–2 C.B. 751.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method and does not apply to any prepaid subscription income received before the first taxable year to which the change applies. Any prepaid subscription income arising prior to the year of change is accounted for under the taxpayer's former method of accounting. See section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: "CHANGE IN METHOD OF ACCOUNTING FOR PREPAID SUBSCRIPTION INCOME UNDER SECTION 7.01 OF THE APPENDIX OF REV. PROC. 97–37." The statement must set forth the information required under § 1.455–6(b).

.02 *Reserved.*

SECTION 8. TAXABLE YEAR OF DEDUCTION (§ 461)

.01 *Timing of incurring liabilities for employee compensation.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to an accrual method taxpayer that

inventory because of the $100,000 increment for 2000.

X's 2000 Ending Inventory:	
Beginning Inventory (With UNICAP costs)	$1,630,000
2000 Increment	100,000
Additional § 263A Costs in 2000 Increment	10,000
Total 2000 Ending Inventory	$1,740,000

X's Unamortized 1999 § 481(a) Adjustment:	
Unamortized 1999 § 481(a) Adjustment—12/31/99	$60,000
Amount Included in 2000 Taxable Income	<60,000>
Unamortized 1999 § 481(a) Adjustment—12/31/00	$ 0

.02 *Reserved.*

SECTION 5. METHODS OF ACCOUNTING (§ 446)

.01 *Cash or hybrid method to accrual method.*

(1) *Description of change and scope.*

(a) *Applicability.* Except as provided in section 5.01(1)(b) of this APPENDIX, this change, which was formerly provided, in part, in Rev. Proc. 92–75, 1992–2 C.B. 448, and Rev. Proc. 92–74, 1992–2 C.B. 442, applies to:

(i) a taxpayer that wants to change to an overall accrual method, or to an overall accrual method in conjunction with the recurring item exception under § 461(h)(3), from the cash receipts and disbursements method (cash method), or from a hybrid method (under which certain items of income or expense are reported on the cash method and other items of income or expense are reported on an accrual method or other methods); or

(ii) a taxpayer that is required to change to an overall accrual method under § 448, but is ineligible to make the change under § 1.448–1(h)(2) (relating to the "first § 448 year").

(b) *Inapplicability.* This change does not apply to:

(i) a financial institution described in § 581 or 591;

(ii) a farmer;

(iii) a cooperative organization described in § 501(c)(12), 521, or 1381;

(iv) an individual taxpayer, except for activities conducted as a sole proprietorship;

(v) a taxpayer required to use an inventory method of accounting, unless:

(A) the taxpayer adopts a proper inventory method under § 471 and the regulations thereunder, the taxpayer is a small reseller within the meaning of § 1.263A–3(a), and, if the taxpayer has production activities, the taxpayer's production activities qualify under the de minimis presumption of § 1.263A–3(a)-(2)(iii); or

(B) the taxpayer adopts a proper inventory method under § 471 and the regulations thereunder, the taxpayer is a reseller eligible to use the simplified resale method under § 1.263A–3(d), and the taxpayer adopts a proper method under that section for the year of change;

(vi) a taxpayer required to use a long-term contract method in accordance with § 460, if the taxpayer is not in compliance with that section and any related administrative guidance;

(vii) a taxpayer required or wanting to use a special method of accounting, unless the taxpayer is permitted to change automatically to the special method under this revenue procedure. A special method of accounting is a method that deviates from the normal tax accounting rules, such as the method of accounting for advance payments pursuant to either Rev. Proc. 71–21, 1971–2 C.B. 549, or § 1.451–5, the installment method of accounting under § 453, or a long-term contract method under § 460; or

(viii) a taxpayer required to change to an overall accrual method under § 448 and eligible to make the change under § 1.448–1(h)(2). *See* § 1.448–1(h)-(2), which provides an automatic consent procedure for a taxpayer changing for the first taxable year that it is subject to § 448. *See also* § 1.448–1(h)(1), which provides that § 1.448–1(h) does not apply to a change required under any Code section (or regulations thereunder) other than § 448 (for example, a taxpayer with inventories).

(2) *Section 481(a) adjustment.*

(a) *In general.* The § 481(a) adjustment takes into account the accounts receivable, accounts payable, inventory, and any other item determined to be necessary in order to prevent items from being duplicated or omitted. The § 481(a) adjustment does not include any item of income accrued but not received that was worthless or partially worthless (within the meaning of § 166(a)) on the last day of the year preceding the year of change.

(b) *Recurring item exception.* As part of the change to an overall accrual method, a taxpayer may adopt the recurring item exception for the year of change if the taxpayer is eligible and follows the procedures of § 1.461–5(d). If the taxpayer is eligible and wants to adopt this method as specified in § 461(h)(3), the amount of the § 481(a) adjustment must be modified to account for the amount of any additional deduction.

(3) *Change to a special method of accounting.* If a taxpayer that wants to change to an accrual method in conjunction with a change to a special method of accounting is not permitted to make the change under this revenue procedure, the taxpayer may request to make both changes only by filing one application under the provisions of Rev. Proc. 97–27, 1997–21 I.R.B. 10. Only one user fee will be required for these changes.

.02 *Multi-year service warranty contracts.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to an eligible accrual method manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods that wants to change to the service warranty income method described in section 5 of Rev. Proc. 97–38, page 43. Under the service warranty income method, a qualifying taxpayer may, in certain specified and limited circumstances, include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income generally over the life of the service warranty obligation. This change was formerly provided in Rev. Proc. 92–98, 1992–2 C.B. 512.

(b) *Inapplicability.* This change does not apply to a taxpayer outside the scope of Rev. Proc. 97–38.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method, under which the taxpayer begins the use of the service warranty income method for all qualified advance payment amounts received in the year of change and thereafter. *See* section 2.06 of this revenue procedure.

was required to include a $20,000 positive § 481(a) adjustment in its 1995 taxable income.

X elected to use the simplified resale method without a historic absorption ratio election under § 1.263A–3(d)(3) for determining the amount of additional § 263A costs to be capitalized to each LIFO layer. Assume that X was required to add $10,000 of additional § 263A costs to the cost of its 1995 ending inventory because of the $100,000 increment for 1995.

X's 1995 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,000,000
1995 Increment	100,000
Additional § 263A Costs in Beginning Inventory	80,000
Additional § 263A Costs in 1995 Increment	10,000
Total 1995 Ending Inventory	$1,190,000

X's Unamortized 1995 § 481(a) adjustment:

1995 § 481(a) Adjustment	$80,000
Amount Included in 1995 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/95	$60,000

Because X failed to satisfy the small reseller exception for 1996, X was required to continue using the UNICAP method for its inventory costs. Furthermore, X was required to include $20,000 of the unamortized 1995 positive § 481(a) adjustment in 1996 taxable income. Assume that X was required to add $10,000 of additional § 263A costs to the cost of its 1996 ending inventory because of the $100,000 increment for 1996.

X's 1996 Ending Inventory:

Beginning Inventory (With UNICAP costs)	$1,190,000
1996 Increment	100,000
Additional § 263A Costs in 1996 Increment	10,000
Total 1996 Ending Inventory	$1,300,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/95	$60,000
Amount Included in 1996 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/96	$40,000

Because X satisfies the small reseller exception for 1997, X may change voluntarily from the UNICAP method to a permissible non-UNICAP inventory capitalization method under section 4.01 of this APPENDIX. To reflect the removal of the additional § 263A costs from the cost of its 1997 beginning inventory, X must compute a corresponding § 481(a) adjustment, which is a negative $100,000 ($1,200,000 — $1,300,000). Because X used the UNICAP method for only two years (that is, 1995 and 1996), X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1997. Thus, X must include a $50,000 negative § 481(a) adjustment in 1997 taxable income. In addition, X must include $20,000 of the unamortized 1995 § 481(a) adjustment in 1997 taxable income.

X's 1997 Ending Inventory:

Beginning Inventory (With UNICAP costs)	$1,300,000
1997 Increment	100,000
1997 § 481(a) Adjustment <Negative>	<100,000>
Total 1997 Ending Inventory	$1,300,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/96	$40,000
Amount Included in 1997 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000

X's Unamortized 1997 § 481(a) Adjustment:

1997 § 481(a) Adjustment <Negative>	$<100,000>
Amount Included in 1997 Taxable Income	50,000
Unamortized 1997 § 481(a) Adjustment—12/31/97	$< 50,000>

X also satisfies the small reseller exception for 1998 and, therefore, is not required to return to the UNICAP method for 1998. X, however, must include $20,000 of the unamortized 1995 positive § 481(a) adjustment and $50,000 of the unamortized 1997 negative § 481(a) adjustment in 1998 taxable income.

X's 1998 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,300,000
1998 Increment	100,000
Total 1998 Ending Inventory	$1,400,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000
Amount Included in 1998 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/98	$ 0

X's Unamortized 1997 § 481(a) Adjustment:

Unamortized 1997 § 481(a) Adjustment—12/31/97	$<50,000>
Amount Included in 1998 Taxable Income	50,000
Unamortized 1997 § 481(a) Adjustment—12/31/98	$ 0

In 1999, X fails to satisfy the small reseller exception and, therefore, must return to the UNICAP method as provided under section 4.01 of this APPENDIX. X changes to the simplified resale method without a historic absorption ratio election under § 1.263A–3(d)(3). Assume that X must capitalize $120,000 of additional § 263A costs to the cost of its 1999 beginning inventory because of this change in inventory method. In addition, X must determine the appropriate adjustment period for the corresponding positive § 481(a) adjustment. Because X used its former inventory method for two taxable years before 1999 (that is, 1997 and 1998), X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1999. Thus, X must include a $60,000 positive § 481(a) adjustment in its 1999 taxable income. Assume that X must add $10,000 of additional § 263A costs to the cost of its 1999 ending inventory because of the $100,000 increment for 1999.

X's 1999 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,400,000
1999 Increment	100,000
Additional § 263A costs in Beginning Inventory	120,000
Additional § 263A costs in 1999 Increment	10,000
Total 1999 Ending Inventory	$1,630,000

X's Unamortized 1999 § 481(a) Adjustment:

1999 § 481(a) Adjustment	$120,000
Amount Included in 1999 Taxable Income	< 60,000>
Unamortized 1999 § 481(a) Adjustment—12/31/99	$ 60,000

Because X fails to satisfy the small reseller exception for 2000, X must continue using the UNICAP method for its inventory costs. Furthermore, X is required to include $60,000 of the unamortized 1999 positive § 481(a) adjustment in 2000 taxable income. Assume that X is required to add $10,000 of additional § 263A costs to the cost of its 2000 ending

tization method, the taxpayer must attach a statement to its timely filed application. The statement must provide a description of each package design, the date on which each was placed in service, and the cost basis of each (as determined under sections 5.01(2) or 5.02(2) of Rev. Proc. 97–35).

.02 *Reserved.*

SECTION 4. UNIFORM CAPITALIZATION (§ 263A)

.01 Certain uniform capitalization (UNICAP) methods used by small resellers, formerly small resellers, and reseller-producers.

(1) *Description of change and scope.*

(a) *Applicability.* This change, which was formerly provided in Rev. Proc. 95–33, 1995–2 C.B. 380, applies to:

(i) a small reseller of personal property changing from a permissible UNICAP method to a permissible non-UNICAP inventory capitalization method in any taxable year that it qualifies as a small reseller;

(ii) a formerly small reseller changing from a permissible non-UNICAP inventory capitalization method to a permissible UNICAP method in the first taxable year that it does not qualify as a small reseller;

(iii) a reseller-producer changing from a permissible UNICAP method for both its production and resale activities to a permissible simplified resale method described in § 1.263A–3(d)(3) in any taxable year that it qualifies to use a simplified resale method for both its production and resale activities under § 1.263A–3(a)(4) (resellers with de minimis production activities); or

(iv) a reseller-producer changing from a permissible simplified resale method described in § 1.263A–3(d)(3) for both its production and resale activities to a permissible UNICAP method for both its production and resale activities in the first taxable year that it does not qualify to use a simplified resale method for both its production and resale activities under § 1.263A–3(a)(4).

(b) *Scope limitations inapplicable.* A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(c) *Inapplicability.* This change does not apply to a taxpayer making a historic absorption ratio election under § 1.263A–2(b)(4) or 1.263A–3(d)(4).

(2) *Definitions.*

(a) "Reseller" means a taxpayer that acquires real or personal property described in § 1221(1) for resale.

(b) "Small reseller" means a reseller whose average annual gross receipts for the three immediately preceding taxable years (or fewer, if the taxpayer has not been in existence during the three preceding taxable years) do not exceed $10,000,000. See § 263A(b)(2)(B).

(c) "Formerly small reseller" means a reseller that no longer qualifies as a small reseller.

(d) "Producer" means a taxpayer that produces real or tangible personal property.

(e) "Reseller-producer" means a taxpayer that is both a producer and a reseller.

(f) "Permissible UNICAP method" means a method of capitalizing costs that is permissible under § 263A.

(g) "Permissible non-UNICAP inventory capitalization method" means a method of capitalizing inventory costs that is permissible under § 471.

(3) *Section 481(a) adjustment.* Beginning with the year of change, a taxpayer changing its method of accounting for costs pursuant to section 4.01 of this APPENDIX generally must take any applicable § 481(a) adjustment into account ratably over the same number of taxable years, not to exceed four, that the taxpayer used its former method of accounting. See section 5.04(3) of this revenue procedure for exceptions to this general rule.

(4) *No audit protection. A taxpayer* does not receive audit protection under section 7 of this revenue procedure in connection with this change.

(5) *Example.* The following example illustrates the principles of section 4.01 of this APPENDIX for small resellers and formerly small resellers.

Assume X, a corporate reseller of personal property, incorporated January 2, 1991, adopted a taxable year ending December 31. X determines that its average annual gross receipts for the three taxable years (or fewer, if applicable) immediately preceding taxable years 1991 through 2000 are as shown in the table below:

Current Taxable Year	*AVERAGE Annual Gross Receipts for the Three Taxable Years Immediately Preceding the Current Taxable Year*
1991	$ 0
1992	5,000,000
1993	6,000,000
1994	7,000,000
1995	11,000,000
1996	11,000,000
1997	9,000,000
1998	8,000,000
1999	11,000,000
2000	12,000,000

Furthermore, X, which adopted the dollar-value LIFO inventory method, has the following LIFO inventory balances determined without considering the effects of the UNICAP method:

	Beginning	*Ending*
1995	$1,000,000	$1,100,000
1996	1,100,000	1,200,000
1997	1,200,000	1,300,000
1998	1,300,000	1,400,000
1999	1,400,000	1,500,000
2000	1,500,000	1,600,000

X was required by § 263A to change to the UNICAP method for 1995 because its average annual gross receipts for the three taxable years immediately preceding 1995 were $11,000,000, which exceeded the $10,000,000 ceiling permitted by the small reseller exception. Assume that X was required to capitalize $80,000 of "additional § 263A costs" to the cost of its 1995 beginning inventory because of this change in inventory method. In addition, X was required to include one-fourth of the § 481(a) adjustment when computing taxable income for each of the four taxable years beginning with 1995. Thus, X

the-years-digits method, or the declining-balance method using any proper percentage of the straight-line rate;

(f) a change in the interest factor used in connection with a compound interest method or sinking fund method;

(g) a change in averaging convention as set forth in § 1.167(a)–10(b). However, as specifically provided in § 1.167(a)–10(b), in any taxable year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used (see Rev. Rul. 73–202, 1973–1 C.B. 81);

(h) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense and including salvage proceeds in taxable income as set forth in § 1.167(a)–8(e)(2). *See* Rev. Rul. 74–455, 1974–2 C.B. 63. This change, however, may be made under this revenue procedure only if:

(i) the change is applied to all items in the account for which the change is being made; and

(ii) the removal costs are not required to be capitalized under any provision of the Code (for example, § 263(a), 263A, or 280B);

(i) a change from crediting the depreciation reserve with the salvage proceeds realized on normal retirement sales to computing and recognizing gains and losses on such sales (see Rev. Rul. 70–165, 1970–1 C.B. 43);

(j) a change from crediting ordinary income (including the combination method of crediting the lesser of estimated salvage value or actual salvage proceeds to the depreciation reserve, with any excess of salvage proceeds over estimated salvage value credited to ordinary income) with the salvage proceeds realized on normal retirement sales, to computing and recognizing gains and losses on such sales (see Rev. Rul. 70–166, 1970–1 C.B. 44); or

(k) a change from item accounting for specific assets to multiple asset accounting for the same assets, or vice versa.

(4) *Additional requirements.* A taxpayer also must comply with the following:

(a) *Basis for depreciation.* At the beginning of the year of change, the basis for depreciation of property to which this change applies is the adjusted basis of the property as provided in § 1011 at the end of the taxable year immediately preceding the year of change (determined under the taxpayer's present method of accounting for depreciation). If applicable under the taxpayer's proposed method of accounting for depreciation, this adjusted basis is reduced by the estimated salvage value of the property (for example, a change to the straight-line method).

(b) *Rate of depreciation.* The rate of depreciation for property changed to:

(i) the straight-line or sum-of-the-years-digits method of depreciation must be based on the remaining useful life of the property as of the beginning of the year of change; or

(ii) the declining-balance method of depreciation must be based on the useful life of the property measured from the placed-in-service date, and not the expected remaining life from the date the change becomes effective.

(c) *Regulatory requirements.* For changes in method of depreciation to the sum-of-the-years-digits or declining-balance method, the property must meet the requirements of § 1.167(b)–0 or 1.167(c)–1, as appropriate.

(5) *Section 481(a) adjustment.* Because the adjusted basis of the property is not changed as a result of a method change made under section 2.02 of this APPENDIX, no items are being duplicated or omitted. Accordingly, the § 481(a) adjustment is zero.

.03 *Sale or lease transactions.*

(1) *Description of change and scope.*

(a) *Applicability.* Except as provided in section 2.03(1)(b) of this APPENDIX, this change applies to a taxpayer that wants to change its method of accounting from treating property as sold by the taxpayer to treating property as leased by the taxpayer, and vice versa, and to a taxpayer that wants to change its method of accounting from treating property as purchased by the taxpayer to treating property as leased by the taxpayer, and vice versa.

(b) *Inapplicability.* This change does not apply to:

(i) a rent-to-own dealer that wants to change its method of accounting for rent-to-own contracts described in section 3 of Rev. Proc. 95–38, 1995–2 C.B. 397; or

(ii) a taxpayer that holds assets for sale or lease, if any asset so held is not the subject of a sale or lease transaction as of the beginning of the year of change.

(2) *Manner of making the change.*

(a) The change in method of accounting under section 2.03 of this APPENDIX is made using a cut-off method and applies to transactions entered into on or after the beginning of the year of change. *See* section 2.06 of this revenue procedure.

(b) If a taxpayer wants to change its method of accounting for existing sale or lease transactions, the taxpayer must file an application with the Commissioner in accordance with the requirements of § 1.446–1T(e)(3)(i) and Rev. Proc. 97–27. A change involving existing sale or lease transactions will require a § 481(a) adjustment. Consent to change a method of accounting for an existing sale or lease transaction is granted only in unusual and compelling circumstances.

(3) *No audit or ruling protection.* A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change. Furthermore, the Commissioner's consent to this change does not constitute acceptance or approval of the taxpayer's characterization of any transaction as a sale or lease.

SECTION 3. CAPITAL EXPENDITURES (§ 263)

.01 *Package design costs.*

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change to one of the three alternative methods of accounting for package design costs described in section 5 of Rev. Proc. 97–35, page 11. The three alternative methods of accounting for package design costs described are: (1) the capitalization method, (2) the design-by-design capitalization and 60-month amortization method, and (3) the pool-of-cost capitalization and 48-month amortization method. This change was formerly provided in Rev. Proc. 90–63, 1990–2 C.B. 664.

(2) *Additional requirements.* If a taxpayer is changing its method of accounting for package design costs to the capitalization method or the design-by-design capitalization and 60-month amor-

ation is determined under § 167, is determined either:

(i) under the depreciation method adopted by a taxpayer for the property; or

(ii) if that depreciation method does not result in a reasonable allowance for depreciation or a taxpayer has not adopted a depreciation method for the property, under the straight-line depreciation method.

For determining the estimated useful life and salvage value of the property, see §§ 1.167(a)–1(b) and (c), respectively. The depreciation allowable for any taxable year for property subject to § 167(f) (regarding certain property excluded from § 197) is determined by using the depreciation method and useful life prescribed in § 167(f).

(c) *Section 168 property.* The depreciation allowable for any taxable year for property for which depreciation is determined under § 168, is determined by using either:

(i) the general depreciation system in § 168(a); or

(ii) the alternative depreciation system in § 168(g) if the property is required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) or other provisions of the Code (for example, property described in § 263A(e)(2)(A) or 280F(b)(1)). Property required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) includes property in a class (as set out in § 168(e)) for which the taxpayer made a timely election under § 168(g)(7).

(d) *Section 197 property.* The depreciation allowable for any taxable year for an amortizable § 197 intangible (including any property for which a timely election under § 13261(g)(2) of the 1993 Act was made) is determined by using the straight-line method over a 15-year period.

(e) *Former § 168 property.* The depreciation allowable for any taxable year for property subject to former § 168 is determined by using either:

(i) the accelerated method of cost recovery applicable to the property (for example, for 5-year property, the recovery method under former § 168(b)(1)); or

(ii) the straight-line method applicable to the property if the property is required to be depreciated under the straight-line method (for example, property described in former § 168(f)(12) or former § 280F(b)(2)) or if the taxpayer elected to determine the depreciation allowance under the optional straight-line percentage (for example, the straight-line method in former § 168(b)(3)).

.02 *Permissible to permissible method of accounting for depreciation.*

(1) *Description of change.* This change applies to a taxpayer that wants to change from a permissible method of accounting for depreciation under § 167 to another permissible method of accounting for depreciation under § 167. Pursuant to §§ 1.167(a)–7(a) and (c), a taxpayer may account for depreciable property either by treating each individual asset as an account or by combining two or more assets in a single account and, for each account, depreciation allowances are computed separately. This change was formerly provided in Rev. Proc. 74–11, 1974–1 C.B. 420.

(2) *Scope.*

(a) *Applicability.* Except as provided in section 2.02(2)(b) of this APPENDIX, this change applies to any taxpayer wanting to make a change in method of accounting for depreciation specified in section 2.02(3) of this APPENDIX for the property in an account:

(i) for which the present and proposed methods of accounting for depreciation specified in section 2.02(3) of this APPENDIX are permissible methods for the property under § 167; and

(ii) that is owned by the taxpayer at the beginning of the year of change.

(b) *Inapplicability.* This change does not apply to:

(i) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(iii) any intangible property;

(iv) any property described in § 167(f) (regarding certain property excluded from § 197);

(v) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(vi) any property for which depreciation is determined under § 168 or 168 prior to its amendment in 1986 (former § 168);

(vii) any property that the taxpayer elected under § 168(f)(1) or former § 168(e)(2) to exclude from the application of, respectively, § 168 or former § 168;

(viii) any property for which depreciation is determined in accordance with § 1.167(a)–11 (regarding the Class Life Asset Depreciation Range System (ADR)); or

(ix) any depreciable property for which the taxpayer is changing the depreciation method pursuant to § 1.167(e)–1(b) (change from declining-balance method to straight-line method), § 1.167(e)–1(c) (certain changes for § 1245 property), or § 1.167(e)–1(d) (certain changes for § 1250 property). These changes must be made prospectively and are not permitted under the cited regulations for property for which the depreciation is determined under § 168 or former § 168.

(3) *Changes covered.* Section 2.02 of this APPENDIX only applies to the following changes in methods of accounting for depreciation:

(a) a change from the straight-line method to the sum-of-the-years-digits method, the sinking fund method, the unit-of-production method, or the declining-balance method using any proper percentage of the straight-line rate;

(b) a change from the declining-balance method using any percentage of the straight-line rate to the sum-of-the-years-digits method, the sinking fund method, or the declining-balance method using a different proper percentage of the straight-line rate;

(c) a change from the sum-of-the-years-digits method to the sinking fund method, the declining-balance method using any proper percentage of the straight-line rate, or the straight-line method;

(d) a change from the unit-of-production method to the straight-line method;

(e) a change from the sinking fund method to the straight-line method, the unit-of-production method, the sum-of-

section 2.03 of this APPENDIX for making this change).

(3) *Taxpayer with under- and over-depreciated properties.*

(a) Because this revenue procedure is not the exclusive procedure to change a method of accounting to which section 2.01 of this APPENDIX applies, a taxpayer that wants to change a method of accounting for depreciation to which section 2.01 of this APPENDIX applies on some items of property and to change an impermissible method of accounting for depreciation under which the taxpayer claimed more than the depreciation allowable on other items of property, may file:

(i) one application under Rev. Proc. 97–27 for both the under- and over-depreciated properties; or

(ii) two applications—one application under this revenue procedure for the under-depreciated property and one application under Rev. Proc. 97–27 for the over-depreciated property.

(b) In either situation, the omitted depreciation for the under-depreciated property and the excess depreciation for the over-depreciated property from taxable years prior to the year of change will be taken into account through a § 481(a) adjustment.

(4) *Additional requirements.* A taxpayer also must comply with the following:

(a) *Permissible depreciation method.* A taxpayer must change to a permissible method of accounting for depreciation for the item of property. This method is the same method that determines the depreciation allowable for the item of property (as provided in section 2.01(7) of this APPENDIX).

(b) *Statements required.* A taxpayer must provide the following statements, if applicable, and attach them to the completed application:

(i) a detailed description of the former and new methods of accounting. A general description of these methods of accounting is unacceptable (for example, MACRS to MACRS or erroneous method to proper method);

(ii) to the extent not provided elsewhere on the application, a statement describing the taxpayer's business or income-producing activities. Also, if the taxpayer has more than one business or income-producing activity, a statement describing the taxpayer's business or income-producing activity in which the item of property at issue is primarily used by the taxpayer;

(iii) to the extent not provided elsewhere on the application, a statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class in, as appropriate, Rev. Proc. 87–56 or Rev. Proc. 83–35. If the taxpayer is the owner and lessor of the item of property at issue, the statement of the facts and law supporting the new asset class also must describe the business or income-producing activity in which that item of property is primarily used by the lessee;

(iv) to the extent not provided elsewhere on the application, a statement identifying the year in which the item of property was placed in service;

(v) if the item of property is depreciated under former § 168, a statement identifying the asset class in Rev. Proc. 83–35 that applies under the taxpayer's former and new methods of accounting (if none, state and explain);

(vi) if the taxpayer is changing the classification of an item of § 1250 property to a retail motor fuels outlet under § 168(e)(3)(E)(iii), a statement containing the following representation: "For purposes of § 168(e)(3)(E)(iii) of the Internal Revenue Code, the taxpayer represents that (A) 50 percent or more of the gross revenue generated from the item of § 1250 property is from the sale of petroleum products (not including gross revenue from related services, such as the labor cost of oil changes and gross revenue from the sale of nonpetroleum products such as tires and oil filters), (B) 50 percent or more of the floor space in the item of property is devoted to the sale of petroleum products (not including floor space devoted to related services, such as oil changes and floor space devoted to nonpetroleum products such as tires and oil filters), or (C) the item of § 1250 property is 1,400 square feet or less."; and

(vii) if the taxpayer is changing the classification of an item of property from § 1250 property to § 1245 property under § 168 or former § 168, a statement of the facts and law supporting the new § 1245 property classification, and a statement containing the following representation: "Each item of property that is the subject of the application filed under section 2.01 of the APPENDIX of Rev. Proc. 97–37 for the year of change beginning *[Insert the date]*, and that is reclassified from *[Insert, as appropriate: nonresidential real property, residential rental property, 19-year real property, 18- year real property, or 15-year real property] to an asset class of [Insert, as appropriate, either: Rev. Proc. 87–56, 1987–2 C.B. 674, or Rev. Proc. 83–35, 1983–1 C.B. 745]* that does not explicitly include § 1250 property, is § 1245 property for depreciation purposes."

(5) *Section 481(a) adjustment.* The § 481(a) adjustment is a negative § 481(a) adjustment (a decrease in taxable income) to prevent the omission of the allowable but unclaimed depreciation for open and closed years prior to the year of change. This negative § 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's former method of accounting, and the total amount of depreciation allowable for the property under the taxpayer's new method of accounting (as determined under section 2.01(7) of this APPENDIX), for all taxable years prior to the year of change. The amount of the negative § 481(a) adjustment, however, must be offset by any allowable but unclaimed depreciation that is required to be capitalized under any provision of the Code (for example, § 263A) at the beginning of the year of change.

(6) *Basis adjustment.* The basis of depreciable property to which section 2.01 of this APPENDIX applies must reflect the reductions required by § 1016(a)(2) for the depreciation allowable for the property (as determined under section 2.01(7) of this APPENDIX).

(7) *Meaning of depreciation allowable.*

(a) *In general.* Section 2.01(7) of this APPENDIX provides the amount of the depreciation allowable, determined under § 167, 168, 197, or former § 168. This amount, however, may be limited by other provisions of the Code (for example, § 280F).

(b) *Section 167 property.* Generally, for any taxable year, the depreciation allowable for property for which depreci-

Cl. Ct. 184 (1987); *Canelo v. Commissioner,* 53 T.C. 217 (1969), *aff'd per curiam,* 447 F.2d 484 (9th Cir. 1971).

.02 *Reserved.*

SECTION 2. DEPRECIATION OR AMORTIZATION (§ 167, 168, OR 197)

.01 *Claiming less than the depreciation or amortization allowable.*

(1) *Description of change.*

(a) This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization (depreciation) under which the taxpayer claimed less than the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable. The taxpayer has the option of either making the change in method of accounting under this revenue procedure or requesting permission to make the change under Rev. Proc. 97–27, 1997–21 I.R.B. 10. This change was formerly provided in Rev. Proc. 96–31, 1996–1 C.B. 714.

(b) A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required. Sections 1.167(e)–1(a) and 1.446–1(e)(2)(ii)(b). This method change, however, does not include any correction of mathematical or posting errors. Section 1.446–1(e)(2)-(ii)(b).

(2) *Scope.*

(a) *Applicability.* Except as provided in section 2.01(2)(b) of this APPENDIX, this change applies to any taxpayer that has used an impermissible method of accounting for depreciation in at least the two taxable years immediately preceding the year of change, and is changing that accounting method to a permissible method of accounting for depreciation, for any item of property:

(i) for which, under the taxpayer's impermissible method of accounting, the taxpayer has not taken into account any depreciation allowance or has taken into account some depreciation but less than the depreciation allowable (claimed less than the depreciation allowable);

(ii) for which depreciation is determined under § 167, 168, 197, or 168 prior to its amendment in 1986 (former § 168); and

(iii) that is owned by the taxpayer at the beginning of the year of change.

(b) *Inapplicability.* This change does not apply to:

(i) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(ii) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.01 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(iii) any intangible property subject to § 167, except for property subject to § 167(f) (regarding certain property excluded from § 197);

(iv) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(v) any § 1250 property that a taxpayer is reclassifying to an asset class of Rev. Proc. 87–56, 1987–2 C.B. 674, or Rev. Proc. 83–35, 1983–1 C.B. 745, as appropriate, that does not explicitly include § 1250 property (for example, asset class 57.0, Distributive Trades and Services);

(vi) any property for which a taxpayer is revoking a timely valid election, or making a late election, under § 167, 168, former § 168, or § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (1993 Act), 1993–3 C.B. 1, 128 (relating to amortizable § 197 intangibles). A taxpayer may request consent to revoke or make the election by submitting a request for a letter ruling under Rev. Proc. 97–1, 1997–1 I.R.B. 11 (or any successor);

(vii) any property subject to § 167 (other than § 167(f), regarding certain property excluded from § 197), for which a taxpayer is changing only the estimated useful life of the property. A change in the estimated useful life of property for which depreciation is determined under § 167 (other than § 167(f)) must be made prospectively (*see*, for example, § 1.167(b)–2(c)) (In contrast, section 2.01 of this APPENDIX generally applies to a change in the recovery period of property for which depreciation is determined under § 168 or former § 168);

(viii) any depreciable property that changes use but continues to be owned by the same taxpayer (*see*, for example, § 168(i)(5));

(ix) any property for which a taxpayer has claimed depreciation in excess of the depreciation allowable;

(x) any change in method of accounting involving a change from deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis;

(xi) any change in method of accounting involving a change from one permissible method of accounting for the property to another permissible method of accounting for the property. For example:

(A) a change from the straight-line method of depreciation to the income forecast method of depreciation for videocassettes. *See* Rev. Rul. 89–62, 1989–1 C.B. 78;

(B) a change in the classification of a retail motor fuels outlet placed in service before August 20, 1996, from nonresidential real property to 15–year property under § 168 (see Rev. Proc. 97–10, 1997–2 I.R.B. 59, for the exclusive procedures for making this change); or

(C) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense (provided the costs of removal are not required to be capitalized under any provision of the Code, such as, § 263(a)) and including salvage proceeds in taxable income (see section 2.02 of this APPENDIX for making this change for property for which depreciation is determined under § 167); or

(xii) any change in method of accounting for an item of income or deduction other than depreciation, even if a taxpayer's present method of accounting may have resulted in the taxpayer claiming less than the depreciation allowable. For example, a change in method of accounting involving:

(A) a change in inventory costs (for example, when property is reclassified from inventory property to depreciable property); or

(B) a change in the character of a transaction from sale to lease (see

SECTION 1. TRADE OR BUSINESS EXPENSES (§ 162)

.01 *Advances made by a lawyer on behalf of clients — Description of change and scope.* This change applies to a lawyer handling cases on a contingent fee basis that advances money to pay for costs of litigation or for other expenses on behalf of clients and that wants to change the method of accounting for such advances from treating them as deductible business expenses to treating them as loans. *See Boccardo v. United States,* 12

616; 92–98, 1992–2 C.B. 512; 92–97, 1992–2 C.B. 510; 92–79, 1992–2 C.B. 457; 92–75, 1992–2 C.B. 448; 92–74, 1992–2 C.B. 442; 90–63, 1990–2 C.B. 664; 90–37, 1990–2 C.B. 361; 89–46, 1989–2 C.B. 597; 88–15, 1988–1 C.B. 683; 84–76, 1984–2 C.B. 751; and 74–11, 1974–1 C.B. 420; and Notice 95–57, 1995–2 C.B. 337; are modified, and as modified, are superseded.

.02 *Obsoleted.* The following revenue procedures are obsoleted:

(1) Rev. Proc. 85–8, 1985–1 C.B. 495 (a revenue procedure that allows a taxpayer to change its method of accounting for bad debts);

(2) Rev. Proc. 84–30, 1984–1 C.B. 482 (a revenue procedure that allows a taxpayer to change its method of accounting for interest on certain consumer loans from the Rule of 78's method to the economic accrual method);

(3) Rev. Proc. 84–29, 1984–1 C.B. 480 (a revenue procedure that provides a simplified procedure for an individual borrower to use to compute interest deductions for certain loans if the taxpayer has been reporting interest deductions on these loans based on the Rule of 78's method);

(4) Rev. Proc. 84–28, 1984–1 C.B. 475 (a revenue procedure that allows a taxpayer to change its method of accounting for interest from the Rule of 78's method to the economic accrual method, but only for those loans in which the interest computed using the Rule of 78's method exceeds the loan payments during any year of the term of the loan);

(5) Rev. Proc. 84–27, 1984–1 C.B. 469 (a revenue procedure that allows a taxpayer to change its method of accounting for interest from the Rule of 78's method to the economic accrual method); and

(6) Rev. Proc. 83–40, 1983–1 C.B. 774 (a revenue procedure that allows a taxpayer to use the Rule of 78's method to compute interest on certain short-term consumer loans).

SECTION 15. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551.

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.

The collections of information in this revenue procedure are in sections 6, 10, 13, and sections 2, 3, 5, 6, 7, 10, and 12 of the APPENDIX. This information is necessary and will be used to determine whether the taxpayer properly changed to a permitted method of accounting. The collections of information are required for the taxpayer to obtain consent to change its method of accounting. The likely respondents are the following: individuals, farms, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 5,464 hours.

The estimated annual burden per respondent/recordkeeper varies from 1/10 hour to 5 7/10 hours, depending on individual circumstances, with an estimated average of 1 1/2 hours. The estimated number of respondents is 2,000.

The estimated annual frequency of responses is on occasion.

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.

* * * * *

APPENDIX

CHANGES IN METHODS OF ACCOUNTING TO WHICH THIS REVENUE PROCEDURE APPLIES

applicable provisions of this revenue procedure, the national office will notify the taxpayer that consent to make the change in method of accounting either (1) is not granted, or (2) is granted, provided the taxpayer makes appropriate adjustments to conform its change in method of accounting to the applicable provisions of this revenue procedure. Any adjustments so made must be accompanied by conforming amendments to any federal income tax returns filed for the year of change and subsequent taxable years.

SECTION 11. APPLICABILITY OF REV. PROCS. 97–1 AND 97–4

Rev. Procs. 97–1 and 97–4 (or any successors) are applicable to applications filed under this revenue procedure, unless specifically excluded or overridden by other published guidance (including the special procedures in this document).

SECTION 12. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 13. EFFECTIVE DATE

.01 *In general.* Except as provided in sections 13.02 and 13.03 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after August 18, 1997. Except as provided in sections 13.02 and 13.03 of this revenue procedure, the Service will return any application that is filed on or after August 18, 1997, if the application is filed with the national office pursuant to the Code, regulations, or administrative guidance other than this revenue procedure and the change in method of accounting is within the scope of this revenue procedure.

.02 *Transition rules.*

(1) *Previously filed applications.*

(a) *Applications for advance consent.* If a taxpayer filed an application with the national office under Rev. Proc. 97–27 or Rev. Proc. 92–20, 1992–1 C.B. 685, to make a change in method of accounting authorized by this revenue procedure, and the application is pending with the national office on August 18, 1997, the taxpayer may make the change under this revenue procedure. However, the national office will process the application in accordance with the revenue procedure under which the application was filed, unless prior to the later of September 30, 1997, or the issuance of the letter ruling granting or denying consent to the change, the taxpayer notifies the national office that it wants to make the change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, the national office will require the taxpayer to make appropriate modifications to the application to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application will be returned to the taxpayer.

(b) *Applications for automatic consent.* If a taxpayer filed an application with the national office (or a service center) previously authorized by an automatic consent procedure listed in section 14.01 of this revenue procedure, before August 18, 1997, to make a change in method of accounting authorized by this revenue procedure, the taxpayer may make the change under this revenue procedure. However, the national office will process the application in accordance with the automatic consent procedure under which the application was filed, unless prior to September 30, 1997, the taxpayer notifies the national office in writing (at the address provided in section 6.02(6) of this revenue procedure) that it wants to make the change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, the national office will require the taxpayer to make appropriate modifications to the application to comply with the applicable provisions of this revenue procedure.

(2) *New applications.*

(a) *Prior automatic consent procedures.* A taxpayer that wants to make a change in method of accounting previously authorized by an automatic consent procedure listed in section 14.01 of this revenue procedure, for a taxable year that ends on or after August 18, 1997, may make the change under that automatic consent procedure by complying with that procedure and the following additional filing requirement. In lieu of filing the application with the national office (or a service center) pursuant to that automatic consent procedure, the taxpayer must file a copy of the application with the national office no earlier than the first day of the year of change, and no later than the earlier of December 31, 1997, or when the original application is filed with the timely filed original federal income tax return (including extensions) for the year of change. A taxpayer changing its method of accounting under Rev. Proc. 85–8, 1985–1 C.B. 495, for a taxable year ending on or before December 31, 1997, may file under that revenue procedure. The additional filing requirement described above does not apply to this change.

(b) *New automatic consent procedures.* A taxpayer making a change in method of accounting authorized by this revenue procedure, other than a change previously authorized by an automatic consent procedure listed in section 14.01 of this revenue procedure or a change authorized by section 13.01 of the APPENDIX of this revenue procedure, that files a copy of an application under the provisions of this revenue procedure no later than the earlier of December 31, 1997, or when the original application is filed with the timely filed original federal income tax return (including extensions) for the year of change, may apply the § 481(a) adjustment period determined under sections 5 and 8 of Rev. Proc. 92–20. The taxpayer must affirmatively state in an attachment to the application (a) that it requests to apply the § 481(a) adjustment period determined under sections 5 and 8 of Rev. Proc. 92–20, and (b) the applicable § 481(a) adjustment period and the authority therefor.

.03 *Timing of incurring liabilities for payroll taxes.* To change a method of accounting under section 8.04 of the APPENDIX of this revenue procedure, a taxpayer may use the provisions of this revenue procedure for taxable years ending on or after October 21, 1996.

SECTION 14. EFFECT ON OTHER DOCUMENTS

.01 *Modified and superseded.* Rev. Procs. 96–31, 1996–1 C.B. 714; 95–33, 1995–2 C.B. 380; 94–29, 1994–1 C.B.

method of valuing increments in the current year.

(3) *Prior year Service-initiated change.* The Service may make adjustments to the taxpayer's returns for the same item for taxable years prior to the requested year of change to reflect a prior year Service-initiated change.

(4) *Criminal investigation.* The Service may change a taxpayer's method of accounting for the same item for taxable years prior to the year of change if there is any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's federal tax liability for any taxable year prior to the year of change, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change.

SECTION 8. EFFECT OF CONSENT

.01 *In general.* A taxpayer that changes to a method of accounting pursuant to this revenue procedure may be required to change or modify that method of accounting for the following reasons:

(1) the enactment of legislation;

(2) a decision of the United States Supreme Court;

(3) the issuance of temporary or final regulations;

(4) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;

(5) the issuance of written notice to the taxpayer that the change in method of accounting was not in compliance with all the applicable provisions of this revenue procedure or is not in accord with the current views of the Service; or

(6) a change in the material facts on which the consent was based.

.02 *Retroactive change or modification.* Except in rare or unusual circumstances, if a taxpayer that changes its method of accounting under this revenue procedure is subsequently required under section 8.01 of this revenue procedure to change or modify that method of accounting, the required change or modification will not be applied retroactively, provided that:

(1) the taxpayer complied with all the applicable provisions of this revenue procedure;

(2) there has been no misstatement or omission of material facts;

(3) there has been no change in the material facts on which the consent was based;

(4) there has been no change in the applicable law; and

(5) the taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change or modification retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW BY DISTRICT DIRECTOR

.01 *In general.* The district director must apply a change in method of accounting made in compliance with all the applicable provisions of this revenue procedure in determining the taxpayer's liability, unless the district director recommends that the change in method of accounting should be modified or revoked. (See section 6.06 of this revenue procedure if a change in method of accounting is made without complying with all the applicable provisions of this revenue procedure.) The district director will ascertain if:

(1) the representations on which the change was based reflect an accurate statement of the material facts;

(2) the amount of the § 481(a) adjustment was properly determined;

(3) the change in method of accounting was implemented in compliance with all the applicable provisions of this revenue procedure;

(4) there has been any change in the material facts on which the change was based during the period the method of accounting was used; and

(5) there has been any change in the applicable law during the period the method of accounting was used.

.02 *National office consideration.* If the district director recommends that a change in method of accounting (other than the § 481(a) adjustment) made in compliance with all the applicable provisions of this revenue procedure should be modified or revoked, the district director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 97–2 (or any successor) will be followed.

SECTION 10. REVIEW BY NATIONAL OFFICE

.01 *In general.* Any application filed under this revenue procedure may be reviewed by the national office. If the application is reviewed by the national office, the procedures in sections 10.02 through 10.04 of this revenue procedure apply.

.02 *Incomplete application—21 day rule.* If the Service reviews an application and determines that the application is not properly completed in accordance with the instructions of the Form 3115 or the provisions of this revenue procedure, or if supplemental information is needed, the Service will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be permitted 21 days from the date of the notification to furnish the necessary information. The Service reserves the right to impose shorter reply periods if subsequent requests for additional information are made. An extension of the 21-day period to furnish information, not to exceed 15 days, may be granted to a taxpayer. A request for an extension of the 21-day period must be made in writing and submitted within the 21-day period. If the extension request is denied, there is no right of appeal.

.03 *Conference in the national office.* If the national office tentatively determines that the taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure (for example, the taxpayer changed to a method of accounting that varies from the applicable accounting method described in this revenue procedure or the taxpayer is outside the scope of this revenue procedure), the national office will notify the taxpayer of its tentative adverse determination and will offer the taxpayer a conference of right, if the taxpayer has requested a conference. For conference procedures for taxpayers other than exempt organizations, see section 11 of Rev. Proc. 97–1 (or any successor). For conference procedures for exempt organizations, see section 12 of Rev. Proc. 97–4, 1997–1 I.R.B. 96 (or any successor).

.04 *National office determination.* If the national office determines that the taxpayer has changed its method of accounting without complying with all the

sideration at the time the copy of the application is filed or an issue the examining agent(s) has placed in suspense at the time the copy of the application is filed.

(b) A taxpayer changing a method of accounting under this 90-day window must provide a copy of the application to the examining agent(s) at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s). The taxpayer must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

(3) *120-day window period.*

(a) A taxpayer may file a copy of the application with the national office to change a method of accounting under this revenue procedure during the 120-day period following the date an examination ends (the "120-day window"), regardless of whether a subsequent examination has commenced. This 120-day window is not available if the method of accounting the taxpayer is changing is an issue under consideration at the time a copy of the application is filed or an issue the examining agent(s) has placed in suspense at the time the copy of the application is filed.

(b) A taxpayer changing a method of accounting under this 120-day window must provide a copy of the application to the examining agent(s) for any examination that is in process at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s). The taxpayer must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

(4) *Consent of district director.*

(a) A taxpayer under examination may change its method of accounting under this revenue procedure if the district director consents to the change. The district director will consent to the change unless, in the opinion of the district director, the method of accounting to be changed would ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the district director will consent to a change from a clearly permissible method of accounting. The district director will also consent to a change from an impermissible method of accounting where the impermissible method was adopted subsequent to the years under examination. The question of whether the method of accounting from which the taxpayer is changing is permissible or was adopted subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 97–2 (or any successor).

(b) A taxpayer changing a method of accounting under this revenue procedure with the consent of the district director must attach to the application a statement from the district director consenting to the change. The taxpayer must provide a copy of the application to the district director at the same time it files a copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s).

.04 *Taxpayer before an appeals office.* A taxpayer that is before an appeals office must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration by the appeals office. The taxpayer must provide a copy of the application to the appeals officer at the same time it files a copy of the application with the national office. The application must contain the name and telephone number of the appeals officer.

.05 *Taxpayer before a federal court.* A taxpayer that is before a federal court must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration by the federal court. The taxpayer must provide a copy of the application to the counsel for the government at the same time it files a copy of the application with the national office. The application must contain the name and telephone number of the counsel for the government.

.06 *Compliance with provisions.* If a taxpayer to which this revenue procedure applies changes to a method of accounting without complying with all the applicable provisions of this revenue procedure (for example, the taxpayer changes to a method of accounting that varies from the applicable accounting method described in this revenue procedure or the taxpayer is outside the scope of this revenue procedure), the taxpayer has initiated a change in method of accounting without obtaining the consent of the Commissioner as required by § 446(e). Upon examination, a taxpayer that has initiated an unauthorized change in method of accounting may be required to effect the change in an earlier or later taxable year and may be denied the benefit of spreading the § 481(a) adjustment over the number of taxable years otherwise prescribed by this revenue procedure.

SECTION 7. AUDIT PROTECTION FOR TAXABLE YEARS PRIOR TO YEAR OF CHANGE

.01 *In general.* Except as provided in section 7.02 or the APPENDIX of this revenue procedure, when a taxpayer timely files a copy of the application with the national office in compliance with all the applicable provisions of this revenue procedure, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.

.02 *Exceptions.*

(1) *Change not made or made improperly.* The Service may change a taxpayer's method of accounting for prior taxable years if (a) the taxpayer fails to implement the change; (b) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure, or (c) the method of accounting is changed or modified because there has been a misstatement or omission of material facts (*see* section 8.02(2) of this revenue procedure).

(2) *Change in sub-method.* The Service may change a taxpayer's method of accounting for prior taxable years if the taxpayer is changing a sub-method of accounting within the method. For example, an examining agent may propose to terminate the taxpayer's use of the LIFO inventory method during a prior taxable year even though the taxpayer changes its

counting filed pursuant to this revenue procedure. See § 1.446–1(e)(3)(ii).

(2) *Timely duplicate filing requirement.*

(a) *In general.* A taxpayer changing a method of accounting pursuant to this revenue procedure must complete and file an application in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change. A copy of the application must be filed with the national office (see section 6.02(6) of this revenue procedure for the address) no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change.

(b) *Limited relief for late application.* A taxpayer that fails to file the application for the year of change as provided in section 6.02(2)(a) of this revenue procedure will not be granted an extension of time to file under § 301.9100 of the Procedure and Administration Regulations, except in unusual and compelling circumstances. *See* § 301.9100–3T(c)(2).

(3) *Label.*

(a) In order to assist in processing an application under this revenue procedure, the section of the APPENDIX of this revenue procedure describing the specific change in method of accounting should be included in the application. For example, a phrase such as "Section 1.01 of the APPENDIX of Rev. Proc. 97–37" should be included on the appropriate line on the Form 3115.

(b) If a taxpayer is authorized under the APPENDIX of this revenue procedure to file a statement in lieu of a Form 3115, the taxpayer must include the taxpayer's name and employer identification number (or social security number in the case of an individual) at the top of the first page of the statement underneath any other required label.

(4) *Signature requirements.* The application must be signed by, or on behalf of, the taxpayer requesting the change by an individual with authority to bind the taxpayer in such matters. For example, an officer must sign on behalf of a corporation, a general partner on behalf of a state law partnership, a member-manager on behalf of a limited liability company, a trustee on behalf of a trust, or an individual taxpayer on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, an application submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. See the signature requirements set forth in the General Instructions attached to a current Form 3115 regarding those who are to sign. If an agent is authorized to represent the taxpayer before the Service, receive the original or a copy of the correspondence concerning the application, or perform any other act(s) regarding the application filed on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this section will not be given any information regarding the application.

(5) *Additional statement required.* In addition to providing all the information that is required by the application, a taxpayer must attach to the application a written statement providing as follows:

(a) the taxpayer agrees to all of the terms and conditions in this revenue procedure; and

(b) if a § 481(a) adjustment is required, the reason for claiming the § 481(a) adjustment period over which the taxpayer agrees to take the applicable § 481(a) adjustment into account.

(6) *Where to file.* A taxpayer, other than an exempt organization, changing a method of accounting pursuant to this revenue procedure must file a copy of the application with the national office addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, P.O. Box 7604, Benjamin Franklin Station, Washington, DC 20044 (or, in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224). An exempt organization must address the application to the Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: E:EO, P.O. Box 120, Benjamin Franklin Station, Washington, DC 20044 (or, in the case of a designated private delivery service: Assistant Commissioner (Employee Plans and Exempt Organizations), Attention: E:EO, 1111 Constitution Avenue, NW, Washington, DC 20224).

(7) *No user fee.* A user fee is not required for an application filed under this revenue procedure, and the receipt of an application filed under this revenue procedure will not be acknowledged.

(8) *Single application for certain consolidated groups.* A parent corporation may file a single application to change an identical method of accounting on behalf of more than one member of a consolidated group. To qualify, the taxpayers in the consolidated group must be members of the same affiliated group under § 1504(a) that join in the filing of a consolidated tax return, and they must be changing from the identical present method of accounting to the identical proposed method of accounting. All aspects of the change in method of accounting, including the present and proposed methods, the underlying facts, and the authority for the change, must be identical, except for the § 481(a) adjustment. *See* section 15.07(3) of Rev. Proc. 97–1, 1997–1 I.R.B. at 49 (or any successor), for the information required to be submitted with the application.

.03 *Taxpayer under examination.*

(1) *In general.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, sections 4.01 and 12.01 of the APPENDIX of this revenue procedure), a taxpayer that is under examination may file an application to change a method of accounting under section 6 of this revenue procedure if the taxpayer is within the provisions of section 6.03(2) (90-day window), 6.03(3) (120-day window), or 6.03(4) (district director consent) of this revenue procedure. A taxpayer that files an application beyond the time periods provided in the 90-day and 120-day windows will not be granted an extension of time to file under § 301.9100, except in unusual and compelling circumstances.

(2) *90-day window period.*

(a) A taxpayer may file a copy of the application with the national office to change a method of accounting under this revenue procedure during the first 90-days of any taxable year (the "90-day window") if the taxpayer has been under examination for at least 12 consecutive months as of the first day of the taxable year. This 90-day window is not available if the method of accounting the taxpayer is changing is an issue under con-

engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer. For this purpose, "substantially all" has the same meaning as in section 3.01 of Rev. Proc. 77–37, 1977–2 C.B. 568.

(ii) *Examples of transactions that are treated as the cessation of a trade or business.* The following is a nonexclusive list of transactions that are treated as the cessation of a trade or business for purposes of accelerating the § 481(a) adjustment under section 5.04(3)(c) of this revenue procedure:

(A) the trade or business to which the § 481(a) adjustment relates is incorporated;

(B) the trade or business to which the § 481(a) adjustment relates is purchased by another taxpayer in a transaction to which § 1060 applies;

(C) the trade or business to which the § 481(a) adjustment relates is terminated or transferred pursuant to a taxable liquidation;

(D) a division of a corporation ceases to operate the trade or business to which the § 481(a) adjustment relates; or

(E) the assets of a trade or business to which the § 481(a) adjustment relates are contributed to a partnership.

(iii) *Conversion to or from S corporation status.* Except as provided in section 10.01 of the APPENDIX of this revenue procedure, no acceleration of a § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when a C corporation elects to be treated as an S corporation or an S corporation terminates its S election and is then treated as a C corporation.

(iv) *Certain transfers to which § 381(a) applies.* No acceleration of the § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when a taxpayer transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another taxpayer in a transfer to which § 381(a) applies and the accounting method (the change to which gave rise to the § 481(a) adjustment) is a tax attribute that is carried over and used by the acquiring corporation immediately after the transfer pursuant to § 381(c). The acquiring corporation is subject to any terms and conditions imposed on the transferor (or any predecessor of the transferor) as a result of its change in method of accounting.

(v) *Certain transfers pursuant to § 351 within a consolidated group.*

(A) *In general.* No acceleration of the § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when one member of an affiliated group filing a consolidated return transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another member of the same consolidated group in an exchange qualifying under § 351 and the transferee member adopts and uses the same method of accounting (the change to which gave rise to the § 481(a) adjustment) used by the transferor member. The transferor member must continue to take the § 481(a) adjustment into account pursuant to the terms and conditions set forth in this revenue procedure. The transferor member must take into account activities of the transferee member (or any successor) in determining whether acceleration of the § 481(a) adjustment is required. For example, except as provided in the following sentence, the transferor member must take any remaining § 481(a) adjustment into account in computing taxable income in the taxable year in which the transferee member ceases to engage in the trade or business to which the § 481(a) adjustment relates. The § 481(a) adjustment is not accelerated when the transferee member engages in a transaction described in section 5.04(3)(c)(iv) or 5.04(3)(c)(v)(A) of this revenue procedure.

(B) *Exception.* The provisions of section 5.04(3)(c)(v)(A) of this revenue procedure cease to apply and the transferor member must take any remaining balance of the § 481(a) adjustment into account in the taxable year immediately preceding any of the following: (1) the taxable year the transferor member ceases to be a member of the group; (2) the taxable year any transferee member owning substantially all the assets of the trade or business which gave rise to the § 481(a) adjustment ceases to be a member of the group; or (3) a separate return year of the common parent of the group. In applying the preceding sentence, the rules of paragraphs (j)(2), (j)(5), and (j)(6) of § 1.1502–13 apply, but only if the method of accounting to which the transferor member changed and to which the § 481(a) adjustment relates is adopted, carried over, or used by any transferee member acquiring the assets of the trade or business that gave rise to the § 481(a) adjustment immediately after acquisition of such assets. For example, the transferor member is not required to accelerate the § 481(a) adjustment if a transferee member ceases to be a member of a consolidated group by reason of an acquisition to which § 381(a) applies and the acquiring corporation (1) is a member of the same group as the transferor member, and (2) continues, under § 381(c)(4) and the regulations thereunder, to use the same method of accounting as that used by the transferor member with respect to the assets of the trade or business to which the § 481(a) adjustment relates.

.05 *NOL carryback limitation for taxpayer subject to criminal investigation.* Generally, no portion of any net operating loss that is attributable to a negative § 481(a) adjustment may be carried back to a taxable year prior to the year of change that is the subject of any pending or future criminal investigation or proceeding concerning (1) directly or indirectly, any issue relating to the taxpayer's federal tax liability, or (2) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability.

.06 *Change treated as initiated by the taxpayer.* For purposes of § 481, a change in method of accounting made under this revenue procedure is a change in method of accounting initiated by the taxpayer.

SECTION 6. GENERAL APPLICATION PROCEDURES

.01 *Consent.* Pursuant to § 1.446–1(e)-(2)(i), the consent of the Commissioner is hereby granted to any taxpayer within the scope of this revenue procedure to change a method of accounting, provided the taxpayer complies with all the applicable provisions of this revenue procedure.

.02 *Filing requirements.*

(1) *Waiver of taxable year filing requirement.* The requirement under § 1.446–1T(e)(3)(i)(B) to file a Form 3115 within the taxable year for which the change is requested is waived for any application for a change in method of ac-

copy of the application with the national office, the taxpayer is under examination (as provided in section 3.08 of this revenue procedure), except as provided in sections 6.03(2) (90-day window), 6.03(3) (120-day window), and 6.03(4) (district director consent) of this revenue procedure;

(2) *Before an appeals office.* If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is before an appeals office with respect to any income tax issue and the method of accounting to be changed is an issue under consideration by the appeals office (as provided in section 3.09(2) of this revenue procedure);

(3) *Before a federal court.* If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is before a federal court with respect to any income tax issue and the method of accounting to be changed is an issue under consideration by the federal court (as provided in section 3.09(3) of this revenue procedure);

(4) *Consolidated group member.* A corporation that is (or was formerly) a member of a consolidated group is under examination, before an appeals office, or before a federal court (for purposes of sections 4.02(1), (2), and (3) of this revenue procedure) if the consolidated group is under examination, before an appeals office, or before a federal court for a taxable year(s) that the corporation was a member of the group;

(5) *Partnerships and S corporations.* For an entity (including a limited liability company) treated as a partnership or an S corporation for federal income tax purposes, if, on the date the entity would otherwise file a copy of the application with the national office, the entity's accounting method to be changed is an issue under consideration in an examination of a partner, member, or shareholder's federal income tax return or an issue under consideration by an appeals office or by a federal court with respect to a partner, member, or shareholder's federal income tax return;

(6) *Prior change.* If the taxpayer, within the last four taxable years prior to the year of change, (a) has made a change in the same method of accounting (with or without obtaining the Commissioner's consent) or (b) has applied to change the same method of accounting without effecting the change (whether the application to change was withdrawn, not perfected, not granted, or denied); or

(7) *Section 381(a) transaction.* If the taxpayer engages in a transaction to which § 381(a) applies within the proposed taxable year of change (determined without regard to any potential closing of the year under § 381(b)(1)).

.03 *Nonautomatic changes.* If either section 4.02(6) or 4.02(7) of this revenue procedure precludes a taxpayer from using this revenue procedure to make a change in method of accounting, the taxpayer requesting such a change must file a Form 3115 with the Commissioner in accordance with the requirements of § 1.446–1(e)(3)(i) and Rev. Proc. 97–27, 1997–21 I.R.B. 10 (or any other applicable Code, regulation, or administrative provision).

SECTION 5. TERMS AND CONDITIONS OF CHANGE

.01 *In general.* An accounting method change filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Year of change.* The year of change is the taxable year designated on the application and for which the application is timely filed under section 6.02(2).

.03 *Section 481(a) adjustment.* Unless otherwise provided in this revenue procedure, a taxpayer making a change in method of accounting under this revenue procedure must take into account a § 481(a) adjustment in the manner provided in section 5.04 of this revenue procedure.

.04 *Section 481(a) adjustment period.*

(1) *In general.* Except as otherwise provided in section 5.04(3) or the APPENDIX of this revenue procedure, the § 481(a) adjustment period for positive and negative § 481(a) adjustments is four taxable years.

(2) *Short period as a separate taxable year.* If the year of change, or any taxable year during the § 481(a) adjustment period, is a short taxable year, the § 481(a) adjustment must be included in income as if that short taxable year were a full 12-month taxable year. *See* Rev. Rul. 78–165, 1978–1 C.B. 276.

Example 1. A calendar year taxpayer received permission to change an accounting method beginning with the 1997 calendar year. The § 481(a) adjustment is $30,000 and the adjustment period is four taxable years. The taxpayer subsequently receives permission to change its annual accounting period to September 30, effective for the taxable year ending September 30, 1998. The taxpayer must include $7,500 of the § 481(a) adjustment in gross income for the short period from January 1, 1998, through September 30, 1998.

Example 2. Corporation *X*, a calendar year taxpayer, received permission to change an accounting method beginning with the 1997 calendar year. The § 481(a) adjustment is $30,000 and the adjustment period is four taxable years. On July 1, 1999, Corporation *Z* acquires Corporation *X* in a transaction to which § 381(a) applies. Corporation *Z* is a calendar year taxpayer that uses the same method of accounting to which Corporation *X* changed in 1997. Corporation *X* must include $7,500 of the § 481(a) adjustment in gross income for its short period income tax return for January 1, 1999, through June 30, 1999. In addition, Corporation *Z* must include $7,500 of the § 481(a) adjustment in gross income in its income tax return for calendar year 1999.

(3) *Shortened or accelerated adjustment periods.* The § 481(a) adjustment period provided in section 5.04(1) or the APPENDIX of this revenue procedure will be shortened or accelerated in the following situations.

(a) *De minimis rule.* A taxpayer may elect to use a one-year adjustment period in lieu of the § 481(a) adjustment period otherwise provided by this revenue procedure if the entire § 481(a) adjustment is less than $25,000 (either positive or negative). A taxpayer makes an election under this de minimis rule by so indicating on the application. For example, for a taxpayer filing a Form 3115, the taxpayer must complete the appropriate line on the Form 3115 to elect this de minimis rule.

(b) *Cooperatives.* A cooperative within the meaning of § 1381(a) generally must take the entire amount of a § 481(a) adjustment into account in computing taxable income for the year of change. *See* Rev. Rul. 79–45, 1979–1 C.B. 284.

(c) *Ceasing to engage in the trade or business.*

(i) *In general.* A taxpayer that ceases to engage in a trade or business or terminates its existence must take the remaining balance of any § 481(a) adjustment relating to the trade or business into account in computing taxable income in the taxable year of the cessation or termination. Except as provided in sections 5.04(3)(c)(iv) and (v) of this revenue procedure, a taxpayer is treated as ceasing to

date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. An examination ends:

(i) in a case in which the Service accepts the return as filed, on the date of the "no change" letter sent to the taxpayer;

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the "closing" letter (for example, Letter 891 or 987) sent to the taxpayer; or

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by Appeals that the case has been referred to Appeals from Examination, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to Appeals under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575.

(c) An examination resumes on the date the taxpayer (or its representative) is notified by Appeals (or otherwise) that the case has been referred to Examination for reconsideration.

(2) *Partnerships and S corporations subject to TEFRA.* For an entity (including a limited liability company), treated as a partnership or an S corporation for federal income tax purposes, that is subject to the TEFRA unified audit and litigation provisions for partnerships and S corporations, an examination begins on the date of the notice of the beginning of an administrative proceeding sent to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in a case in which the Service accepts the partnership or S corporation return as filed, on the date of the "no adjustments" letter or the "no change" notice of final administrative adjustment sent to the TMP;

(b) in a fully agreed case, when all the partners, members, or shareholders execute a Form 870–P, 870–L, or 870–S; or

(c) in an unagreed or a partially agreed case, on the earliest of the date the TMP (or its representative) is notified by Appeals that the case has been referred to Appeals from Examination, the date the TMP (or a partner, member, or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires.

But see section 4.02(5) of this revenue procedure for certain rules that preclude an entity from requesting a change in accounting method. Also note that S corporations are not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996. See Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996).

.09 *Issue under consideration.*

(1) *Under examination.* A taxpayer's method of accounting for an item is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the treatment of the item as an issue under consideration. For example, a taxpayer's method of pooling under the dollar-value, last-in, first-out (LIFO) inventory method is an issue under consideration as a result of an examination plan that identifies LIFO pooling as a matter to be examined, but it is not an issue under consideration as a result of an examination plan that merely identifies LIFO inventories as a matter to be examined. Similarly, a taxpayer's method of determining inventoriable costs under § 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs, but it is not an issue under consideration as a result of an IDR that requests documentation supporting the amount of cost of goods sold reported on the return. The question of whether a method of accounting is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 97–2, 1997–1 I.R.B. 64 (or any successor).

(2) *Before an appeals office.* A taxpayer's method of accounting for an item is an issue under consideration for the taxable years before an appeals office if the treatment of the item is included as an item of adjustment in the examination report referred to Appeals or is specifically identified in writing to the taxpayer by Appeals.

(3) *Before a federal court.* A taxpayer's method of accounting for an item is an issue under consideration for the taxable years before a federal court if the treatment of the item is included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the counsel for the government.

.10 *Change within the LIFO inventory method.* A change within the LIFO inventory method is a change from one LIFO inventory method or sub-method to another LIFO inventory method or sub-method. A change within the LIFO inventory method does not include a change in method of accounting that could be made by a taxpayer that does not use the LIFO inventory method (for example, a method governed by § 471 or § 263A).

SECTION 4. SCOPE

.01 *Applicability.* Except as otherwise provided in section 4.02 of this revenue procedure, this revenue procedure applies to a taxpayer requesting the Commissioner's consent to change to a method of accounting described in the APPENDIX of this revenue procedure. Except as otherwise provided in this revenue procedure (see, for example, section 2.01 of the APPENDIX of this revenue procedure), this revenue procedure is the exclusive procedure for a taxpayer within its scope to obtain the Commissioner's consent.

.02 *Inapplicability.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, sections 4.01 and 12.01 of the APPENDIX of this revenue procedure), this revenue procedure does not apply in the following situations:

(1) *Under examination.* If, on the date the taxpayer would otherwise file a

accounting, this revenue procedure provides specific adjustment periods that are intended to achieve an appropriate balance between the goals of mitigating distortions of income that result from accounting method changes and providing appropriate incentives for voluntary compliance.

.06 *Method change using a cut-off method.* The Commissioner may determine that certain changes in methods of accounting will be made without a § 481(a) adjustment, using a "cut-off method." Under a cut-off method, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new method of accounting. Any items arising before the year of change (or other operative date) continue to be accounted for under the taxpayer's former method of accounting. See, for example, § 263A (which generally applies to costs incurred after December 31, 1986, for noninventory property), § 461(h) (which generally applies to amounts incurred on or after July 18, 1984), and § 1.446–3 (which applies to notional principal contracts entered into on or after December 13, 1993). Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

.07 *Consistency and clear reflection of income.* Methods of accounting should clearly reflect income on a continuing basis, and the Internal Revenue Service exercises its discretion under §§ 446(e) and 481(c) in a manner that generally minimizes distortions of income across taxable years and on an annual basis.

.08 *Separate trades or businesses.*

(1) Sections 1.446–1(d)(1) and (2) provide that when a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business provided the method of accounting used for each trade or business clearly reflects the overall income of the taxpayer as well as that of each particular trade or business. No trade or business is separate and distinct unless a complete and separable set of books and records is kept for that trade or business.

(2) Section 1.446–1(d)(3) provides that if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer are not separate and distinct.

.09 *Penalties.* Any otherwise applicable penalty for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under § 6662 or the fraud penalty under § 6663) may be imposed if the taxpayer does not timely file a request to change a method of accounting. See § 446(f). Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under § 6694. However, penalties will not be imposed when a taxpayer changes from an impermissible method of accounting to a permissible one by complying with all applicable provisions of this revenue procedure.

.10 *Change made as part of an examination.* Section 446(b) and § 1.446–1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in a manner that, in the opinion of the Commissioner, does clearly reflect income. If a taxpayer under examination is not eligible to change a method of accounting under this revenue procedure, the change may be made by the district director. A change resulting in a positive § 481(a) adjustment will ordinarily be made in the earliest taxable year under examination with a one-year § 481(a) adjustment period.

SECTION 3. DEFINITIONS

.01 *Application.* The term "application" includes a Form 3115, or any statement that is authorized under the APPENDIX of this revenue procedure to be filed in lieu of a Form 3115, and any attachments.

.02 *Taxpayer.*

(1) *In general.* The term "taxpayer" has the same meaning as the term "person" defined in § 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in § 7701(a)(14)).

(2) *Consolidated group.* For purposes of (a) sections 3.08(1), 3.09(1), and 4.02(1) of this revenue procedure (taxpayer under examination), (b) sections 3.09(2) and 4.02(2) of this revenue procedure (taxpayer before an appeals office), or (c) sections 3.09(3) and 4.02(3) of this revenue procedure (taxpayer before a federal court), the term "taxpayer" includes a consolidated group.

.03 *Filed.* Any form (including an application), statement, or other document required to be filed under this revenue procedure is filed on the date it is mailed to the proper address (or an address similar enough to complete delivery). If the form, statement, or other document is not mailed (or the date it is mailed cannot be reasonably determined), it is filed on the date it is delivered to the Service.

.04 *Mailed.* The date of mailing will be determined under the rules of § 7502. For example, the date of mailing is the date of the U.S. postmark or the applicable date recorded or marked by a designated private delivery service. *See* Notice 97–26, 1997–17 I.R.B. 6.

.05 *Timely performance of acts.* The rules of § 7503 apply when the last day for the taxpayer's timely performance of any act (for example, filing an application or submitting additional information) falls on a Saturday, Sunday, or legal holiday. The performance of any act is timely if the act is performed on the next succeeding day that is not a Saturday, Sunday, or legal holiday.

.06 *Year of change.* The year of change is the taxable year for which a change in method of accounting is effective, that is, the first taxable year the new method is to be used, even if no affected items are taken into account for that year.

.07 *Section 481(a) adjustment period.* The § 481(a) adjustment period is the applicable number of taxable years for taking into account the § 481(a) adjustment required as a result of the change in method of accounting. The year of change is the first taxable year in the adjustment period and the § 481(a) adjustment is taken into account ratably over the number of taxable years in the adjustment period. The applicable adjustment periods are set forth in section 5.04 of this revenue procedure.

.08 *Under examination.*

(1) *In general.*

(a) Except as provided in section 3.08(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the

SECTION 1. PURPOSE

This revenue procedure provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting described in the APPENDIX of this revenue procedure. This revenue procedure consolidates and supersedes most published automatic consent guidance for changes in methods of accounting, and generally provides simplified, uniform procedures and terms and conditions to obtain automatic consent to make these changes. It also provides new automatic consent procedures for changes in several other methods of accounting. A taxpayer complying with all the applicable provisions of this revenue procedure has obtained the consent of the Commissioner of Internal Revenue to change its method of accounting under § 446(e) of the Internal Revenue Code and the Income Tax Regulations thereunder.

SECTION 2. BACKGROUND

.01 *Change in method of accounting defined.*

(1) Section 1.446–1(e)(2)(ii)(a) of the Income Tax Regulations provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. *See* Rev. Proc. 91–31, 1991–1 C.B. 566.

(2) Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446–1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax return(s). *See* Rev. Rul. 90–38, 1990–1 C.B. 57.

(3) A change in the characterization of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another. For example, a change from treating an item as income to treating the item as a deposit is a change in method of accounting. *See* Rev. Proc. 91–31.

(4) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). *See* § 1.446–1(e)(2)(ii)(b).

.02 *Securing permission to make a method change.* Section 446(e) and § 1.446–1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1T(e)(3)-(i)(B) requires that, in order to obtain the Commissioner's consent to a method change, a taxpayer must file a Form 3115, Application for Change in Accounting Method, during the taxable year in which the taxpayer wants to make the proposed change.

.03 *Terms and conditions of a method change.* Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). The terms and conditions the Commissioner may prescribe include the year of change, whether the change is to be made with a § 481(a) adjustment or on a cut-off basis, and the § 481(a) adjustment period.

.04 *No retroactive method change.* Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting, regardless of whether the change is from a permissible or an impermissible method. *See generally* Rev. Rul. 90–38.

.05 *Method change with a § 481(a) adjustment.*

(1) *Need for adjustment.* Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Example. A taxpayer that is not required to use inventories uses the overall cash receipts and disbursements method and changes to an overall accrual method. The taxpayer has $120,000 of income earned but not yet received (accounts receivable) and $100,000 of expenses incurred but not yet paid (accounts payable) as of the end of the taxable year preceding the year of change. A positive § 481(a) adjustment of $20,000 ($120,000 accounts receivable less $100,000 accounts payable) is required as a result of the change.

(2) *Adjustment period.* Section 481(c) and §§ 1.446–1T(e)(3)(i) and 1.481–4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in the manner and subject to the conditions agreed to by the Commissioner and the taxpayer. Generally, in the absence of such an agreement, the § 481(a) adjustment is taken into account completely in the year of change, subject to § 481(b) which limits the amount of tax where the § 481(a) adjustment is substantial. However, under the Commissioner's authority in § 1.446–1(e)(3)(ii) to prescribe terms and conditions for changes in methods of

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.

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26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 162, 165, 166, 167, 168, 197, 263, 263A, 446, 451, 454, 455, 461, 471, 472, 481, 585, 1273, 1281, 1363; 1.165–2, 1.167(e)–1, 1.263(a)–2, 1.263A–1, 1.263A–3, 1.446–1, 1.454–1, 1.455–6, 1.461–4, 1.461–5, 1.471–1, 1.471–2, 1.471–3, 1.472–6, 1.472–8, 1.481–1, 1.481–4, 1.1273–1, 1.1273–2.)

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of parts and accessories, used automobiles and used trucks as of the end of the year of change and for later taxable years under the methods provided in section 10.03(2)(b) of the APPENDIX of Rev. Proc. 97–37, unless it obtains permission to change to another recognized method;

(4) the conversion from the specific goods method, if applicable, to the dollar-value method must be made in accordance with § 1.472–8(f)(2);

(5) the automobile dealer must file Form 970, Application to Use LIFO Inventory Method, with its federal income tax return for the year of change and otherwise comply with the provisions of § 472(d) and § 1.472–3 (*see also* Rev. Rul. 76–282, 1976–2 C.B. 137) to extend the LIFO election (i) to include any new automobiles and new light-duty trucks (for example, demonstrators) to which the LIFO election did not previously apply but that are required to be included in LIFO pools under the Alternative LIFO Method, and (ii) for an automobile dealer changing from the IPIC method, to include any parts and accessories, used automobiles, and used trucks, to which the LIFO election did not previously apply but that are required to be included in LIFO pools under section 10.03 of the APPENDIX to Rev. Proc. 97–37, as of the beginning of the year of change;

(6) the automobile dealer must effect the change to the Alternative LIFO Method, and in the case of an automobile dealer changing from the IPIC method to the methods provided in section 10.03(2)(b) of the APPENDIX of Rev. Proc. 97–37, using the cut-off method. Under the cut-off method, the value of the automobile dealer's new automobile and new light-duty truck inventory, and in the case of an automobile dealer changing from the IPIC method, the parts and accessories, used automobile, and used truck inventory, at the beginning of the year of change must be the same as the value of such inventory at the end of the preceding taxable year plus market value restorations, if any, required pursuant to section 5.03(5) of this revenue procedure;

(7) the automobile dealer must combine and/or separate the dollar-value inventory pool or pools, including any pool resulting from section 5.03(4) of this revenue procedure, if applicable, to conform to the inventory pooling rules provided in section 4 of this revenue procedure, and in the case of an automobile dealer changing from the IPIC method, to the inventory pooling rules provided in section 10.03(2)(b) of the APPENDIX of Rev. Proc. 97–37, in accordance with the provisions of § 1.472–8(g)(2);

(8) in effecting the changes, any layers of inventory increments previously determined and the LIFO value of such increments must be retained. Instead of using the earliest taxable year for which the automobile dealer adopted the LIFO method for any items in the inventory pool or pools, the year of change must be used as the base year in determining the LIFO value of the inventory pool or pools for the year of change and later taxable years (the cumulative index at the beginning of the year of change will be 1.00). The base-year costs of layers of increments in the pool or pools at the beginning of the year of change must be restated in terms of the new base-year costs, using the year of change as the new base year; and

(9) the automobile dealer must maintain and retain complete records of the computations of the LIFO inventory under the Alternative LIFO Method, as well as copies of the actual purchase invoice for each vehicle used in the computation.

SECTION 6. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, DC 20224.

SECTION 7. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 92–79, 1992–2 C.B. 457, is modified, and as modified, is superseded. However, see the transition rules in section 13.02 of Rev. Proc. 97–37.

SECTION 8. EFFECTIVE DATE

This revenue procedure is effective on August 18, 1997.

SECTION 9. ELECTING LIFO AND ADOPTING THE ALTERNATIVE LIFO METHOD

.01 *In general.* An automobile dealer that adopts the Alternative LIFO Method provided in this revenue procedure at the time the automobile dealer makes an election to use (or extend) the dollar-value LIFO inventory method must complete and file a statement of election made on a current Form 970, pursuant to the instructions for Form 970, or in such other manner as may be acceptable to the Commissioner. The use of the Alternative LIFO Method should be clearly indicated on the Form 970, or an attachment to the Form 970, and reference should be made to this revenue procedure. Appropriate LIFO sub-method elections that are an integral part of the Alternative LIFO Method, which are contained on the Form 970, must be selected on the Form 970 upon adoption of the Alternative LIFO Method.

.02 *Conditions.* A taxpayer adopting the Alternative LIFO Method must comply with the conditions stated in section 5.03(1), (2), and (9) of this revenue procedure.

SECTION 10. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551.

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.

The collections of information in this revenue procedure are in section 5. This information is necessary and will be used to determine whether the taxpayer is properly using the Alternative LIFO Method. The collections of information are required for the taxpayer to use the Alternative LIFO Method. The likely recordkeepers are individuals, business or other for-profit institutions, and small businesses or organizations.

The estimated total annual recordkeeping burden is 200,000 hours.

The estimated annual burden per recordkeeper is 25 hours. The estimated number of recordkeepers is 8,000.

Books or records relating to a collection of information must be retained as

caused by a change in an existing vehicle, or (b) a manufacturer's model code, as described in section 4.02(3) of this revenue procedure, created or reassigned because the classified vehicle did not previously exist. Additionally, if there is no change in a manufacturer's model code, but there has been a change to the platform (i.e., the piece of metal at the bottom of the chassis that determines the length and width of the vehicle and the structural set-up of the vehicle) that results in a change in track width or wheel-base, whether or not the same model name was previously used by the manufacturer, a new item category is created.

(6) *Treatment of a new item not in existence in the prior year.* The automobile dealer must use the current-year base vehicle cost of the new item category as the prior-year base vehicle cost of that item category.

(7) *Item in existence in the prior year, but not stocked.* If an item in ending inventory was not stocked by the automobile dealer at the end of the prior year, but was in existence in the prior year, the automobile dealer must determine the prior-year base vehicle cost for that item by reconstructing what the base vehicle cost for the item category would have been using a manufacturer's price list that provides dealer purchase prices. For each such item category, the manufacturer's price list that must be used by the automobile dealer is the list in effect as of the beginning of the last month of the prior taxable year.

.03 *Computational methodology.*

The following rules are applied to compute the LIFO value for each pool of an automobile dealer's ending inventory under the Alternative LIFO Method:

STEP 1. Obtain the actual invoice for each vehicle in the automobile dealer's ending inventory.

STEP 2. For each pool, group all the invoices from Step 1 by item category, as defined in section 4.02(3) of this revenue procedure.

STEP 3. For each item category, add together the dealer's base vehicle costs of all vehicles within each item category, from Step 2.

STEP 4. Within each pool, compute an average base vehicle cost for each item category by dividing the result from Step 3 for each item category by the number of vehicles in the item category. This average base vehicle cost for each item will be used in Step 6 of the succeeding year's computations using the Alternative LIFO Method.

STEP 5. For each pool, compute the total current-year base vehicle cost of the pool by adding together the separate item category totals from Step 3.

STEP 6. For each pool, compute the total base vehicle cost of the ending inventory at prior-year's base vehicle cost. First, multiply the number of vehicles in the current year's ending inventory for each item category by the average base vehicle cost of the same item category from Step 4 of the preceding year's inventory calculation. If the same item was not in the prior year's ending inventory, see sections 4.02(6) and 4.02(7) of this revenue procedure. Then, add together the total prior-year base vehicle cost of all of the item categories.

STEP 7. For each pool, compute the current-year (annual) index by dividing the amount from Step 5 by the amount from Step 6.

STEP 8. For each pool, compute the cumulative index by multiplying the current-year index from Step 7 by the cumulative index at the end of the preceding year (from Step 8 of the preceding year's computation).

STEP 9. For each pool, compute the total current-year total- vehicle cost by adding together the total invoice cost, including installed options, accessories, and other inventoriable cost(s), of all the vehicles in inventory at the end of the current year.

STEP 10. For each pool, compute the total cost of the current-year's ending inventory at base-year cost by dividing the total current-year total-vehicle cost of all the vehicles in ending inventory, from Step 9, by the cumulative index from Step 8.

STEP 11. For each pool, determine if there is an increment for the current year by comparing the total cost of the pool's current-year ending inventory at base-year cost, from Step 10, with the total cost of the pool's preceding year's ending inventory at base-year cost, using the amount from Step 10 of the preceding year's calculation. If the amount from Step 10 of the current year's calculation is greater, there is an increment.

STEP 12. For each pool, value the current year's increment at current-year cost by multiplying the increment amount from Step 11 by the cumulative index from Step 8.

STEP 13. If there is no increment for a pool, but, rather, a liquidation (also referred to as a decrement), reduce the LIFO layers in reverse chronological order until the liquidation is fully absorbed.

STEP 14. For each pool, add together the current year's increment, if any, at current-year cost and the prior years' increments at each prior year's current-year cost to compute the total LIFO value for the pool.

SECTION 5. CHANGING TO ALTERNATIVE LIFO METHOD

.01 *Automatic change.* Except as provided in section 5.02 of this revenue procedure, an automobile dealer wanting to change to the Alternative LIFO Method must follow the provisions in Rev. Proc. 97–37.

.02 *Nonautomatic change.* An automobile dealer that uses the IPIC method for goods other than new automobiles, new light-duty trucks, parts and accessories, used automobiles, and used trucks, must change to the Alternative LIFO Method under Rev. Proc. 97–27, 1997–21 I.R.B. 10.

.03 *Conditions.* An automobile dealer changing to the Alternative LIFO Method must comply with the following conditions:

(1) the automobile dealer must keep its books and records for the year of change and for later taxable years on the LIFO inventory method and use the LIFO inventory method for all reports, including consolidated financial statements, if any, and statements for credit purposes, in conformity with the provisions of § 1.472–2(e) of the regulations;

(2) the automobile dealer must value its inventory of new automobiles and new light-duty trucks as of the end of the year of change and for later taxable years under the Alternative LIFO Method, as provided in section 4 of this revenue procedure, unless it obtains permission to change to another recognized method;

(3) the automobile dealer changing from the IPIC method for its inventory of parts and accessories, used automobiles, and used trucks must value its inventory